Sarbanes-Oxley Section 404 Work

Looking at the Benefits

by

Larry E. Rittenberg, Ph.D., CIA, CPA
Ernst & Young Professor of Accounting
University of Wisconsin

and

Patricia K. Miller, CIA, CPA, CISA
Partner, Deloitte & Touche LLP
Vice-Chairman, Professional Practices, IIA

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ABOUT THE AUTHORS

Larry E. Rittenberg, Ph.D., CIA, CPA, formerly the vice president of research and president of The IIA Research Foundation, replaced John J. Flaherty in January 2005 as chairman of The Committee of Sponsoring Organizations of the Treadway Commission (COSO), a voluntary private-sector organization formed in 1985 to improve the quality of financial reporting through business ethics, effective internal controls, and corporate governance. Rittenberg presently teaches coursework and conducts research on auditing and corporate governance at the University of Wisconsin in Madison. He co-authored *Auditing: Concepts for a Changing Environment* and *The Outsourcing Dilemma: What Works Best for Internal Auditing* and has received many accolades from his peers and colleagues throughout his career, including The IIA's Leon R. Radde Educator of the Year Award in 1998, *Internal Auditor* magazine's Outstanding Contributor Award, and the Outstanding Educator distinction from the Wisconsin Institute of Certified Public Accountants. Larry is a past member of the IIA Executive Committee, Board of Regents, and served on the Guidance Planning Committee and Board of Research Advisors.

Patricia K. Miller, CIA, CPA, CISA is an experienced internal audit partner in the Northern California Enterprise Risk Services practice of Deloitte Touche LLP. During her career with Deloitte, she has provided a broad array of internal audit and Sarbanes-Oxley readiness services. Patty joined the Deloitte & Touche ERS practice in 1997, following a 14-year career with Pacific Telesis and Pacific Bell where she held numerous management positions in diverse areas including internal audit, billing systems, financial management and planning, process design and reengineering, project and program management, and merger planning and integration. Patty is a member of the Executive Committee of the Board of Directors for the Institute of Internal Auditors (IIA), serving in the role of Vice Chairman – Professional Practices, and is a member of the North American Committee. She has also previously served on the Standards Board, the Board of Regents, the District and Regional Representative Committees, and she served a term as President of the San Francisco Chapter of the IIA.

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ABSTRACT

Companies have struggled in implementing the internal control provisions of the U.S. Sarbanes-Oxley Act of 2002. Costs have been high. However, few studies have systematically looked at the benefits. We survey 171 chief audit executives (CAEs) and internal audit managers to help identify the specific benefits associated with Section 404 work. We identify control improvements that have taken place as a direct result of Section 404 evaluations. We also identify lessons learned that can improve the efficiency and effectiveness of control evaluations in the future.

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EXECUTIVE SUMMARY

We surveyed 171 practicing internal auditors about their assessment of costs and benefits associated with Section 404 work. Three major themes emerged in the survey:

First, there are significant benefits associated with the control identification, documentation, and testing process. The evaluation process has led to improvements in basic internal controls such as reconciliations and segregation of duties. There were substantial improvements in the control environment that came about as a direct result of the process. Many companies recognized they have vulnerabilities in the Information Technology (IT) area and will be devoting more resources to improving and evaluating IT controls as they move forward. Companies have more confidence in their control structure and are evaluating accounting risks, which should enable investors to have more confidence in the reliability of unaudited data furnished to the securities market.

Second, the prognosis is that the future costs associated with Section 404 will decrease substantially as we look forward three years. Much of the initial cost came about because controls had not been systematically documented or evaluated prior to the Section 404 requirements. CAEs see the process as becoming more systematized. The authors believe companies will see significant efficiencies as they fully implement the information, communication, and monitoring concepts embedded in COSO's *Internal Control – Integrated Framework.*

Third, there is uncertainty about the future role of internal auditing with respect to Section 404 work. The majority of CAEs want to maintain a strong presence in the risk and control arena, and recognize the need to perform more operational auditing that continues to add value to the organization. The majority of the respondents recognize a need to invest resources in IT auditing. Most CAEs see themselves playing a major role in ongoing monitoring and testing activities associated with Section 404 work.

Overview of the Control Improvements

There were many control improvements and they are described in more detail in the remainder of the report. We have summarized the control improvements into a "Top 10" list that can help companies consider their progress toward improved control processes. The following list is covered more fully in the report:

1. A more engaged control environment — with active participation by the board, the audit committee, and management.

2. More thoughtful analysis of monitoring controls, along with recognition that monitoring is an integral part of the control processes.

3. More structure to the year-end closing process and recording of journal entries, thus recognizing the extent to which these areas have increased in complexity.

4. Implementation of anti-fraud activities with defined processes in place, including responsibility for follow-up by defined parties and resolution approaches.

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5. Better understanding of the risks associated with general computer controls, and the need to improve both control and audit procedures to gain assurances that the risks associated with computer systems are mitigated.

6. Improved documentation of controls and control processes that can serve as a basis for training, practical day-to-day guidance, and management evaluation.

7. Improved definition of controls, and the relationship of controls and risk, across the organization.

8. Control concepts becoming embedded into the organization with a broader understanding by operating personnel and management of their responsibility for controls.

9. Improvements in the adequacy of the audit trail as a basis to support operations as well as to support audit assessment of control adequacy and financial reporting.

10. Re-implementation of basic controls, e.g., segregation of duties, periodic reconciliation of accounts, and authorization processes that had been eroded as organizations downsized or consolidated operations.

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INTRODUCTION

Much has been written about the costs associated with implementing the internal control provisions of the Sarbanes-Oxley Act [hereinafter referred to as Section 404 work]. Essentially, most studies have indicated that the costs have been very high — much more than what was anticipated by the companies performing the work. There has been a severe resource shortage for the internal control documentation and review, including significant accounting staff and auditors (both internal and external), as well as a shortage of proven methodologies to document internal controls — all of which have added significantly to the costs incurred by companies. This has been compounded by what has been perceived as a combination of (a) lack of clear direction on the nature of the work to be performed; (b) very stringent definitions of materiality and internal control deficiencies in Audit Standard 2 (AS2)[1], and (c) significant time pressures to complete the work. Most of the studies issued to date assert that the costs associated with the internal control work far exceed the benefits.

The studies on costs/benefits associated with Section 404 work are incomplete in three important ways. First, they fail to address the benefits that improved controls and reliability of financial reporting have on the investing public. Second, very few of the studies deal with the learning curve associated with new processes, i.e., they fail to address expected ongoing costs as opposed to one-time start-up costs. Third, they fail to identify specific control improvements that have been made as a result of the mandated internal control work.

The research described in this paper has been designed to specifically address the control benefits that have been found by companies and practicing internal auditors in performing 404 work. The IIA Research Foundation has assisted us in this research to provide timely information of interest to practicing accounting and auditing professionals. The research was designed to address four specific objectives:

- Identify specific control benefits associated with Section 404 work,
- Better understand the costs associated with Section 404 work,
- Develop insights on how to reduce future costs associated with ongoing evaluations of controls to meet the public reporting requirements, and
- Understand how internal audit is likely to evolve to meet the required Section 404 work as well as to add value in traditional areas associated with broader operational controls, risk, and governance.

[1] PCAOB Standard 2, *An Audit of Internal Controls Over Financial Reporting Conducted in Conjunction with an Audit of Financial Statements.*

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UNDERSTANDING 404 REQUIREMENTS AND COSTS

Section 404 of the Sarbanes-Oxley Act came about as a direct result of corporate failures of the past decade in which there were significant internal control failures associated with fraudulent financial statements. In the opinion of legislators, it was not sufficient that the external audit profession would be improved; there had to be significant improvement in the governance and control of public registrants. Section 404 was just one part of a more comprehensive set of requirements that included the development of disclosure committees, certification of financial statements by both the CEO and CFO, the development of more financially literate and responsible audit committees, increased independence of the external auditor, and the implementation of fraud risk management processes (like "whistleblower" procedures) that would alert the appropriate levels of governance of potential frauds or illegal acts within the company. Further, the legislation took the setting of auditing standards for the audits of public companies away from the AICPA, a private standard setter, and formed a new body, the Public Company Accounting Oversight Board (PCAOB), to set auditing standards for public companies. The time required to get the PCAOB staffed and in operation led to a delay in the standard-setting process, which contributed to some of the difficulties companies encountered in implementing Section 404.

The control deficiencies at the largest failed companies were extensive and included problems with the "tone at the top" as well as deficiencies in basic processing. For example, within WorldCom, there were material control deficiencies noted in the board of directors report, including issues with (a) the closing process, (b) non-supported journal entries, (c) booking accounting estimates, and (d) recording expenses and fixed assets. These control deficiencies were exacerbated by a lack of integrity at the top of the organization, including both top management and the board of directors.[2] Similar deficiencies were found at other organizations, including HealthSouth, Lucent, and Enron. Early public reports of control deficiencies reinforce the notion that the quality of internal control merits the attention of boards, investors, regulators, management, and internal auditors.

The Public Benefits of Improved Controls

It is important to understand the public perspective in order to form a balanced view on the cost and benefits of internal control certification. Don Nicolaisen, chief accountant at the SEC and a former partner with PricewaterhouseCoopers, describes the importance of the Sarbanes-Oxley Act in motivating him to join the SEC:

> "The Sarbanes Oxley Act required major reform in many areas in response to the financial failures of recent years. The crisis was real, and I believe the Act sets the right perspective and establishes an appropriate foundation upon which to improve financial reporting. This drive to improve financial reporting was one of the main reasons I joined the Commission staff."[3]

Nicolaisen and others, such as the Financial Executives Institute (FEI), have noted the substantial costs associated with Section 404 work. Most of those cost estimates, although high, do not include the cost of the external auditor's extra efforts in performing an integrated audit of internal controls and financial statements. Nicolaisen acknowledges that many question whether the internal control efforts will be worth the costs. He unequivocally answers:

[2] For a thorough review of the problems, see Beresford, Dennis, Nicholas Katzenbaum, and C. B. Rogers, *Special Investigative Committee of the Board of Directors of WorldCom*, at www.Findlaw.com, March 31, 2003.
[3] Nicolaisen, Donald T., Keynote Speech at 11th Annual Midwestern Financial Reporting Symposium; October 7, 2004. Speech is available at www.sec.gov.

