THE IMPACT OF SECTION 404 ON INTERNAL AUDITING

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ABSTRACT

While most studies have focused on the costs of Sarbanes Oxley on reporting companies, this study focuses on the impact of this Act on the internal auditing function. The results of a survey of internal audit executives at large U.S. companies suggests that Section 404 has improved the status of internal auditing. Whether these gains are permanent or transitory remains to be seen.

Introduction

Ever since the passage of the Sarbanes-Oxley Act in 2002, internal auditors have been cast in an unusual limelight. The Act, in Section 404, established that well-documented internal controls not only were a good idea but also were expected for publicly traded companies. In most companies, this tune had been sung by internal audit staffs for some time. Accordingly, as one of the few groups that had working knowledge of what a control was, and what made one effective, internal auditors became suddenly prominent in corporate efforts to become compliant with the law that was designed to restore confidence in the capital markets.

Once the magnitude of Section 404 became known, many have wondered whether it produced a value corresponding to its cost. The conventional wisdom is that Congress greatly under appreciated what even bare bones compliance would cost. While the litany of dollars spent in the effort has been stunning, it begs the question of value acquired. A decade from now will the recollection of the event be: “We were fortunate to get that done when we did,” or “We must have been crazy to spend so much for so little.”

There have been many articles and surveys concerning Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbox). This article is based on the premise that internal audit leaders are best able and better positioned to provide valid knowledge about the impact of this legislation. Survey results from an Institute of Internal Auditors Research Foundation (IARF) sponsored study concerning chief audit executives’ perceptions of the impact of the Section 404 on their respective companies are summarized. This article focuses on how Section 404 efforts may have altered the role of internal auditing and its relationship to audit committees and top management. The results indicate that internal audit leaders think that Section 404 work will lead to material changes in the way that internal controls are looked at by companies. This is likely to have profound impact for internal audit functions.

Data Collection

A survey was designed to allow knowledgeable internal audit leaders from companies most affected by Section 404 to voice their impressions. Following pretesting by the Atlanta Chapter of the IIA and several reviews by various academic accountants, two electronic communications were sent to a mailing list of 583 Chief Audit Executives in February 2005. Seventy-eight usable responses were received from this group of Fortune 1000 companies. Table 1 shows that the respondents came from larger companies. In addition, respondents tended to report that their companies were in strong financial condition. Other results (not shown) suggest that the respondents came from firms that had extensive international operations and large internal audit functions. Table 1 also shows that the survey respondents tended to be chief audit executives of their companies.

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TABLE 1

Demographic Profile of the Respondents and their Companies

Assets	Number	Percentage	**Revenues**	Number	Percentage
Under $500 million	0	0%	under $500 million	0	0%
$500 million to $1 billion	6	8%	$500 million to $1 billion	2	3%
$1 billion to $5 billion	22	28%	$1 billion to $5 billion	34	44%
$5 billion to $10 billion	14	18%	$5 billion to $10 billion	19	24%
$10 billion to $20 billion	14	18%	$10 billion to $20 billion	10	13%
$20 billion to $50 billion	15	19%	$20 billion to $50 billion	10	13%
Over $50 billion	7	9%	over $50 billion	3	3%
Total	**78**	**100%**	**Total**	**78**	**100%**

Financial Strength Relative to Other Companies in the in the Industry			**Geographic Span**		
Very Weak 1	0	0%	Domestic	26	33%
Somewhat Weak 2	4	5%	1 to 3 countries	10	13%
Average 3	7	9%	4 to 6 countries	5	6%
Somewhat Strong 4	27	35%	7 to 9 countries	7	9%
Very Strong 5	40	51%	Global	30	38%
Total	**78**	**100%**	**Total**	**78**	**1**

Respondent Role			**Number of internal auditors in the IA Dept.**		
Chief Audit Executive or Equivalent	65	83%	10 to 20	23	30%
Senior Audit Manager	8	10%	20 to 50	18	23%
Other IA Manager	3	4%	50 to 100	11	14%
Other (Risk Manager, Former CAE)	2	3%	more than 100	4	5%
Total	**78**	**100%**	**Total**	**78**	**100%**

Overall Value of Section 404 Efforts

Whether the Section 404 compliance efforts were “worth it” has been the subject of much debate and serves as the true bottom line. Since the social costs of restoring public confidence has to be borne by the private sector, the perspectives of those within it may be more worthwhile than those to whom it has been a free good.

For these purposes, chief audit executives were asked to rate the value of Section 404 to themselves and various participants. Table 2 contains a summary of a single question that ranged from little impact (1) to significant impact (5). For themselves, the internal auditors perceive nearly as much value coming from Section 404 efforts as they ascribe to audit committees. However, the value of Section 404 to top management and operational management is seen as considerably lower.

