

## Section 404: Challenges facing European SEC registrants

### About this document

The European Audit Committee Leadership Network is a select group of audit committee chairs from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, advisers and auditors who become systematically engaged in this dialogue, the more value will be created for all.

### Introduction

The European Audit Committee Leadership Network held its first meeting on 17 December 2004. In the meeting and through subsequent individual discussions on “Section 404: Challenges facing European SEC registrants” members stated their view that:

- Companies are actively seeking value from Sarbanes-Oxley compliance
- Section 404 implementation is currently on track but, at least in the short-term, is likely to generate more cost than benefit
- International Financial Reporting Standards (IFRS) will complicate Section 404 implementation
- There are opportunities to learn from companies that are completing the process

The members of the network participating in the meeting and individual discussions afterwards sit on the boards of about 24 large, mid and small cap public companies. They were:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Sir Anthony Greener, Audit Committee Chair, BT
- Mr Jan Hommen, Audit Committee Chair, TPG
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Mr Arthur Martinez, Audit Committee Chair, ABN AMRO
- Mr Tom McGrath, Global Managing Partner – Client Service and Accounts, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, AABS, Ernst & Young
- Sir Ian Prosser, Audit Committee Chair, BP
- Dr Ronaldo Schmitz, Audit Committee Chair, GlaxoSmithKline
- Mr Jon Symonds, Audit Committee Chair, Diageo

## Executive summary

The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages. *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments made during conversations with members are not attributed to individuals or corporations.

- **Companies are actively seeking value from Sarbanes-Oxley compliance** (Page 3)

Members of the European Audit Committee Leadership Network expressed a range of reactions to Sarbanes-Oxley legislation. Many members reported their companies have treated compliance as an opportunity to generate value and see it as a positive signal to boards and audit committees about the importance of their roles and responsibilities. Other members see the legislation threatening greater centralisation for traditionally more decentralised European companies and believe it will prove a costly burden to well run medium and small cap companies. Some companies that see a negative impact have even considered de-listing from US markets.

- **Section 404 implementation is currently on track** (Page 4)

Among the companies in the European Audit Committee Leadership Network, Section 404 compliance work is well under way and members are confident of meeting the deadlines for compliance. Many members indicated that their internal controls would be identified and documented by the end of 2004. In the words of one audit chair: *"We are grinding through it"*.

- **Section 404: More cost than benefit in the short term?** (Page 5)

Members also have mixed views about the benefits of Section 404. Those who believe there will be benefits say that Section 404 has made companies' process problems more visible, improving both internal control and productivity over time. They also believe that because many European companies have outdated manual controls, Section 404 compliance will be more costly in the short term but ultimately more beneficial than in the US. Members taking the opposite view believe that: *"The rush to compliance ... is overruling any process improvement"*. They fear that internal control work is being driven by the external audit firms in a one-size-fits-all approach, not a business needs approach.

- **International Financial Reporting Standards (IFRS) conversion will complicate Section 404 implementation** (Page 6)

While some members believe that IFRS is a matter for management, not the audit committee, other members insist that the audit committee must understand management's rationale for choosing particular accounting policies and the implications of those policies for communication with investors. Members indicate that IFRS conversion can have a significant impact on the resources of the finance operation and senior management, and are concerned that undertaking IFRS and Section 404 efforts simultaneously could lead to a diminution of quality for both.

- **Opportunities to learn from companies that are completing the process** (Page 7)

Section 404 compliance efforts among network members' companies are mostly being led by the financial controllers' group, with much of the work undertaken in the business units themselves. This approach contrasts with many US companies that focused their efforts through the internal audit function. Although US audit chairs only started to discuss the reporting requirements of Section 404 a few months before the compliance deadline, a similar discussion has already started in Europe. Members question whether the investor community understands what it means if a company discloses a material weakness in its internal controls.

## Companies are actively seeking value from Sarbanes-Oxley compliance

On 30 July 2002, US President George W Bush signed into law the Sarbanes-Oxley Act, which mandated a number of reforms to enhance corporate responsibility and restore investor confidence. Members of the European Audit Committee Leadership Network expressed a range of reactions to Sarbanes-Oxley legislation:

- On the positive side, as one member pointed out: *“...it is hard to say that Sarbanes-Oxley is a bad thing. It offers protection, transparency and prevents accounting problems. ... There are enough situations where inadequate internal controls, sleepy audit committees, or imperial management existed and you have to try and fix them all. This was one step to fix one part”*. Another member saw the legislation as a *“signal to companies, boards and audit committees, if they need it, and some of them did need it. ... The impact of the law will have a positive effect”*.
- Other members indicated that this regulation is perceived as *“the long arm of US regulation reaching into jurisdictions where it should not be”* and represents the creation of what one member describes as a *“bureaucratic monstrosity that tries to close the stable door after the horse has already bolted”*. Another member said: *“It has become a laborious administrative exercise with less value than cost”*.