> "I suspect that the costs are not easy to estimate, but I know that it is even tougher to quantify the benefits. However, given the massive financial scandals, decline in market capitalization, and resulting loss of investor confidence in our markets, I believe that, of all of the recent reforms, the internal control requirements have the greatest potential to improve the reliability of financial reporting. Our capital markets run on faith and trust that the vast majority of companies present reliable and complete financial data for investment and policy decision-making. Representing to the world that a company has in place an appropriate control system, free of material weaknesses, that gathers, consolidates, and presents financial information strengthens public confidence in our markets and encourages investment in our nation's industries. If that's the case, then it's worth it, and it is absolutely critical that we get the internal control requirements right."[4]

Rating agencies have also indicated that internal control information is important. Fitch Ratings, in a recently published special report, stated their views on the importance of internal control reporting as follows:

> "Fitch believes that investors should consider material weaknesses, as well as significant deficiencies, when assessing credit ratings. While auditors can render "clean" opinions on financial statements, investors should consider the analytical implications of certain disclosures on the entity as a whole, as well as the reliability of unaudited data furnished by management." [5]

A substantial part of the costs incurred are related to winning back the public confidence in a financial reporting system that had become unreliable. Given that objective, it is reasonable to assume that there are two costs associated with Section 404 work:

- The cost associated directly with winning back the public confidence, and
- The cost associated with ongoing internal control documentation and testing efforts.

It is reasonable to expect that the future costs of complying with Section 404 will decrease because (a) the initial investment in winning back the public confidence will already have been made, (b) there is a learning curve associated with control evaluation and testing, and (c) control processes, like many other processes, should become more efficient over time as companies implement process improvement methodologies. Some practitioners make similar observations. James Quigley, CEO of Deloitte & Touche, LLP, in testimony before Congress states it this way:

> "My viewpoint, although costly, the internal control management and auditor attestation are valuable, meaningful safeguards, [and] as businesses and auditors gain experience in complying with the requirements, [the audit and control processes] will become more efficient."[6]

These expectations, although reasonable, are speculative and merit further investigation. We wish to understand whether individuals, such as internal auditors, who have been dealing with internal control processes and evaluations on a daily basis, believe that such changes in cost will take place.

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[4] Nicolaisen, Donald T., Keynote Speech at 11th Annual Midwestern Financial Reporting Symposium; October 7, 2004. Speech is available at www.sec.gov.
[5] Fitch Ratings, *Special Report, Sarbanes-Oxley Section 404;* January 2005, New York, New York, p. 3.
[6] Quigley, James T., *Sarbanes-Oxley Implementation in Restoring Public Confidence*, Washington, D.C, House Committee on Financial Services, July 22, 2004; Deloitte, 2004.

Cost Estimates

There is strong evidence that the cost of complying with Section 404 is very expensive. An August 2004 study by the Financial Executives Institute (FEI) of 224 companies showed costs upward of $3 million for the larger companies in its survey. More recently, Yellow Roadway (a trucking firm) indicated that the Section 404 costs represented over 3% of its annual profits.[7] However, most of the cost estimates do not distinguish the costs that are due to initial documentation and testing (start-up) costs versus ongoing costs, and to what extent the costs were due to uncertainty over the required evaluation process. Our research is designed to gather more insight on these issues.

[7] Henry, David, and Amy Borrus, "No Escaping Sarbanes-Oxley," *Business Week*, January 6, 2005.

RESEARCH METHODOLOGY

In cooperation with The IIA Research Foundation, we utilized the resources of The IIA's research department and GAIN database to survey chief audit executive (CAE) members of The IIA. Many of the CAEs are with larger companies, so the survey reflects the view of those larger organizations. The survey was completed last fall (2004) after most companies had completed their Section 404 evaluations, but before external auditors had completed their testing. We received 171 responses. The respondents represented diversity in size of companies as shown in Exhibit 1, with almost an equal percentage of responses coming from very large, large, and intermediate-sized companies based on our definition of those terms.

Exhibit 1
Size of Companies Responding

Size	Number	Percentage
Very Large – over $6 billion in sales	54	31.6%
Large – between $1 billion and $6 billion in sales	64	37.4%
Intermediate – between $200 million and $1 billion in sales	42	24.6%
Small – less than $200 million in sales	4	2.3%
Not Reporting	7	4.1%
Total	**171**	**100.0%**

Although almost 70% of our responses are from very large and large companies, we believe the lessons learned are useful for most companies, including smaller companies.

The respondents represent a wide variety of industries. A summary of responses by industry is shown in Exhibit 2. We did subsequent analysis by industry, but the results were quite similar across industries.

Exhibit 2
Industry Background of Respondents

Industry	Number	Percentage
Technology	20	11.7%
Manufacturing	41	24.0%
Distribution	4	2.3%
Retail	10	5.8 %
Insurance	16	9.4%
Financial Institutions, other than Insurance	18	10.5%
Wholesale	3	1.8%
Other	54	31.6%
Not Reporting	5	2.9%
Total	**171**	**100.0%**

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RESEARCH FINDINGS

Control Improvements Directly Associated with Section 404 Work

We were most interested in knowing the current view of the specific benefits associated with Section 404 work. For example, the CFO of General Electric (which spent approximately $30 million on Section 404 compliance) states:

> "(GE) had good controls before this, but it [Section 404 work] has added more rigor. . . It certainly gives [CEO Jeff Immelt] and me more confidence when we're signing off on the results."[8]

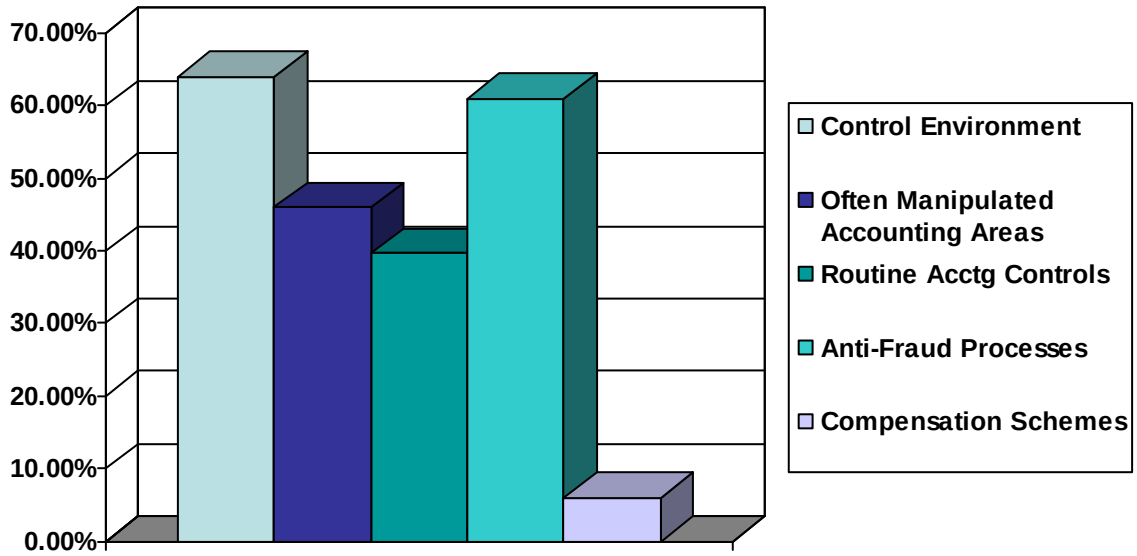
Similar comments are echoed by the CEO of PricewaterhouseCoopers, Sam DiPiazza, who states that "we are finding that the focus on internal controls is uncovering problems at the best of companies."[9] What is the nature of these problems?

We asked the study participants to identify the controls that were improved *directly as a result of 404 work in their organization.* The participants ranked the controls on a 5-point scale, with a 4 indicating agreement with a statement that the controls had improved directly as a result of the work and a 5 indicating strong agreement. We have categorized their responses in four categories:

- The control environment (excluding compensation schemes which we address separately);
- Often-manipulated accounting areas;
- Routine accounting controls; and
- Anti-fraud activities.

The results are shown in Exhibit 3.

Exhibit 3
Agree or Strongly Agree Controls Have Improved Due to Section 404 Work



[8] "No Escaping Sarbanes-Oxley," *Business Week, Online Edition,* January 6, 2005.
[9] Ibid.

The two biggest areas of control improvements are the control environment and the anti-fraud awareness actions taken by the companies. Over 60% of the respondents agreed that there were improvements in these areas that would not have taken place without the Section 404 work. We are not surprised by the emphasis on these two areas because weaknesses in the control environment have often been associated with business failure or financial frauds. Most organizations did not have well-developed anti-fraud programs. Thus, although we are not surprised by the emphasis, we think the percentage of respondents indicating that controls in these areas have improved directly as a result of Section 404 work is significant. Remember, many of the respondents come from very large organizations *and* those organizations have already invested in an internal audit function. In other words, these respondents are saying that the improvements would not have been identified, or taken place, without the systematic review, documentation, testing, and analysis of controls that took place as a direct result of Section 404 work. We analyze each of these areas in greater depth.

Improvements in the Control Environment

There were six control topics under the control environment category:

Exhibit 4
The Control Environment:
Improvements Due to Section 404 Work

Areas of Improvement Due to 404 Work:	Disagree or Strongly Disagree	Neutral	Agree or Strongly Agree
Audit Committee Involvement and Knowledge	9%	20%	71%
Monitoring Controls	11%	18%	71%
Board Knowledge and Role In Controls	10%	24%	66%
Control Environment	16%	22%	62%
Internal Auditing	20%	21%	59%
Greater Acceptance of Codes of Conduct	18%	26%	56%
Mean Response	**14%**	**22%**	**64%**

One of the major objectives of the legislation was to improve governance through more effective audit committees. Over 70% of our respondents identified significant improvements in the knowledge and involvement of the audit committee. In our open-ended responses, the increased knowledge and involvement of the audit committee was cited as one of the five major benefits of the control work. However, the improvements are much broader than the audit committee; all members of the board have developed greater awareness and responsibility for controls over financial reporting. Other areas, such as internal audit activities and greater acceptance of the role an effective code of conduct can play in effective governance, have also improved directly because of the Sarbanes-Oxley legislation and the organization's attention to the "tone at the top" and the control environment.