TABLE 2

Internal Auditing's Perception of Overall Value of 404 Effort

Target	Mean Value (1=None, 5=High)
For Top Management (e.g. CEO and CFO)	2.71
For Operating Management	2.57
For Audit Committee	3.55
For Internal Auditing	3.38

These results are not surprising. The alignment of internal auditing and audit committees suggests that Section 404 has sharpened the division between those that manage and those responsible to oversee the results of operations. Those concerned about the independence of internal auditing from management control could say that Section 404 acts as a decisive tool in the hands of pro-control forces to check those for whom controls are less of a priority.

Nonetheless, the results suggest that Section 404 has considerable value from the perspective of the leadership of internal auditing. However, Section 404 does not have extreme value since 75% of respondents could not rate its value as high (5). The value of Section 404 is also tempered by the fact that internal audit executives know that other powerful players (top and operational management) see things quite differently.

Extent of Time Spent on Section 404 Compliance Efforts

Value perceived may be related to time spent. Table 3 shows that companies disproportionately relied upon their internal audit staffs to work on Section 404 compliance. This result is not surprising given the alignment of talents and occupational awareness within large corporations. However, the disproportionately of effort also suggests that Section 404 has only been modestly successful in changing a wide range of corporate attitudes about controls. To the extent that others were reported to be less involved, the Section 404 agenda might have been seen as an auditing problem that failed to have permanent meaning for others that operate or depend upon the existence of controls.

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TABLE 3

Extent of Time Spent on 404 Compliance Efforts

Unit	Mean Value (1=None, 5=Much)
By Internal Audit	4.59
By Business Process Owners	3.83
By Top Management	2.88

Perceptions of Internal Audit Effectiveness

Table 4 displays the survey results that support the notion that working on Section 404 efforts have improved perceptions about internal audit effectiveness. Some might say that it would be little surprise that internal audit leaders believe this to be the case. Less obvious is that they also report that other key groups such as top management and audit committees believe that an increase in the effectiveness of this function has occurred.

TABLE 4

Changes in Perceptions of Internal Audit Effectiveness

Mean Value
(1=Not Effective, 5=Very Effective)

As Perceived By	Pre-404	Post-404	Change
Top Management	3.76	4.31	+ 0.55
Operating Management	3.48	3.73	+ 0.25
Audit Committees	4.10	4.36	+ 0.26
Internal Audit Leadership	3.92	4.17	+ 0.25

That the largest gain in perceived effectiveness was attributable to higher corporate officials should also be noted. The usefulness of Section 404 to improve the stature of internal auditing cannot be denied. Although operating managers also gained in their appreciation of internal auditing, they are distinctly below all other groups in this revision of attitude.

Impact of Section 404 on the Internal Audit Department

The Section 404 episode may have permanently changed perceptions of the proper role of the internal auditing effort. Table 5 summarizes the respondents' level of agreement with some critical directions for internal auditing.

TABLE 5

Impact of Section 404 on the Internal Audit Department

Area or Type of Impact	Mean Value (1=Little, 5=Great)
Scope ongoing work to include financial reporting emphasis	3.76
Ability to achieve its pre-Sarbox objectives and priorities	3.36
Ongoing staff commitment	3.51
Ability to develop a risk based internal audit plan	2.77

Contrary to much of the modern emphasis of internal auditing, Section 404 seems to have tipped the scales toward a renewed emphasis on work pertaining to the financial statements. Most (89%) of the respondents believed that there has been a moderate or heavy push in that direction.

Less apparent is the belief of respondents that Section 404 has enabled internal auditing to better accomplish its preexisting objectives. The attention created by Sarbanes-Oxley seems to have made an incremental contribution to the morale of internal audit staff. This is consistent with the idea that pre-Sarbanes audit objectives can still be accomplished along with Section 404 directed work.

The only discordant note in these results pertain to whether Section 404 has made a major contribution in reshaping the work plan of internal auditing around risks faced by the company. The results indicated no strong agreement exists that a movement in this beneficial direction has occurred.

Internal Auditing's Contribution to the Organization

The considerable attention given to the Sarbanes-Oxley Act allowed internal auditing with an opportunity to lead change for corporations. Respondents suggested that the function made the most of the event, showing a considerable increase in ability from a 3.57 to a 4.74 on a 5-point scale.