Some members also felt that Sarbanes-Oxley had targeted the wrong issue, believing it should have focused on how companies are led and thus created a separation of roles and responsibilities between the chairman and CEO and strong boards of independent directors.

While all members acknowledge their responsibility to ensure compliance, many are actively seeking value from their investment in Section 404 compliance through improvements in financial processes. One audit chair stated: *“[Management] entered into this looking for value. ... They wanted to see if there are better ways to do what we are doing”*. However, some companies that see a negative impact have considered de-listing from US markets.

### Concerns for European companies

A number of members suggested that Sarbanes-Oxley represents the centralised nature of many US companies and therefore presents a centralising force for more decentralised European companies. One member commented: *“If you are not careful, Sarbanes-Oxley drives you towards typical US centralised command and control. If you have a decentralised organisation it adds more complexity”*. Another member noted that such legislation is rarer in Europe: *“We have chosen a different way ... [preferring] professional recommendations and reports leading to a very pragmatic approach”*.

While larger companies may be able to cope with Section 404, members are concerned about the huge burden on well run medium and small cap companies in Europe, with one member commenting: *“There is a difference between good practice and stifling regulation”*. One audit chair spoke of his fear that the overall impact will be to *“reduce the competitiveness of European companies”*. Ironically, another member sees the US legislation as actually enhancing the comparative attractiveness of European capital markets.

## Improved relationships among the audit committee, management and internal and external audit?

It has been asserted in the US that Sarbanes-Oxley has improved the quality of interaction and clarity of roles among the audit committee, management, the internal auditor and the external auditors. Members of the European network differed in their view of whether or not this aspect of Sarbanes-Oxley was emerging in Europe:

- **In the UK:** One member described the general governance environment in the UK thus: *“Ten years ago the audit committee was the elephants’ burial ground consisting of the most junior directors, the non-performers and the soon to retire. [Intellectual] horsepower was reserved for the compensation committee. Now, directors on audit committees are sharper in questioning and more engaged in the business of the committee. Greater weight is given to the opinions of the internal auditor. Greater weight is given and more expected from the external auditor”*. This, he said, was not driven by compliance with Sarbanes-Oxley, or concerns for individual liability, but by fear of personal embarrassment.
- **In continental Europe:** One member said: *“The relationship between the audit committee, auditors and management has not changed. It may change a little as we go through the [Section 404] process. However, the relationship between external auditor and management has intensified due to the workload”*. Another member said there was a *“laissez-faire, status quo attitude in some parts [of Europe] but there is clearly progress, too”*.

## Section 404 implementation is currently on track

Section 404 of the Act requires that: “each annual report of a company ... contain (1) a statement of management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management’s assessment, as of the end of the company’s most recent fiscal year, of the effectiveness of the company’s internal control structure and procedures for financial reporting”.

European foreign private issuers must comply with Section 404 for fiscal years ending on or after 15 July 2005. From a practical standpoint, the majority of European SEC registrants will need to be in compliance by 31 December 2005 – approximately 12 months from the date of the European Audit Committee Leadership Network’s first meeting.

Studies indicate that the majority of US companies have consistently underestimated critical aspects of Section 404 implementation, including the number of controls to be evaluated and tested, the total level of effort required to complete the project, the length of time required to complete it, and the level of involvement required from executive management and the audit committee.

Last year the Big Four audit firms sent letters to their US clients that were intended to help company management and the board determine their ability to fulfil Section 404 requirements. Anecdotal evidence in the US suggests that less than 20% of companies received positive feedback, with another 65% falling into a broad category where the auditors were unable to provide assurance that the assessment and report on internal control over financial reporting would be completed by the filing deadline. Given the status of their Section 404 activities, the remaining 15% of companies were deemed unlikely to have met the SEC’s requirements within the reporting deadlines.

Among the companies represented by members of the European Audit Committee Leadership Network, Section 404 compliance work is already under way. Companies have established a project management process that has four general phases of Section 404 compliance work – documentation, assessment, testing and remediation.

Many members indicated that their internal controls had been identified and documented by the end of 2004. Several members echoed the words of one audit chair: *“We are grinding through it”*. Members were confident that they would meet the deadline for compliance and would not require any further extension. However, some members felt they were at what one audit chair called, *“the ragged edge”* to meet 2005 compliance.