Controls over Often-manipulated Accounting Areas

Even before the Sarbanes-Oxley Act, many companies had paid increasing attention to the areas that were most often manipulated in financial frauds. These areas include manipulating revenue recognition, inappropriately using accounting estimates (often referred to as "cookie jar reserves") to manage earnings,

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and using unsupported journal entries to manipulate reported earnings.[10] We were interested in whether companies had already implemented significant control improvements in these areas, or whether there were still more to be performed. An overview of these three areas is shown in Exhibit 5.

Exhibit 5
Improvements in Often-Manipulated Accounting Areas

Areas of Improvement Due to 404 Work:	Disagree or Strongly Disagree	Neutral	Agree or Strongly Agree
Closing Process and Unusual Journal Entries	14%	24%	62%
Accounting Estimates	19%	35%	46%
Revenue Recognition	28%	42%	30%
Mean Response	**20%**	**34%**	**46%**

The good news is that many companies had implemented better controls over revenue recognition and had developed more concrete criteria for revenue recognition. Still, a full 30% of the respondents indicated significant improvements in controls over revenue that were directly attributable to Section 404 work.

The significant improvement in the closing process strikes us as very significant. Given the typical volume and complexity of the closing process and year-end journal entries, it is likely that this area had not been subjected to detailed control analysis. Historically, accountants and auditors have had a tendency to focus on controls over routine transaction processing, leaving this fundamental processing area systematically overlooked in many organizations. In our conversations with both internal and external auditors, we also have strong anecdotal evidence that neither internal nor external auditors have historically or systematically tested the closing process. For example, auditors have not used audit software to analyze journal entries, summarize the entries, and select entries for support and review. And it is often difficult to trace journal entries back to the underlying support and origination, or the dollar amounts are below the auditor's scope threshold.[11] The control reviews performed on the closing process and unusual journal entries have led to significant control improvements according to almost two-thirds of the study respondents. It is clearly an area that all organizations ought to review.

AUTHOR ANALYSIS

We believe that internal auditors can be a significant help to organizations by using data analysis software that examines journal entries and effectively traces journal entries back to their originating source. The entries should be monitored within the company and periodically evaluated by the internal or external audit function.

The misuse of accounting estimates has received considerable attention, starting with the 1998 speech on the "Numbers Game" by then-SEC Chairman Arthur Levitt.[12] Levitt described situations where companies would make unusually large accruals to liabilities in good times (for example, this was done with restructuring reserves associated with acquisitions at WorldCom) and then use these "cookie jar reserves" to manage earnings in bad times. Almost half of the respondents indicated that they had made significant control improvements in this area — again, as a direct result of the Section 404 work.

[10] For example, WorldCom used journal entries and restructuring estimates to manipulate its reported earnings. Many companies have hundreds of year-end journal entries — many of which are not subject to detailed scrutiny. The SEC has taken action against many companies for inappropriate revenue recognition.
[11] For example, it has been reported on C-Span that HealthSouth covered up much of its fraudulent reporting by making thousands of journal entries well below $5,000 and across many operating entities to keep the threshold below materiality guidelines. For more details on the nature of the fraud, see Securities & Exchange Commission, Plaintiff vs. HealthSouth Corporation and Richard M. Scrushy, Defendants, at www.findlaw.com, Civil Action No. CV-03-J-0615-S.
[12] Arthur Levitt, "The Numbers Game," speech presented at NYU Center for Law and Business, September 28, 1998, available at http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt.

Routine Accounting Controls

Historically, routine accounting controls receive attention because they are essential for an organization to operate. A company must be able to track its inventory, receivables, and fixed assets, and record basic transactions to operate its business. Thus, we would not be surprised to learn that the overall controls in these areas were generally good. However, there are still a significant number of companies that made improvements in these areas as a result of their Section 404 work. As an example, Visteon, a major automotive parts supplier, reported that it found major control problems dealing with billing and receivables for an important customer, Ford Motor Company, and had made significant improvements to those controls directly as a result of 404 work.[13] An overview of these three areas is shown in Exhibit 6.

Exhibit 6
Improvements in Routine Accounting Controls

Areas of Improvement Due to 404 Work:	Disagree or Strongly Disagree	Neutral	Agree or Strongly Agree
Record Retention/Audit Trail	17%	22%	61%
Asset Safeguarding and Property Accounting	27%	39%	34%
Expense Classification and Accounting	30%	46%	24%
Mean Response	**25%**	**35%**	**40%**

The most important control improvement area in this category, with 61% indicating a strong improvement, is in the record retention/audit trail area. It is an often-neglected area, but it is important to answering customer questions, as well as building documented support for accounting entries. On the other hand, there was significantly less reported improvement in the areas of asset safeguarding, property accounting, and expense classification, perhaps because most companies have adequate controls in these areas. Still, there was room for improvement in a significant minority of the companies in the study.

Anti-fraud Activities

Many companies had not established specific anti-fraud control and reporting measures prior to the Sarbanes-Oxley legislation. This does not mean companies did not have any anti-fraud controls, but many did not have specific procedures, including whistleblower. The Sarbanes-Oxley Act required companies to go a step further, if they had not already done so, to establish effective anti-fraud controls. Implementing anti-fraud activities is much more than establishing whistleblowing; it must include effective monitoring of operations, effective internal audit, continuous risk analysis, and follow-up to unusual results. Not surprisingly, a significant percentage of our respondents found that their companies made significant improvement in anti-fraud activities as a direct result of the legislation.

[13] Henry, David, and Amy Borrus, "No Escaping Sarbanes-Oxley," *Business Week*, January 6, 2005, online edition, p. 2.

Exhibit 7
Improvements in Anti-fraud Activities

Areas of Improvement Due to 404 Work:	Disagree or Strongly Disagree	Neutral	Agree or Strongly Agree
Anti-fraud Activities	**19%**	**33%**	**48%**

Revised Compensation Schemes

We added a question about compensation schemes because many of the financial frauds point directly to the misuse of compensation practices as a direct motivator of frauds. As shown in Exhibit 8, the companies in our sample do not appear to have made a connection between compensation schemes and controls over financial reporting.

Exhibit 8
Revision of Compensation Schemes

Areas of Improvement Due to 404 Work:	Disagree or Strongly Disagree	Neutral	Agree or Strongly Agree
Revised Compensation Schemes	**62%**	**32%**	**6%**

Only 6% of the respondents felt that there had been improvement, and a clear majority (62%) did not believe there had been an improvement due to Section 404 work.

Most Significant Control Improvements Noted by Study Participants

In addition to responding to the specific control improvements evaluated in the previous section, we asked the study participants to write in the five most significant control improvements they had observed. We were interested in specific observations they had about their organization's activities that we might not have captured in our earlier questions. We received numerous thoughtful responses. We were able to classify most of these open-ended responses into seven broad categories, although some of the responses were difficult to classify. Those categories were:

- Specific improvements in controls or documentation processes,
- Improvements in the control environment of the organization,
- Recognition of the need, and improvements made, over computerized controls,
- Implementation of risk management approaches to better analyze and drive the implementation of controls, with more efficient control structures as controls were linked to risks,
- Increased control awareness by the process owners,
- Management acknowledgment of their responsibility for the effective implementation and monitoring of controls, and
- Other, a wide variety of responses that were unique to each participant.

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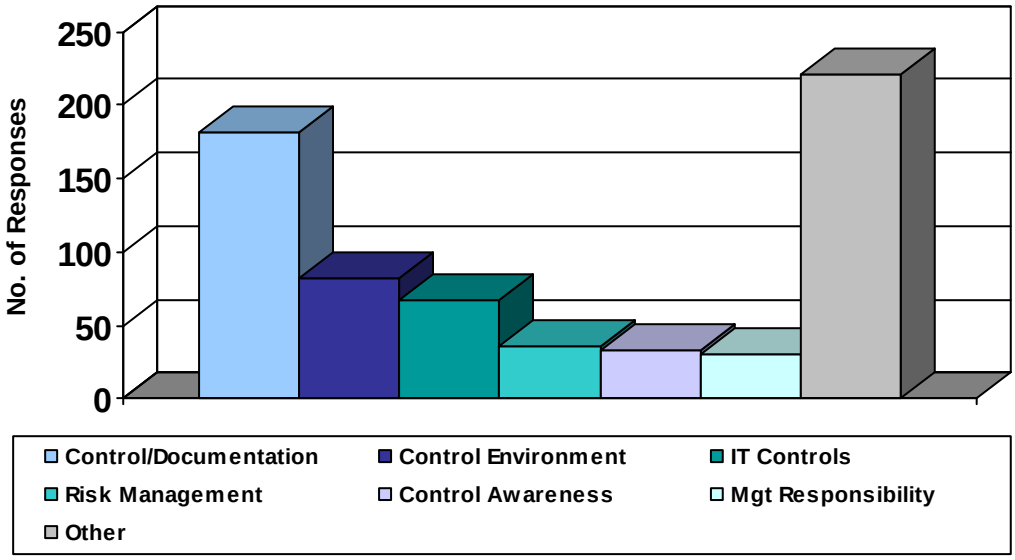
AUTHOR ANALYSIS

The authors believe the lack of attention to compensation plans is a serious omission because compensation is clearly a major motivator of performance. Further, the recent problems with the public accounting profession further demonstrate that a well-established ethical code is not sufficient to overcome dysfunctional compensation schemes.[14] Given the clear linkage between fraud and management incentive plans, compensation plans should be a continuing focus of boards, management, regulators, and legislators.[15] The changes must start at the top of the organization and be carried out consistently throughout the organization. We feel it is a significant omission and should be reconsidered by organizations as they assess the design and effectiveness of internal controls over financial reporting for Section 404.

An overview of the open-ended responses on control improvements is presented in Exhibit 9.

Exhibit 9
Most Significant Control Improvements



[14] Our focus here is not on the public accounting firms. However, the example of the large public accounting firms changing their compensation schemes to focus less on "selling" products and other services to a higher emphasis on quality factors is an example of using compensation schemes to motivate desired performance.

[15] The use of stock options is often cited as an example of a compensation method that has encouraged dysfunctional activities in some organizations. The FASB is, of course, addressing the issue of expensing stock options. Some companies are addressing what they believe may be dysfunctional aspects of stock options through such mechanisms as (a) restricted stock plans, (b) performance objectives that represent a more balanced-scorecard approach, and (c) aligning performance rewards with longer-run results.

