Assurance and Advisory
Business Services

January 2004

Ernst & Young
Quality In Everything We Do

Emerging Trends in Internal Controls

Initial Survey

The survey results and observations included herein are not scientific. The results are meant to provide you with general information as to how companies are acting and reacting to key issues they encounter in implementing the requirements of Section 404 of the Sarbanes Oxley Act of 2002.

To Our Clients and Other Friends

Implementing Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404) is one of the most involved processes companies are facing today. We continue to share what we know about how other companies are approaching key issues. As a result, Ernst & Young has begun an ongoing process of surveying companies and gathering needed information, which we will distribute to you.

We recently completed a survey of 100 major businesses — representing virtually all industries in today's marketplace — about their Section 404 preparations and processes. In addition, we collected information from hundreds of other meetings we have had with global company executives. Our findings and observations from those interactions have helped us identify what we believe are emerging trends and practices — consistent themes among companies as they try to build effectiveness and efficiencies in their processes and embed control consciousness throughout their companies.

Some key issues addressed:

- Companies in our survey initially budgeted from 10,000 to 200,000 hours for the Section 404 project. We explore several lessons learned by companies seeking to contain costs.
- Companies continue to struggle with their approach around company-wide controls, information technology-based controls, and transactions processed by third parties. We analyze the approaches currently being deployed in each of these areas.
- With less than six months until initial reporting, our survey provides a "snap-shot" of where companies are in the process.

This knowledge is important now — and will continue to be so — as your company completes its implementation. We hope our ongoing research and communication process will help you measure your efforts against those of your peers. Ernst & Young will continue to observe and analyze key issues around Section 404 and will provide periodic updates to you to help make your path more confident and predictable.

To provide comments, ask questions, or obtain additional information, contact Tom Bussa, Global Director of Business Risk Services at thomas.bussa@ey.com or your local Ernst & Young office.

Ernst & Young

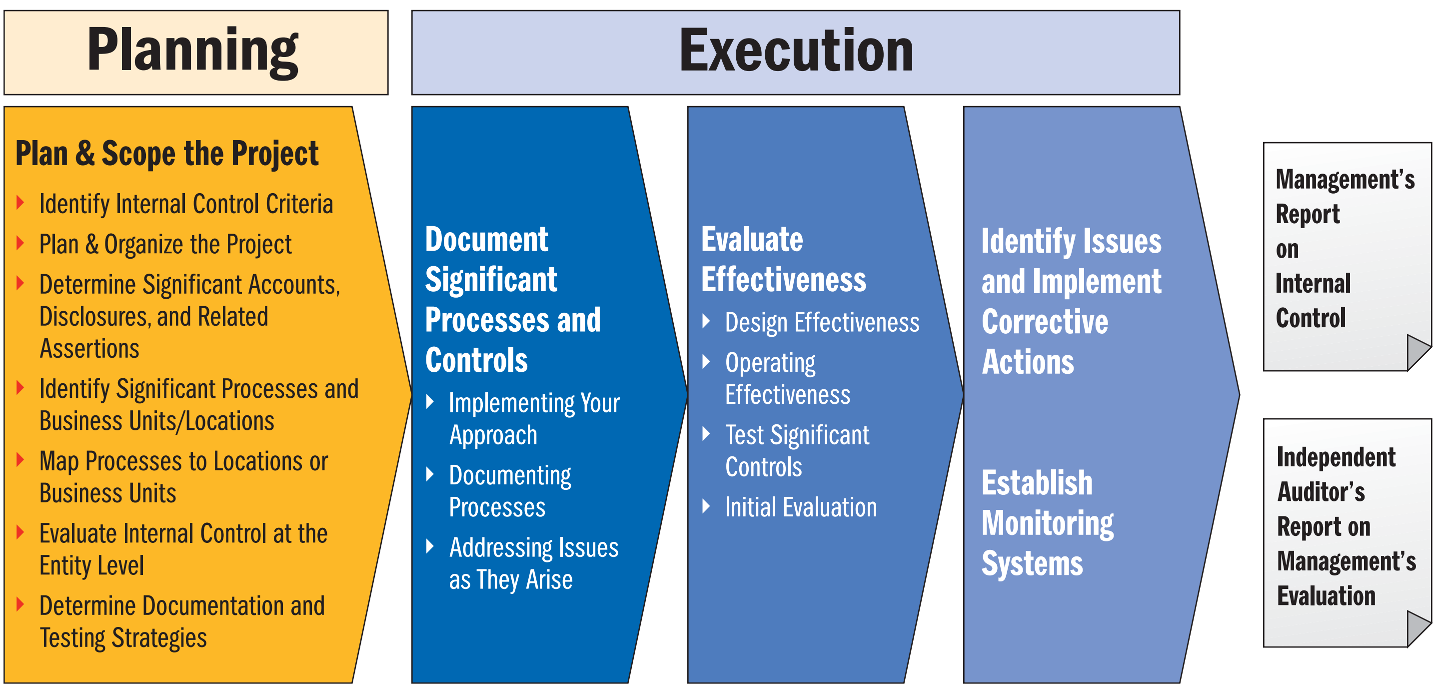
UPCOMING:

February - What Does "404+1" Look Like, and What Should You be Thinking About Now?
March - Updated and Expanded Survey Results

Process Overview

At a high level, the process from start to finish looks easy. But as it has been said many times, “The devil is in the details.” In organizing our data and in communicating the findings and observations, we decided to keep it simple in order to identify key issues, which span industry, company size, and Section 404 approach. Therefore, we have developed a high-level framework to address Planning and Execution. Further, we will analyze Execution across Documentation, Evaluation, and Remediation.

At this time, Section 404 project work is still mainly in the documentation stages of execution. While some companies are in the evaluation and remediation phases, it is too early to provide significant findings and observations of each of the final three phases individually. However, there are several broad execution trends that we can share here. As we gather substantial information on each of the phases, we will share the key issues, findings, and observations across documentation, evaluation, and remediation.



Planning

KEY ISSUE — WHAT IS THE LEVEL OF EFFORT ON INITIAL IMPLEMENTATION AND COMPLIANCE?

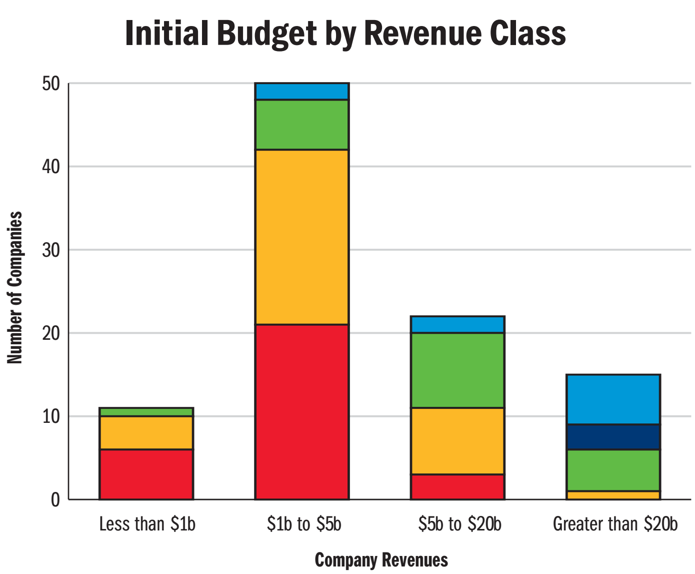
Companies have had to start this significant effort without the benefit of clearly defined regulatory guidelines. However, now that the PCAOB has issued proposed rules, both company and auditor requirements are becoming much more clear. But across the board the effort is larger than initially envisioned, and everyone wants to understand if the amount of work they are doing is reasonable, and what steps can be taken to minimize unnecessary activities.