Members revealed several issues already emerging from their implementation work:

- Software tools that have failed in their individual IT environment
- Difficulty in obtaining advice from external auditors on the level of documentation required: *“We are needlessly building out [documentation] in the absence of firm guidelines”*
- Inconsistency in the state of internal control across business units and geographies. As one member put it: *“Some are well ahead, others way behind”*
- Challenge of documenting internal controls in cultures with a *“trust based system of controls”* where business is mostly conducted orally: *“We underestimate how much education you have to put in place to get people to first base”*
- The need for perfection: *“We can’t expect every little part of our business to be foolproof”*

Network members feel they are receiving regular and adequate updates from management and that there are resources – both internal and external – available to their companies, even taking into account the contemporaneous programmes for IFRS conversion. Members report that management has already mapped thousands of internal controls across their organisations. However, they are already beginning to question the value of documenting some of the more formal controls: *“When is 404 completed? When you have two metres of documentation on your bookshelf”*.

## Section 404: More cost than benefit in the short term?

With a range of views on Sarbanes-Oxley as a whole, it is perhaps unsurprising that members also have mixed opinions about the benefits of Section 404. One member pointed out that: *“The big improvements are typically a year out, as people push to comply in year one. If Section 404 is handled as a compliance exercise you will get a compliance exercise. The example of FDICIA<sup>1</sup> shows that the banks that went for benefit, got it over time”*.

- **Looking for benefits.** Members who believe there will be benefits to be had from Section 404 say the legislation has made companies’ process problems more visible, which will improve both internal control and productivity over time. These audit chairs also recognise the impact of modernising manual controls in their businesses, leading to business transformation. One member said that by reorganising the finance department at the same time as implementing Section 404, there is an opportunity to eliminate duplication. Another member talked about the benefit of

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<sup>1</sup> Section 112 of the 1991 US Federal Deposit Insurance Corporation Improvement Act (FDICIA) deals with internal controls.

improving oversight of people and controls in remote locations: *“You can’t afford to have accident prone areas any more”*.

Some members believe that in Europe, with distributed financial functions, lack of consistency and many companies with outdated manual controls, compliance with Section 404 will be more costly in the short-term than in the US but also provide more benefit in the long-term. One member stated: *“European companies may have more benefit as we are starting further behind”*. Another member said: *“In many major publicly listed companies in Europe, the standard of internal control is not sufficient”*.

- **Looking for compliance.** Members taking the opposite view believe that: *“The rush to compliance – driven by the fear of failing – is overruling any process improvement”*. They fear that internal control work is being driven by the external auditor firms in a one-size-fits-all approach, not a business needs approach. *“The demands of Sarbanes-Oxley stop businesses doing what they should be doing – modernising and moving forward – because we have to [implement Section] 404.”* One member even felt that: *“...unless interpreted in a pragmatic way, [Section 404] may even be detrimental to normal business control”*.

Members have commented on the difficulty of estimating the budget required for Section 404 efforts, with one member indicating that their estimates *“have a 100% error rate”*. This may be because, while it is easier to identify the costs of the external auditors, it is problematic to identify the internal costs in staff hours. One member invoked Parkinson’s Law that work expands to fill the time available<sup>2</sup>. Another member said: *“We are using 60 man-years from people we’ve already got. The opportunity cost is what they could be doing. It’s not the end of the world. Well-organised companies are used to this sort of thing. My concern is for other, smaller companies”*.

Members define external costs as those including advisers and auditors, but most can only estimate the external auditors’ fees as a proportion of the standard audit fee. These estimates vary from 30-100% of the standard audit fee in year one. There is even more uncertainty with regard to year two costs, with major decisions about whether to seek business process improvements in year two.

## IFRS conversion will complicate Section 404 implementation

While leading European companies’ IFRS conversion efforts have been under way for months, the additional requirements associated with conversion come at a time that, as one member put it, *“does not make these things [Sarbanes-Oxley compliance] any easier for us”*.

Members have different views on the role of the audit committee in IFRS conversion:

- **Management-led process.** Some members believe that IFRS is a matter for management, not the audit committee. In the words of one audit chair: *“Each business must organise itself appropriately. We are interested in the outputs not the process of getting there”*. These members expect regular reports to the audit committee to track progress – *“if there are hiccups we should be involved”*.
- **Audit committee oversight.** Other members insist that the audit committee must understand management’s rationale for choosing particular accounting policies. One member commented: *“IFRS is an exercise in communication, not technical accounting. ... Shareholders have never*

<sup>2</sup> C. Northcote Parkinson, “Parkinson’s Law: The Pursuit of Progress”, London, John Murray (1958).