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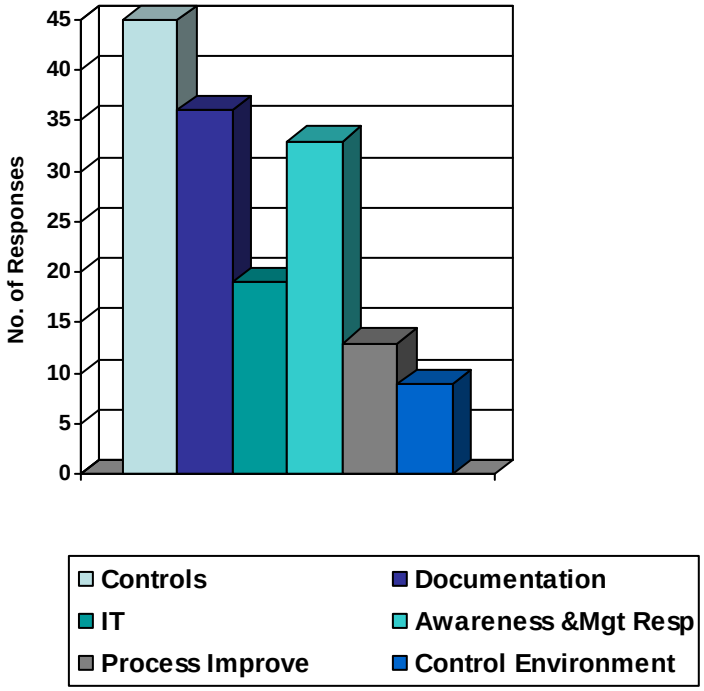
We further explored the responses by performing a separate analysis of the first item identified by our respondent on the assumption that the first item was most important or had the greatest effect. We present this analysis in Exhibit 10.

Exhibit 10
Most Important Control Improvement



There is a consistency between the overall analysis and the separate analysis of the first item identified. The first item most often mentioned related to the identification of specific, easily identifiable control improvements such as the documentation or improvement of controls. Improvements in the control environment, awareness of the importance of controls across the organization, and management's responsibility for controls also rank highly, and the need for improved information technology controls remains. We discuss the overall findings below.

Management Awareness and Ownership for Controls

Overall, most survey participants believed that their companies have gained valuable awareness throughout all levels of the organization about internal controls and the need for those controls. A large number of survey participants wrote comments supporting their view that management and employees more fully understand how controls affect operations and that management has accepted responsibility for controls.

Many respondents described the embedding of internal control ownership into the culture of the organization as a major benefit. However, based on answers to a subsequent question, there remain a significant number of companies where control ownership (or at least the ownership of Section 404 compliance efforts) does not necessarily reside with management.

Control Benefits: A Summary

It is difficult to summarize the major control benefits because of the diversity of improvements noted by the study participants. Our observation of both the structured questions and the open-ended responses leads to our assessment of a "Top 10" list of control improvements:

1. A more engaged control environment — with active participation by the board, the audit committee, and management.
2. More thoughtful analysis of monitoring controls, along with recognition that monitoring is an integral part of the control processes.
3. More structure to the year-end closing process and recording of journal entries, thus recognizing the extent to which these areas have increased in complexity.
4. Implementation of anti-fraud activities with defined processes in place, including responsibility for follow-up by defined parties and resolution approaches.
5. Better understanding of the risks associated with general computer controls, and the need to improve both control and audit procedures to gain assurances that the risks associated with computer systems are mitigated.
6. Improved documentation of controls and control processes that can serve as a basis for training, practical day-to-day guidance, and management evaluation.
7. Improved definition of controls, and the relationship of controls and risk, across the organization.
8. Control concepts becoming embedded into the organization with a broader understanding by operating personnel and management of their responsibility for controls.
9. Improvements in the adequacy of the audit trail as a basis to support operations as well as to support audit assessment of control adequacy and financial reporting.
10. Re-implementation of basic controls, e.g., segregation of duties, periodic reconciliation of accounts, and authorization processes that had been eroded as organizations had downsized or consolidated operations.

Section 404 Compliance Ownership

To comply with the requirements of Section 404, organizations tried different models for assigning ownership and responsibility. These included:

- Creating a compliance team,
- Assigning responsibility to process owners (generally the heads of operating units),
- Assigning responsibility to the controller, or
- Outsourcing major efforts to a third party with oversight and responsibility by an internal leader.

Others have used some combination of the above alternatives. The wide divergence of practice is evident in the results to our question about responsibility. The following chart summarizes the answers to our question about current responsibility for various aspects of Section 404 compliance:

Exhibit 11
Current Responsibility for Section 404 Effort

	Management	Controller	Internal Audit
Overall Section 404 Ownership	41%	39%	20%
Documentation	59%	20%	21%
Ongoing Testing	28%	7%	65%
Monitoring Process	26%	17%	57%

For our respondents, management (central compliance team and/or process owners) generally had overall ownership and responsibility for documenting controls, but internal audit owned testing and monitoring. It is interesting to note that there is no consistent assignment of overall ownership, and that internal audit is described as the "overall owner" for 20% of the companies responding.

AUTHOR ANALYSIS
Our Observations on Control Ownership

We have noted a number of themes regarding control and process ownership. The most common theme is that the "process owner" ought to be the owner of the controls and should be held responsible for the adequacy of the controls. That concept is embodied in the Sarbanes-Oxley requirement that the CEO and CFO certify both the report on internal control over financial reporting and the financial statements. However, the comments received in the open-ended responses from the CAEs indicate that they believe many process owners do not fully understand controls, although they do understand control objectives and the responsibility to see that controls are adequate.

We believe that organizations are going to continue to struggle with control ownership. The process owners are not "control experts," but they are an integral part of the control system. Process owners also have an obligation to ensure that the processes under their control are efficient — and rightly, or wrongly, they often believe that "controls" create unnecessary work and slow down the underlying processes, or at a minimum add unnecessary overhead. Controllers (and auditors) are generally the control experts within the organization. However, they usually do not have the authority to mandate controls, and more important, they are not part of the system that ensures that employees are motivated to comply with control requirements or follow control procedures. That is management's job. Thus we have a dilemma. Either the process owners have to become control experts and controls have to become embedded in the organization's culture, or alternatively, the controller's function must provide sufficient guidelines, training, and selection choices that provide a foundation on which control objectives can be achieved. In the latter alternative, the process owners still have a responsibility to see that control objectives are achieved.

An example might help explain our concerns. Think of a manufacturing process with a number of stamping machines working in serial processing to manufacture goods. The engineers (controllers) set up tolerances in the machines and then develop monitoring controls that tell the plant manager whether any machine is failing to meet the quality objectives, i.e., the machines are producing products outside of tolerance. The plant manager is responsible for monitoring the performance of the process and taking corrective action when the machines are out of tolerance. Who has responsibility for the controls? It seems to us that there is a joint responsibility. The engineers (controllers) are responsible for establishing the control objectives and standardized processes to accomplish the objectives. However, it then becomes part of the owner's responsibility (the plant manager) to monitor the system, identify instances of control deviations, and take timely and effective corrective action. This model is consistent with COSO's *Internal Control – Integrated Framework*, which anticipates that an effective information and communication system, coupled with monitoring and feedback, are essential elements of the control process. We believe that organizations will need to expand their thinking about the COSO model to achieve more responsibility and efficiency in the control process. Ownership and development of the control activities and system may differ from the process owners' responsibility to monitor and signal control failures.

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Enhanced Documentation and Control Evidence

There are two components of improved documentation that were mentioned by our respondents:

- Documentation of the processes, workflow, and controls, and
- Documentation of the evidence that the controls are working.

Improving the documentation of controls and processes is not surprising because it has been mandated by regulation and auditing standards. In completing the readiness effort, organizations have better captured not only the process flow and associated controls, but also updated the associated policies, procedures, handbooks, job descriptions, and other pertinent documents. Respondents believed that the development of adequate documentation will pay future dividends in areas such as training new employees, enabling backfill and succession planning for key positions, and identifying process improvement opportunities. Many respondents mentioned that the improved documentation is an important control from a global control perspective.

A major finding is that there was little documentation or evidence that existing controls were working. For example, how would an organization determine that there was a proper review of an exception report, or a proper reconciliation, if there was no documentation that the review of the reconciliation was performed? Respondents noted the improvement in documenting the evidence of supervisory reviews and approvals, management committee actions and decisions, and the investigation and resolution of unreconciled or outstanding items. The need to properly and clearly develop evidence of the operation of each key control has become a more common practice.

Stronger Tone at the Top

Several respondents noted the "tone at the top" and control environment are now better understood by company executives and employees. The board is more aware of its control responsibilities and the audit committee has taken leadership in supporting improved controls. The "tone at the top" has extended beyond management and into the governance process. Anti-fraud efforts have been established or strengthened, including the implementation of fraud and ethics hotlines. The audit committee has become more involved in accounting policies and practices, earnings releases, and the evaluation of internal controls.

Strengthened Information Technology Controls

Information technology (IT) controls is perhaps the Achilles' heel of financial reporting controls. Everyone knows that we need improved controls over IT, but the responsibility has often been delegated to the IT staff. Many organizations have recognized the increased need to more actively evaluate IT controls using appropriate resources, such as IT auditors. The five most mentioned enhancements to information system controls were:

- Improved information system security,
- Better understanding and improvement of segregation of duties,
- Improved access controls and access monitoring,
- Improved testing procedures and program change management, and
- Improved processes to document policies, procedures, and controls.

AUTHOR ANALYSIS

Many participants indicated the biggest thing that was needed going forward was that a "control culture" become embedded into the organization. The audit committee is clearly giving such direction. However, we would like to see those responsible for the "tone at the top" embrace controls as a more effective way of operating, as opposed to something that must be done to meet a governmental regulation. This applies to both large and small organizations. The authors believe that COSO's *Internal Control – Integrated Framework*, as well as COSO's *Enterprise Risk Management – Integrated Framework*, provide rich frameworks for management and audit committees to use in embedding a risk and control culture within the organization.

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As one respondent stated: *"Without the push from SOX, this [IT control improvement] would not have happened, when it happened."*

Many respondents voiced the opinion that as organizations grow and become more technologically dependent, there is an increased need to "automate" more controls — essentially to build the controls into the business process, much as the engineer builds tolerances into the stamping machines. The audit/control challenge will be to develop an effective information, communication, and monitoring system that will identify when the controls that are built into the system are not working within their prescribed tolerances, and then signal evaluation activities and monitor correction.