The legacy of Section 404 may be its contribution to operating manager's ability to understand and effectively deal with control problems. Respondents indicated an increase from 2.47 to 3.42 in operating managers' ability to identify control weaknesses. At the same time, their ability to correct weaknesses improved from 2.76 to 3.50. In other words, Section 404 work, largely led by internal auditors, has changed an average level of identification abilities into an above average level of these abilities.

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DISCUSSION

The close connection between internal auditing and Section 404 seems to have been good for internal auditing. A major regulatory change required immediate attention, and internal auditing was there to answer the bell. Status and recognition appeared to have increased as a result of being at the forefront of this highly visible effort.

The results suggest the continuation of a divide in corporate America about the value of effective controls. Auditing leaders, together with the audit committees, continue to line up in a camp somewhat removed from management. The latter may have allocated resources to get into compliance with the new documentation and testing requirements but they did not apparently get to the point where they really believed in the intrinsic value of more effective controls.

The divide in beliefs may spell trouble looming on the horizon. As attention on corporate controls abates, support needed to sustain the enhancements brought about by Sarbanes-Oxley may also drop off. This would leave internal auditors less able to do that which they believe to be necessary.

The special expertise possessed by internal auditors could have been used in a variety of ways by corporations that had to scramble to comply with Section 404. For example, many companies used internal audit staff members to test the controls that others had documented. Such an approach would have spread the work so that the existence and importance of controls could have been more broadly experienced. This study suggests that corporations did not generally take advantage of this potential learning opportunity. Internal auditing may have been too heavily relied upon, thereby not allowing the notion of controls to permeate the fabric of the more general community.

The results suggest that Sarbanes-Oxley work helped improve the stature of internal auditing within the corporation. More respect now exists for the work that internal auditors do and the way that they do it. Section 404 presented what many saw as a serious threat to business as usual. Coupled as it was with sudden corporate bankruptcies and instances of outrageous managerial fraud, many that may not have well understood these events must have been very grateful that internal auditors were apparently taking care of compliance for their companies.

Those that suggested that internal auditors should concede the financial statements to external auditors have been dealt a setback by Section 404. Work on underlying controls restored internal auditors to a close relationship with financial results. To assert that internal auditors need to establish a domain in operational affairs or in non-financial compliance work is more difficult today than it was five years ago. Moving in this direction may also underlie the more satisfactory psychological environment that audit leadership reported.

The massive efforts undertaken by internal auditing in the Section 404 area were not without its costs. Most prominently, it appears to have taken the steam out of broader efforts to conceptualize risk as the dominant dimension of audit plans. One could also speculate the internal auditor inroads into important issues of operational efficiency may have been undermined, at least for the present time.

Some have suggested that the problem with internal auditing is that it is excessively reactive. While the corporate is seizing opportunities, taking risks and achieving growth, internal audit has been seen as a brake on this progress by insisting on procedures and for time-tested ways of doing things. Sarbanes-Oxley provided internal auditing with an opportunity to lead change rather than slowly follow it. To the extent that Sarbanes-Oxley can be seen as an encouragement for companies to protect itself from itself, changes in the extent of control effectiveness are distinctly for the good.

Internal auditing also deserves the lion's share of the credit for making others in the company more conscious of the control environment. Since internal auditors cannot be omnipresent, this contribution may be more consequential for the everyday operations of the company. Section 404, as a well-publicized event, may have been more powerful than the quiet discipline that internal auditors have been advocating for years.

Remaining Questions

Surveys offer a snapshot that captures a reality that may not persist into the future. The major question that clouds the interpretation of the results is whether or not they are sustainable. In other words, is the positive effect of the Sarbanes-Oxley Act on internal auditing a fleeting episode, or will it usher in a new era?

Section 404 asked companies to do quite a bit merely to comply with the law. Although the money involved in this process was difficult for many to accept, it can be normalized as a one-time event. Some could say that these expenditures are merely "catch-up" spending for work that should have been done many years before. Nonetheless, for most companies, such a shock to the system cannot continue. The effort needed to keep documentation up to date and to revise controls in accordance with new technology must be less than that which has been spent to initially adhere to the new legal minimum. Therefore, spending and attention has to wane in the upcoming years. The lesser known issue is whether the image improvements and respect won by internal auditing will also slowly evaporate.

Much probably depends upon how internal auditing leaders deal with their new found prominence and visibility. Knowing that Section 404 will not last as a newsworthy event forever, some effort to capitalize upon it must be made. While perceptions of effectiveness are favorable, efforts should be made to make structural changes that are likely to be more enduring. To capitalize upon the times, changes in regular relationships within the corporation must be made.

No matter how this is resolved, Sarbanes-Oxley has changed the corporations that have strained to comply with its demands. Internal auditing, at the fulcrum of this activity, has its own fate in its hands.

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