*really understood what goes on in the accounting engine. As audit committee chair, I have been interested in this as a communication process. There is also a behavioural component about how to manage the company differently”.*

However, members indicate that IFRS conversion can have a significant impact on the resources of the finance operation and senior management, particularly for smaller companies. Companies will need adequate internal controls over all the accounting changes that are taking place. As one member pointed out: *“The accounting change is huge. Significant resource is needed. Internal controls need to stand up to these new standards”.*

Members are concerned that undertaking IFRS and Section 404 efforts simultaneously could lead to a diminution of quality for both. *“The big question is, ‘will the regulators create a monster that will confuse everyone?’. IFRS adds complexity to the process. The interpretation of IFRS comes first. 404 will be tacked on afterwards”.* Another member agreed with this sentiment, saying: *“These two tasks will have to be dealt with successively”.*

## Opportunities to learn from companies that are completing the process

Members expressed concern that the implementation approach to Section 404 in the US is being driven by the external audit firms’ need to meet PCAOB standards, rather than management’s need to adopt a business-led approach to mitigate potential risk issues in particular companies. Now they worry that: *“The audit firms ... are doing the same thing here. It is an infection from the US”.* Another member revealed that he was trying to get more customisation into the work: *“We are learning as we go simply by improving a rigid framework and adapting the process”.*

### Learning from the US experience? Network members have six questions for the audit committee chairs of US public companies:

- How are you defining significant deficiencies and material weaknesses?
- What is the relationship like with your external auditors? What advice can you give us about getting a clean opinion?
- What can be learned from companies that had ‘near misses’ in completing the work?
- In hindsight, was Section 404 a roadmap for improving the internal control environment? Are there benefits to Section 404 implementation, or was this simply a tick-the-box exercise? How would you define the benefits?
- How are you handling the investor communication issues around reporting?
- What action can we take together to ensure Section 404 becomes a value-adding process in future years?

## Controllers, not internal audit, in the driving seat

Among network members, Section 404 compliance efforts are mostly being led by controllers with much of the work undertaken in the business units themselves. In other companies, a specialised compliance function or project team has been created to lead these efforts. The emphasis on the controllers’ group provides an interesting contrast with US practice where internal audit has often taken the lead role. Members of the Audit Committee Leadership Network in North America have

expressed concern about the opportunity cost associated with such an approach, as internal auditors are not available to perform other functions.

One European network member said his company had consciously decided that controllers should lead the effort in order to maximise the potential benefits of financial process reengineering. Another member felt that using the controllers' group better reflected the decentralised nature of his company. In another company, the work was moved from internal audit to a dedicated project team since *"...internal audit wouldn't be able to perform their regular function and we would have to abandon a robust internal audit plan"*. That company is still planning to use internal audit to undertake testing of the work being driven by the central finance function.

However, one member warned that, based on US experience, companies that have started the Section 404 process late may well find they have to bring in the internal audit function as an additional resource. If this does happen, he suggested that companies should be diligent in protecting the internal audit function's objectivity.

### **Clear leadership required**

Regardless of which function is involved, members agree that senior management must embrace the work: *"If management is not taking responsibility, [Section 404] is more difficult to do, regardless of function"*. Another said clear leadership is required: *"If people feel the company is not committed, they are not committed either"*. In order to encourage senior management sponsorship, one company has made gaining a clean opinion on internal controls a condition for paying senior executive bonuses.

One audit chair told us that securing the involvement of business unit management was also critical to ensure that they *"...are taking a commercial view of the risks and benefits of putting [internal controls] right. Compliance will cost a lot and we will look at all possible returns in efficiency"*.

### **Section 404 reporting requirements**

Although US audit chairs only started to discuss the reporting requirements of Section 404 a few months before the compliance deadline, a similar discussion has already started in Europe. Members question whether the investor community understands what it means if a company discloses a material weakness in its internal controls. For instance, members are interested in whether investors will see a difference between a material weakness in interpreting US GAAP accounting principles and a material weakness caused by a lack of control over financial reporting that could lead to the misappropriation of assets. Members noted that the credit rating agency, Moody's Investor Services, has started to categorise aspects of material weakness in internal controls.<sup>3</sup>

One member declared: *"US GAAP is not our primary accounting. We have to have internal control to cover US GAAP but that's not how our companies think, it is not how we measure or reward people. If that is a problem [under Section 404] the market shouldn't be punitive"*. Members feel that because investors do not understand internal control issues, they will see Section 404 compliance as a *"box ticking exercise"* and will not take the time to understand why companies want to respond in a more individual way.

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<sup>3</sup> "Section 404 Reports on Internal Control: Impact on Ratings Will Depend on Nature of Material Weaknesses Reported", Moody's Investor Services (2004).

## Conclusion

Many audit committee chairs in the US have said that Section 404 implementation has proved to be a time and resource consuming activity which to date has produced little in the way of business benefit. Meanwhile, many European audit chairs are facing additional hurdles, including the contemporaneous conversion to IFRS accounting standards. However, most European network members are confident that their companies will meet compliance deadlines, learn from the US experience and ultimately – because many European companies are starting from a worse position on internal controls – they may reap greater benefits from Section 404 compliance.

*The views expressed in this document represent those of the European Audit Committee Leadership Network, a select group of audit committee chairs from Europe's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.*

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