Strengthening Other Controls

Improvement of specific controls was the item most often noted. The controls that were improved varied with the nature of the company and the industry. The most often-cited control improvements were:

- The reconciliation process — at all levels within the processing system,
- Specific accounting processes, most often payables and inventory,
- The journal entry and closing process,
- Better segregation of duties, and
- Improved consistency in definition and application of control adequacy across the organization.

AUTHOR ANALYSIS

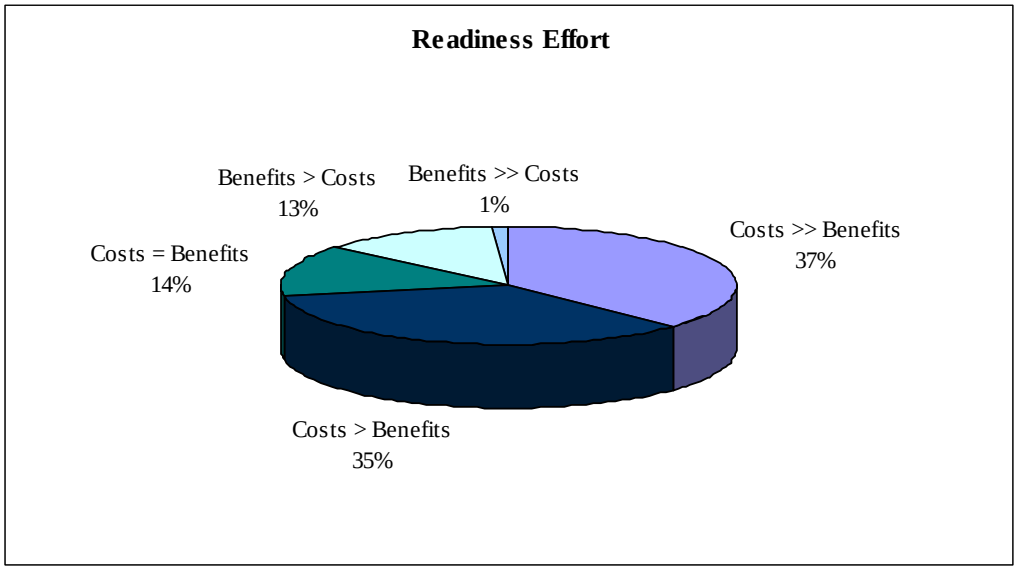
Given (a) the nature of accounting failures in the past decade, and (b) the basic auditing evolution away from testing and relying on controls to more analytic and substantive procedures, we are not surprised that some organizations may have ignored basic internal controls. As organizations grow and become more complex, there is an increasing need for timely and thorough reconciliations — between parent and subsidiary ledgers, and of account balances to the detail. For example, finding weaknesses in reviewing journal entries, the year-end accounting closing process, or performing basic reconciliations is a sign of less control emphasis. Companies are now finding that they have to drive new control philosophies consistently across entities to achieve required control objectives. Many of the respondents indicated a major problem uncovered by Section 404 work was that independent units did not feel they needed to follow corporate policies. The systematic approach to controls assessment, brought on by Section 404, is changing that belief.

Cost-benefit of Section 404 Work

The first year costs to comply with the Sarbanes-Oxley Act were significant, and significantly more than understood or forecast at the beginning of the process. And the total cost of compliance mushroomed — the FEI August 2004 noted that the average expected cost had increased more than 62%, from $1.93 million to $3.14 million, in a period of only six months (January - July 2004). This paralleled the expected increase in employee hours — from 12,265 estimated in January to 25,667 estimated in July.

We asked survey participants for their opinion regarding the relative costs and benefits associated with readiness. When asked about the up-front costs to get ready, 72% of the respondents answered that the costs exceeded (>) or greatly exceeded (>>) the benefits. The breakout by answer is depicted in Exhibit 12; only 14% of the respondents indicating that year one benefits exceeded or greatly exceeded the costs.

Exhibit 12
Relationship of Cost of Readiness Activities and Benefits



There is some differentiation in the results when looking at the cost versus benefit responses by industry. The percentage of respondents by industry who selected costs exceeded or greatly exceeded benefits ranged from 50% (Retail) to 81% (Insurance), with the average 72%. The breakout was:

Average	Financial Institutions	Insurance	Manufacturing	Retail	Technology	Other
72%	61%	81%	80%	50%	75%	70%

The size of organization did not appear to be a factor in the participant's responses – when looked at by company size, the percentage of respondents answering negatively (costs greater than benefits) ranged from 72% to 75%.

In answering this cost/benefit question, many respondents acknowledged the difficulty in quantifying the types of benefits received to date. For example, one participant pondered: *"… how do you quantify the benefit of continuing to be able to access equity markets because you have not had any "Enron" type disaster?"* Even so, the costs were so significant the shared belief seemed to be that they dwarfed the benefits — tangible as well as intangible.

Reasons for the High Costs

To understand the answers above, we also asked participants to provide reasons for their response to the cost question, and to provide recommendations to retain the benefit of internal control assessments while significantly reducing the cost of the assessments. Five clear themes emerged from their answers.

1) <u>Learning Curve</u>
While external auditors and internal auditors have historically assessed (but not necessarily tested) internal controls, a company-wide effort to identify, document, and test all key controls associated with financial reporting has never been undertaken. Financial reporting controls are not limited to what goes on in the accounting department to reconcile accounts, close the books, and produce

quarterly and annual financial statements. Companies learned they needed to start at the beginning of the transaction stream, where the sale is contracted, the order entered, the product produced, the loan originated, or the revenue recognition principle applied. Preventive controls were recognized as being just as — if not more than — important as the detective controls. Operational employees, who had limited accounting or auditing knowledge, were, by necessity, involved in the process. So — not only was the entire effort a new undertaking with no tried-and-tested methodology, the individuals performing the work were frequently inexperienced in basic control and accounting concepts.

2) Time Pressure and Fees

The Sarbanes-Oxley Act was signed into law in July 2002, with an original December 2003 due date for complying with Section 404. All affected public companies and their boards wanted to get a clean opinion. The question was how to go about it. Since failure was not a desirable option, companies with December year-ends sought advice from professional service firms (including The Big 4), law firms, and their external auditor to understand the requirements. And due to the relatively short time period to implement and no abundance of spare internal resources, many organizations chose to engage external consultants and contractors to advise them as well as to augment their internal resources. As the demand for the audit and accounting consultants grew, so did the cost of engaging them.

Ultimately the implementation date was postponed. However, the issuance of the independent audit attestation standards (Audit Standard 2) increased the perceived requirements on management as well as the external auditor. So, although it would appear the time pressure had been alleviated, in actuality the work pressure remained because of the perceived increase in the amount of effort required to get a clean opinion. To compound the costs issue, the external auditor's fee estimate to complete the integrated control and financial statement audit was increasing. In the same August 2004 FEI survey noted earlier, the expected external audit fees for the internal control attestation had increased 40% between January 2004 and July 2004.

3) Uncertainty

The Sarbanes-Oxley Act Section 404 required management to acknowledge its responsibility "for establishing and maintaining an adequate internal control structure and procedures for financial reporting"; and to assess the "effectiveness of the internal control structure and procedures of the issuer for financial reporting." In addition, the external auditor was responsible to "attest to, and report on, the assessment made by the management..." The internal control requirement was viewed as a "principles-based" concept, but auditors and management worried that Audit Standard 2 required "more" and sought greater guidance to meet the reporting requirements. With tight deadlines, companies had to begin the process of identifying and documenting controls over financial reporting based on the broad concepts in COSO's *Internal Control – Integrated Framework*.

Meanwhile, the new regulatory body to oversee the public accounting profession, the PCAOB, was forming. One of the PCAOB's first jobs was to develop the standard by which the auditors would attest to management's internal control certification as required by Section 404. In the absence of final standards, and in order to maintain independence from management's process, the auditors were reluctant to provide guidance to their clients on how much documentation was sufficient, on what constituted sufficient internal controls, and on what exceptions might constitute a material weakness. Ultimately, the final Audit Standard 2 (AS 2) was issued in June 2004, almost two years after the Sarbanes-Oxley Act was signed into law. Associated guidance and clarification continued to be released by the SEC and the PCAOB through December 2004. One respondent summarized the problem as follows:

> *"Accelerated time line, with relatively no guidance from SEC or external audit firms... All issues are treated with the same level of importance."*

During this period of unclear requirements and standards, most companies continued their documentation and testing efforts, believing they were living up to the principles of the legislation. However, in the view of many, the final PCAOB standard "raised the bar" on the attestation requirement above the original expectations and dictated rigorous testing requirements for the auditor. For many companies, the final PCAOB rules led to a higher standard of documentation and control testing by both management and the external auditor. This, in turn, led to significant amounts of rework to their documentation and expanded testing beyond the level originally planned.

Many in our survey believe AS 2 still lacks clarity, particularly in the definitions of significant deficiency and material weakness. Many of those involved in testing controls express concern that there remains too much uncertainty about how to quantify control breakdowns in terms of a dollar misstatement, and how to judge the likelihood that the breakdown could cause a misstatement. This seems especially true with information systems weaknesses — where companies continue to struggle with equating a weakness in an area like operating system access privileges to a dollar misstatement.

4) Attestation Requirement

One of the objectives of Sarbanes-Oxley was to ensure that the chief executive officer and the chief financial officer took personal responsibility for the effectiveness of the internal controls over financial reporting. The Act also requires an independent opinion on the effectiveness of their controls. Many of the respondents to our survey believe that there is excess cost in the system because of the requirement for duplicative detailed testing by the organization and by the external auditor.

AUTHOR ANALYSIS

This is a difficult dilemma for the accounting and auditing profession as a whole. On one hand, the profession and many user groups feel that we would be better served by professional auditors and managers who make decisions based on fundamental concepts of control and economic analysis. In order to get to that point, however, auditors and managers have to feel that every judgment that is made is not second-guessed by standard setters (or worse yet, plaintiff lawyers) by yet-unspecified criteria. Our view is that the profession is better served by professionals who understand the fundamental concepts of controls and the objectives of financial reporting established in the COSO framework. It will take some time to get to the point where everyone is comfortable in making those decisions, and it will come only if the PCAOB and the SEC allow good faith judgments to be made by management and the external auditors.

For an auditor to opine, there must be clear evidence to review, test, and, ultimately, rely upon. It is not enough for management to assess and certify to the CEO and CFO that the existing controls are effective. The challenge for management is to ensure that sufficient documentation is available for the external auditor to carry out the procedures shown in Exhibit 13.

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Exhibit 13

Documentation and Process by Management to Facilitate an External Audit

Management has to maintain sufficient documentation and evidence of their assessment work effort so that the auditor can:

- Confirm the sufficiency of management's risk assessment and scoping process,
- Understand and confirm the sufficiency of the COSO entity level controls,
- Understand the primary business processes and transaction flows and confirm this understanding during an independent walk-through,
- Confirm that all significant classes of transactions are included,
- Confirm that all relevant financial assertions are considered for each significant account and disclosure,
- Reperform to the same conclusion tests of the effectiveness of controls,
- Independently test the effectiveness of selected key controls at selected significant locations.

For many of our respondents, this level of documentation and additional controls evidence was perceived as "overkill."

"In short, most aspects of financial reporting were already well controlled, but informal. We've made tweaks, but spent a lot of time focusing on evidence rather than being satisfied that the control — evidence or not — actually works."

"External auditors will be retesting and reevaluating controls work already done by the companies; in effect

5) Compliance, Not Improvement, Effort

The readiness effort for Section 404 certification was fairly quickly recognized to be a major effort. It is important to note that as companies sought to be more cost efficient in their operations over the past few years, they have often downsized, stripping away non-critical positions and leaving the remaining staff stretched to complete business as usual. Control requires resources — and many of those resources had been stripped away, and there was no ready resource "standing by" to meet the sizable demands of Section 404 certification.

"Documentation resources are scarce and therefore costs are high."

AUTHOR ANALYSIS

The PCAOB would likely argue that such a view is misguided because (a) management must establish a mechanism to ensure itself that controls are effective, (b) independent testing of the system by the organization is an appropriate method to gain such assurance, and (c) management must understand its obligation to independently assure the effectiveness of internal controls over financial reporting. The PCAOB takes a firm view that the auditor must attest management's assertion, i.e., management, not the auditor, is responsible for documenting and gaining assurance about the effectiveness of internal controls. The authors believe that future improvements in control processes, particularly with advances in the automation of controls, coupled with better information, communication, and monitoring systems, will allow management to gather sufficient evidence to meet their obligations on attesting to the effectiveness of internal controls by assuring themselves that monitoring and feedback controls are effective. Tests of individual controls can be limited in extent to providing evidence that the overall control process, especially the effectiveness of monitoring controls, is effective. We believe such a change is inevitable because of the need to be cost efficient, and such a change is compatible with the COSO internal control framework. However, the change may require a change in thinking on the roles of three major parties involved: management, auditors, and the PCAOB.

"Company views 404 as a compliance exercise and not an improvement exercise; will only do what it takes to comply but no more."

"To meet the first year of compliance, companies are scrambling to document and test controls along with managing the external auditor. No time to analyze and implement any potential benefits."

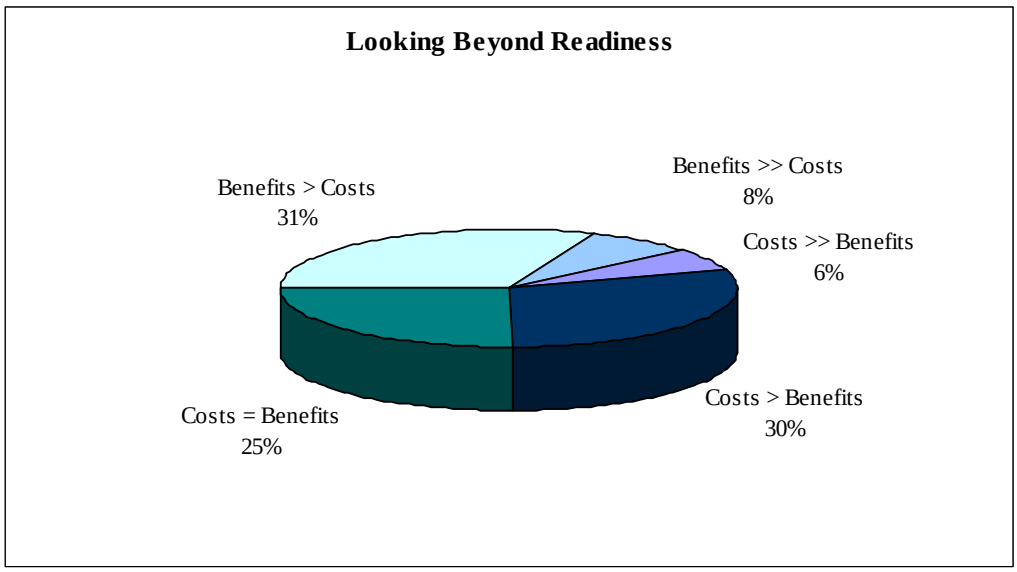
AUTHOR ANALYSIS

Our practical observation is that most organizations began the process with an unstated, but real objective of doing the minimum required to get a clean opinion from the external auditor. In other words, the emphasis was on meeting the literal requirements of the legislation. However, in doing so, the companies often missed opportunities to streamline processes, automate activities, and eliminate redundancies. In the effort to gain base-level compliance only, most organizations have ignored the opportunity to identify inefficiencies, remediate, and reap savings.

Prognosis – Cost/Benefit Tips in Favor of Benefits

When looking beyond the first year readiness costs and learning costs, 4% of the survey respondents felt the long-run benefits from the internal control evaluation processes would at least equal the cost, with over half of those respondents believing the benefits would be greater (>) or significantly greater (>>) than the costs. The results are displayed in Exhibit 14.

Exhibit 14
Relationship of Cost of Readiness Activities and Benefits Considering a Reduced Level of Continuing Costs



Earlier when we looked at only the first year efforts, only 28% of the respondents felt that the benefits were at least equal to the costs when considering the upfront readiness effort. Looking beyond the first-year costs, the view has changed significantly. A comparison of the two views is displayed in Exhibit 15.

Exhibit 15
Relationship of Cost of Readiness Activities and Benefits

	First Year -- Readiness Effort		Looking Forward to Steady State of Control Assessments	
Costs Greatly Exceed Benefits	37%		6%	
Costs Exceed Benefits	35%		30%	
Costs Equal Benefits	14%	28%	25%	64%
Benefits Exceed Costs	13%		31%	
Benefits Greatly Exceed Costs	1%		8%	

During the first year, only 14% of the total respondents felt benefits exceeded costs. When asked to look ahead and ignore the one-time costs, 39% believed benefits would exceed costs, while another 25% perceived that costs and benefits would equal out. We perform more detailed analysis by groups as shown in Exhibit 16. It is interesting to note that 50% of Retail, Distribution, and Technology respondents felt that benefits exceeded or greatly exceeded costs when looking beyond the one-time costs. The least favorable responses to this question came from manufacturing respondents, with only 34% believing benefits exceeded or greatly exceeded costs. A breakout by industry grouping is provided below.

Exhibit 16
Benefits Exceed Costs - Looking Forward
Analysis By Industry

Average	Financial Institutions	Insurance	Manufacturing	Retail	Technology	Other
39%	44%	38%	34%	50%	50%	34%

This overall shift in perspective appeared to be driven both by a belief in increasing benefits over time, as well as an expectation for significant compliance cost savings going forward.

Reaping the Benefits

As noted above, many of the participants believe management will be able to take advantage of the readiness investment to streamline, simplify, and standardize their processes. What they could not accomplish in year 1 due to time and cost constraints they believe they will accomplish in the future.

> *"SOX 404 has been invaluable to improving controls in our business, especially as it provides a 'big stick' when necessary to encourage action by some managers."*
>
> *"Monitoring processes done as a matter of routine rather than add-on work will drive cost efficiency."*
>
> *"Unique processes and systems create a multiplier effect when creating risk/control profiles which increase documentation, testing, and remediation efforts. Greater ownership by management allows them to see such inefficiencies and improve the operating and control environment which they manage."*

Reduced Maintenance Costs

Our respondents did see the narrow focus on compliance changing in future years. When asked to answer the cost/benefit question looking forward, after the significant upfront costs associated with readiness, the perspective of the relative costs and benefits shifted greatly. Respondents believed that costs will significantly decline in the future. When asked "To what extent do you believe costs will decrease in future years as compared to this year?", 43% of the respondents estimated reductions of 50% or greater in year 2, and 54% felt cost savings of at least 40% would be realized. When asked to look into years 3 and 4, increasing reductions were expected. Over half of the respondents felt costs would be reduced another 20% in year 3, and over 75% of the respondents expected another 10% reduction by the end of year 4.

Exhibit 17
Expected Cost Reductions in Future Years for Section 404 Compliance
% of Respondents

	Compliance Costs Savings Equal to or Greater Than:				
	50%	**40%**	**30%**	**20%**	**10%**
In Year 2	43%	54%	70%	93%	99%
In Year 3	12%	17%	25%	52%	87%
In Year 4	12%	18%	21%	29%	77%

As we move into year 2, companies expect to realize cost savings of this magnitude for three primary reasons: the upfront documentation effort is completed, management now understands the process and requirements, and third-party services will be greatly reduced.

However, there was also caution expressed. Will companies be able to embed the needed control awareness and ownership into the fabric of their ongoing business activities, or will it become a once a quarter (or worse, once a year) mad rush to document, test, and remediate? Will monitoring processes be automated, or will management continue to rely on a collection of spreadsheets and narrative documents, with the ongoing challenge of version control and update? In the words of some of the survey participants:

"Need to remember SOX is not a one-time thing and now we can move on to something else. If senior management does not speak positively, nobody else will be supportive of the continuing efforts and benefits."

"It is cheaper to maintain control documentation on a continual basis than having to recreate each quarter or year end. More automated processes improve reliance on controls and decreases costs of manual efforts and related testing."

"Two dangers going forward are that management heaves a sigh of relief when compliant and forgets to keep the assessment going. Secondly, they establish their own "testing" people which duplicates work done by internal audit and adds unnecessary cost."

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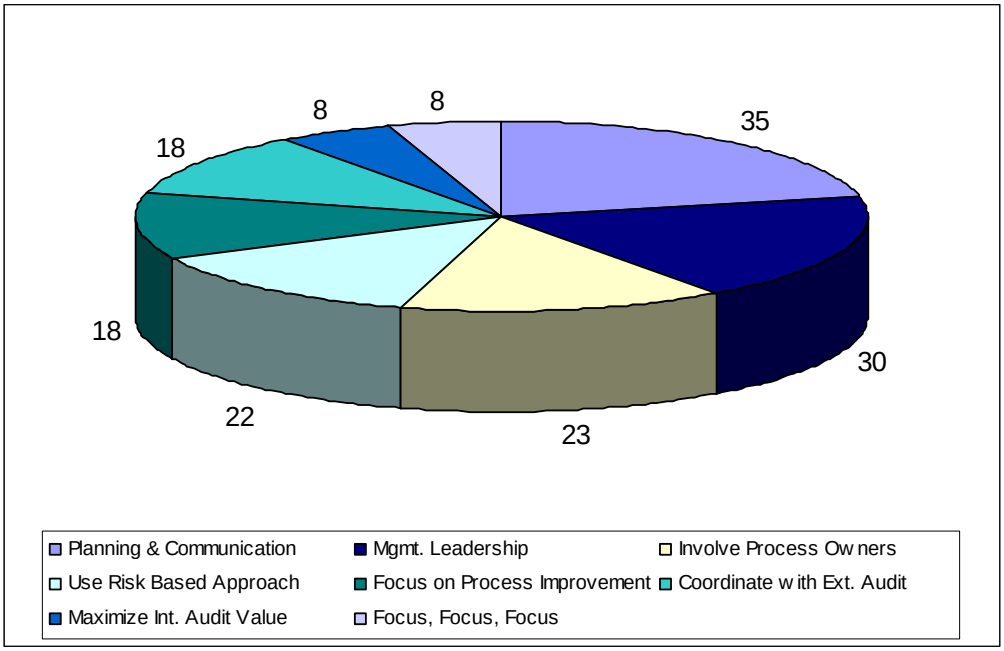
Lessons Learned

It is important that we learn from the efforts made by all those involved in this year's process of meeting the regulatory requirements. The responses are somewhat as expected, e.g., get involved earlier, develop a consistent methodology, automate controls and the documentation process as much as possible, reinvest in the control system (like other processes it needs adequate resources). We probed each of these areas to develop a deeper understanding of the processes.

We have summarized the major comments in Exhibit 18.

Exhibit 18
Lessons Learned for Going Forward
Number of Responses



It is not unusual to significantly underestimate the time it will take to accomplish a particular task. Thus, the number one recommendation is to plan the project early — and in detail with assigned responsibilities and timetables for completion. The plan must include the necessary training of the process owners, as well as developing consistent control and documentation guidelines to be used throughout the organization. Management can play an important role in providing support for the project. Respondents phrased it in various ways, but all essentially followed the tone of the comments below.

Need for Supportive Management

"Audit committee and CEO active support are essential to people taking the process seriously."

"Board and execs must have robust understanding of control systems, and set right tone."

"Senior line management needs to be actively engaged in process — cannot be delegated to a special 404 staff."

We like two comments that really summarize the lessons:

"START NOW"

and

"Anyone can make something complicated, but few can make it simple."

AUTHOR ANALYSIS

The common theme we saw from the respondents is that management must take ownership right away, set the tone for a constructive exercise rather than just meeting regulatory requirements, involve the process owners to help embed the control consciousness in the organization, apply a risk-based approach to determine the areas needing greater focus, do not wait too long to evaluate technology and IT controls, and most important, START NOW! The respondents did not uniformly recommend a software package, and did not uniformly recommend who should own what role. However, they did recommend that the organization develop uniform policies and procedures, and that there are significant advantages (and sometimes cultural difficulties) in communicating to all organizational units the ONE standard for effective controls.

Recommendations to Regulatory Agencies to Improve the Process

Auditors, management, and process owners dealt with significant uncertainty this year as they attempted to address the legislative requirements while waiting for the PCAOB to issue audit standards and guidance. We asked for the CAEs' insights on lessons to be learned from having dealt with the Section 404 control processes for a year. We also asked for their recommendations to regulatory agencies which would continue to achieve the legislative objectives, but would be more practicable and cost effective. A summary of their responses is shown in Exhibit 19.

Exhibit 19
Recommendations to Legislative Agencies

Nature of Recommendations	Number	Percentage
Clearer Direction on Requirements • Material deficiency • Threshold – needs to be more reasonable • Understand integration of accounting & other controls	44	29%
More Detailed Guidance • Industry guidance • Smaller business • Apply definitions in IT environment • Standardized approaches	33	22%
Less Detailed, More Principles-based Guidance • Less detail, more concepts • Keep framework simple • Allow management more flexibility in achieving objectives as long as objectives are achieved	16	11%
More of a Risk-based Approach • Allow risk to differentiate work • Focus more on management, less on transactions	14	9%
More Focus on Control Environment • Too much emphasis on transactions • Include systematic evaluation of compensation schemes	9	6%
Expanded Role for Internal Audit	9	6%
Less Focus on Documentation	6	4%
Other: • Reduced version for smaller companies • Develop lessons learned • Drop independent auditor attestation • Understand control correction is part of the process, i.e., there is no deficiency when errors are identified by the control system for correction	20	13%

Some of the responses were predictable. Auditors want more precise guidance. An interesting question, analogous to the debate in financial accounting standard setting, is whether guidance can be "principles-based" or whether the guidance must be detailed. While it seems that all auditors and accountants endorse a "principles-based" approach to accounting and auditing, they want the certainty of detailed prescriptions.

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Some of the other responses are quite insightful:

- Error identification and correction are normal parts of a good control system; thus, if the system identifies and corrects errors as a regular part of the process, there is no control deficiency,
- Encourage auditors to spend more time looking at the "tone at the top" and considering the implications on the overall financial statement assertions,
- Include specific requirements to evaluate the effect of compensation schemes on management motivation and how the schemes may affect the overall control structure,
- Understand that it is difficult to segregate accounting and other controls, and
- Allow the organization to follow a risk-based approach to identifying and evaluating controls.

AUTHOR ANALYSIS

The tension between "principles-based" standard setting and detailed guidance is interesting, and applies to control evaluations just as much as it does to financial accounting. The respondents seem to indicate they are capable of making "principles-based" decisions, and perceived PCAOB Audit Standard 2 to be prescriptive rather than principles-based. They also found the definitions of significant and material deficiencies to be somewhat abstract. The most important issue, from our viewpoint, is that if the regulatory agencies want to move to a "principles-based" approach to standard setting, the standards must be conceptual and capable of relative uniform implementation of professionals. It also means that we must wean professional accountants/auditors away from reliance on checklists and detailed guidance and instead require informed decisions based on a solid understanding of the concepts and evidence of control effectiveness. This is an education process that must begin in our universities and must be reinforced by every aspect of practice.

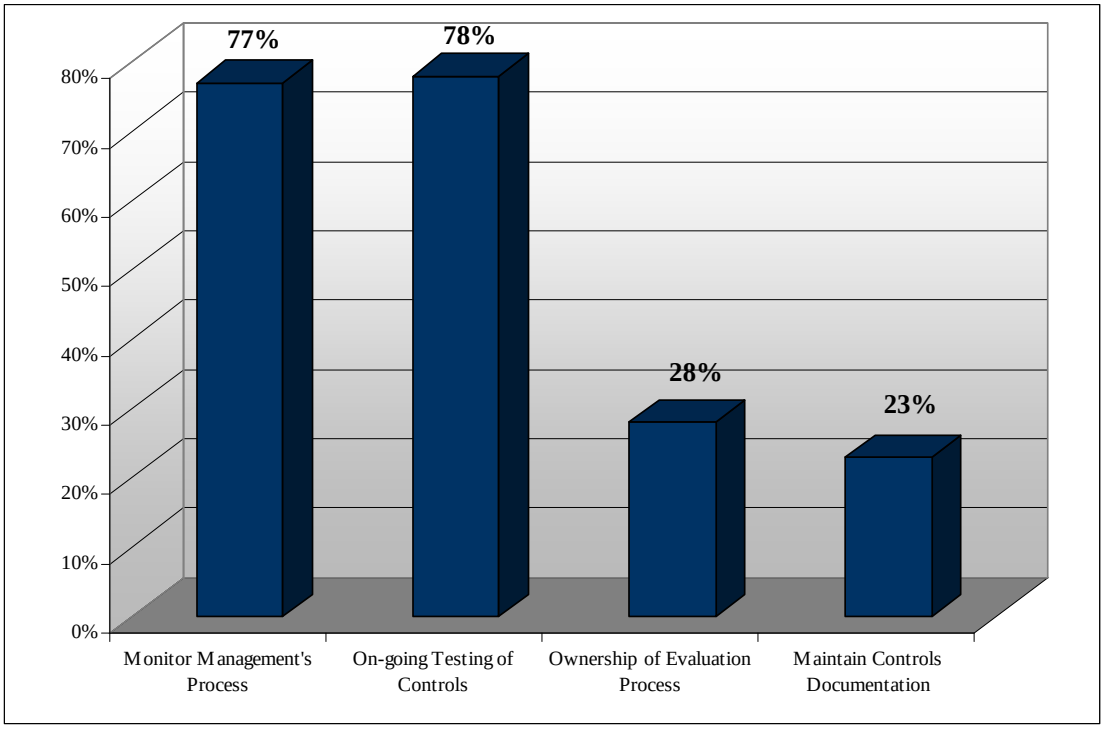
Future of Internal Auditing

To date, most organizations have focused their Section 404 efforts on achieving first-year compliance, and not on creating an ongoing, repeatable compliance process. In many instances, the organizational responsibilities and structures to support an ongoing assessment process, as well as supporting tools and technologies, have not yet been implemented. As noted earlier in this study, internal audit has played a significant role in most organizations' first-year compliance efforts — ranging from 20% of organizations in our survey who assigned the overall responsibility to internal audit, to the 65% of the organizations where internal audit was responsible for the testing of controls. In this environment, a clear question emerges on the future role of internal audit: How much will internal audit "own" of Section 404 compliance going forward?

To help answer this question, our survey included two forward-looking questions — one asking participants to describe the role of internal audit regarding 404 work looking ahead, and a second asking participants to describe their expectations for the level of internal audit work in the coming year in a variety of potential audit areas, including Section 404.

The answers to the first question are noted graphically in Exhibit 20 and suggest the heavy ongoing involvement of internal auditing in Section 404 compliance efforts, or at least in the monitoring and testing processes. The vast majority of respondents see internal audit as the responsible function to monitor management's Section 404 compliance processes. Given internal audit's responsibility to help monitor risk management and governance processes in an organization, this is not surprising. Perhaps what is surprising is that 23% of the respondents did NOT see this as internal audit's role!

Exhibit 20
Likely Role of Internal Audit Looking Forward
% of Total Survey Respondents

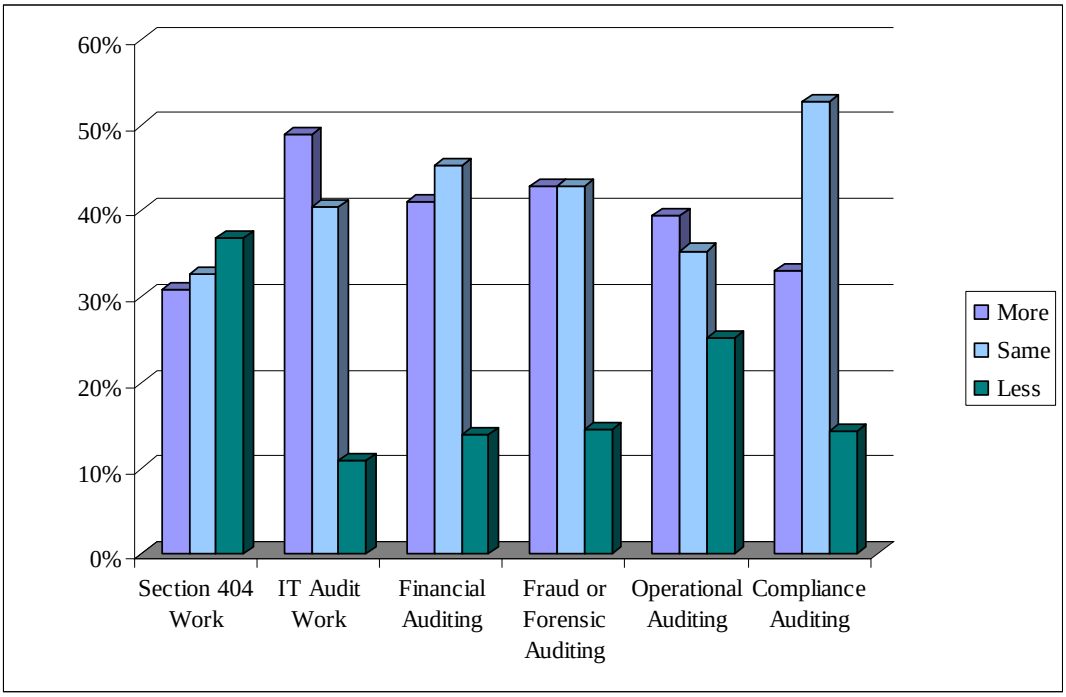


In addition, over 75% of the survey participants believe internal auditing will be responsible to conduct the ongoing testing of control effectiveness to support management's year-end certification. Given that internal audit houses the control expertise for most organizations, this result is, again, not surprising. The internal auditing profession's view, as described in the May 2004 position paper from The IIA titled "Internal Auditing's Role in Sections 302 and 404 of the U.S. Sarbanes-Oxley Act of 2002," is that internal audit should support management's compliance effort, to the extent this support does not impact objectivity or the ability of internal audit to cover major risk areas in the organization. The guidance recognizes that internal audit may be called upon to assist in the design and execution of testing, but reinforces management's responsibility for testing. It appears that most organizations are still choosing to have internal audit take on the total testing responsibility.

What is surprising is the percentage of companies planning to have internal audit responsible for maintaining controls documentation (23%) or for overall ownership of the evaluation process (28%) — areas generally viewed as the clear responsibility of management: the controller, a compliance manager, and/or the business process owners.

We also sought information as to where internal auditing was likely to go in the future, i.e., would they focus on risk management, operational audits, IT audits, or would they become a slave to Section 404 work and management and the audit committee's need to focus on financial reporting controls? An overview of the responses is shown in Exhibit 21.

Exhibit 21
Expectations Regarding Nature of Internal Audit Work in Coming Year



Recall that the expectations in Exhibit 20 are based on the work that internal auditors performed this year, i.e., most internal auditors had devoted a significant portion of their audit resources to Section 404 work. Thus, we wanted to know — starting with this biased base — if internal auditors would be switching back to operational or compliance audits.

The results are mixed: they expect to reduce the amount of 404 work, but do not expect a significant change back to operational and compliance audits. The area of biggest new effort will be IT audits — a common theme among the control findings. Their responses also show a continuing focus on Section 404, thus somewhat limiting the extent of other value-added services internal auditors have been providing in the past decade.

Exhibit 22
Future Work Planned for Internal Audit

Nature of IA Audit Work in the Next Year	Less or Substantially Less	Same	More or Substantially More
IT Audit Work	11%	40%	49%
Fraud or Forensic Auditing	14%	43%	43%
Financial Auditing	14%	45%	41%
Operational Auditing	25%	35%	40%
Compliance Auditing	14%	53%	33%
Section 404 Work	37%	32%	31%

AUTHOR ANALYSIS

From the respondents' answers and our experience to date, it appears that internal auditing is — at least temporarily — being significantly defined by the pressures of the required assessment of internal controls over financial reporting brought on by the Sarbanes-Oxley Act. This is understandable, as internal auditors have proudly built a reputation of being "internal control experts." But with this current focus, there is also a risk that internal auditing may lose some of its past identity – and reduce its potential contribution to the organization — as it minimizes its operational focus in favor of Section 404 compliance.

There have always been more opportunities for internal audit to assess activities and projects than time and resources would allow. A robust internal audit group has looked beyond control assessment to the broader concepts of risk management and governance for several years. The definition of internal auditing promulgated by The Institute of Internal Auditors clearly describes the broad character of the function:

> "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

One of the CAE's ongoing challenges has been to develop a plan and process, after consideration of these broad areas, which would focus his or her limited resources and provide the most value to the organization. Historically, CAEs have dealt with this challenge by basing their annual audit plan on the results of a rigorous enterprise-wide risk assessment, enabling them with confidence to allocate their resources to topics of highest perceived risk.

In an enterprise-wide risk assessment, all aspects of an organization and key alliances were "fair game" — operating, support, and corporate organizations, as well as contractual partners.

Has this plan development process now changed, or does it need to change? That is, are CAEs now faced with allocating a significant percentage of their available resources to Section 404 compliance activities regardless of the risk profile, with the remaining leftover time, if any, available for risk-based auditing? If so, has the function been relegated to a legal compliance/quality assurance support function for management's assertion? Alternatively, one could conclude that Section 404 compliance, due to the associated legal and regulatory requirements and the potential for harm to the organization's reputation, is defacto a "high risk" activity warranting internal audit's attention.

Our survey does not hold the answers to these questions, and we suspect the answer varies by organization and size of internal audit function. However, we do believe that focusing only on Section 404 compliance without a significant focus on operational processes and controls will lead to a decreased value of internal audit to the organization. Early reviews of the COSO Enterprise Risk Management framework indicate that companies can enhance the effectiveness of their control activities — from a broad operational viewpoint — by embedding risk management activities within the culture of the organization. We believe the chief audit executive needs to be proactive in developing risk-based audit plans and in making the case for the incremental resources to address and reduce the identified risks. In other words, we do not believe that internal audit should sit and wait for the audit committee to initiate a discussion about the breadth of activities because the audit committee, by necessity, has to have a high priority on Section 404 compliance as organizations win back the public trust.

This conversation is significant. Not only does it impact the character of internal audit, it determines the function's ability to provide value to an organization, and it impacts its ability to attract and retain new talent, as well as changing the hiring profile, training needs, and career development opportunities for the professional staff. CAEs should plan to strategically leverage the Section 404 experience — the heightened visibility of internal audit and increased appreciation for the importance of controls, risk management, and governance throughout the business — to further the value internal audit can provide. Our vision includes a continuation of risk-based audit planning, with internal audit fulfilling an important monitoring role over Section 404 compliance without "owning" Section 404 compliance, and, most importantly, internal audit fulfilling an important risk management and governance role.

SUMMARY

We surveyed 171 practicing internal auditors about their assessment of costs and benefits associated with Section 404 work. Three major themes emerged in the survey:

First, there are significant benefits associated with the control identification, documentation, and testing process. The evaluation process has led to improvements in basic internal controls, such as reconciliations. There were substantial improvements in the control environment that came about as a direct result of the process. Many companies recognized they have vulnerabilities in the Information Technology area and will be devoting more resources to improving and evaluating IT controls as they move forward. Companies have more confidence in their control structure and are evaluating accounting risks, which should enable investors to have more confidence in the reliability of unaudited data furnished to the securities market.

Second, the prognosis is that the future costs associated with Section 404 will decrease substantially as we look forward three years. Much of the initial cost came about because controls had not been systematically documented or evaluated prior to the Section 404 requirements. CAEs see the process as becoming more systematized. The authors believe companies will see significant efficiencies as they fully implement the information, communication, and monitoring concepts embedded in COSO's *Internal Control – Integrated Framework.*

Third, there is uncertainty about the future role of internal auditing with respect to Section 404 work. The majority of chief audit executives recognize a need to invest resources in IT auditing. The majority of internal auditors want to maintain a strong presence in the risk and control arena, and recognize the need to perform more operational auditing that continues to add value to the organization. Most CAEs see themselves playing a major role in ongoing monitoring and testing activities associated with Section 404 work. We were a bit surprised that a not-insignificant minority (20%) saw themselves as taking responsibility for Section 404 work. We were surprised because such ownership is inconsistent with both the concept of internal auditing as well as The IIA's *Standards*.

Challenges remain: control evaluation must become more efficient; a culture of risk and control must be embedded in the organization; companies must invest more internal resources in control activities (downsizing had hurt); and companies must invest more resources in the internal audit activity. Our research indicates that the substantial costs in implementing Section 404 work in the first year was necessary because of (a) years of control neglect and downsizing by many companies; and (b) the nature of start-up work necessary to win back investor's confidence. The control processes will become more efficient and effective. We now have some idea about the benefits associated with Section 404 work and our assessment is that the benefits have been underestimated and they are substantial.

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