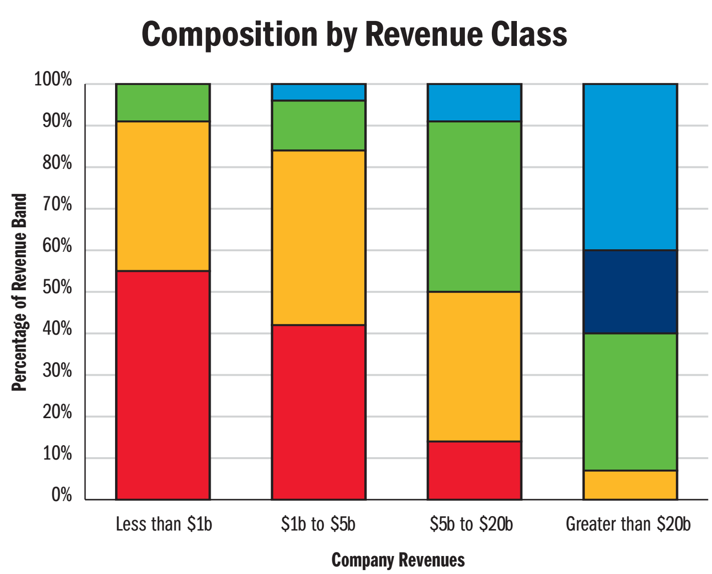
Findings

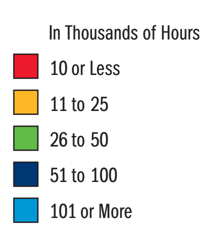
The effort of 70% of all companies surveyed is greater than 10,000 hours, with 36% planning to incur greater than 25,000 hours. Of the companies with over $100 billion in sales, 40% plan to incur more than 100,000 hours, with a sizable number in excess of 200,000 hours. Most companies have not included remediation time in their budgets because they are uncertain how to estimate it.

The average hours by size of company is as follows:

Less than $1 billion	8,000
$1 billion to $5 billion	14,000
$5 billion to $20 billion	25,000
Greater than $20 billion	80,000







Ernst & Young Observations

While larger companies spend on average much more than their smaller counterparts, there is no clearly discernable formula to determine the number of hours needed. The degree of effort required depends on a number of factors, including the complexity and geographic spread of a company's operations, its IT environment, the current state of its documentation, and the need to remediate controls. As project teams get further into documentation and testing, we expect to see the initial hours estimate rise to meet the demands of the project.

Over the past year, Ernst & Young has encountered few organizations for which project scope has not been a growing concern; two leading practices for helping organizations manage the "scope creep" have emerged.

First and most important is the determination of the number of processes and locations to document. Management needs clarity on this aspect of scope before implementing their approach to help keep the project team focused, the project well defined, and activities on schedule. This is a critical component — well-defined guidelines can keep teams on target and help them avoid unnecessary steps. The scope should be clearly communicated so that all locations understand whether they need to perform work and to what extent. Leading organizations also establish, early on, specific guidelines for the work, including documentation, and testing protocols that include sample size, materiality, corrective action and review steps.

Second, from a process standpoint, organizations have taken a pilot-based approach before wide-scale roll-out. They identify a significant division, account, or process and complete an exercise at that level in order to understand the dynamics of what is required, the level of documentation that exists, the level of staffing required to complete the exercise, and to identify potential key challenges in getting prepared for evaluation, remediation, and compliance. A solid understanding of the approach leads to better management of the project and helps avoid unnecessary scope creep.

We have also found that leading organizations keep their pilot efforts focused on clearly spelled-out pilot objectives, and avoid the pitfall of using an unstructured pilot to determine the optimal implementation approach.

Managing the Effort – Key Lessons Learned

Approach, Methodology and Resources:

- You can't determine resource needs until the work plan, scope, level of documentation and timelines are finalized.
- Use a pilot project to validate effort/approach – revisit resource needs after completion.
- If taking a decentralized approach, it is critical to establish clear, required minimum standards for documentation and evaluation.
- Involve the independent auditors throughout the project to obtain agreement with project management on key assumptions and processes and to validate project deliverables.
- Manage as an "ongoing" process – build in monitoring mechanisms and anticipate likely business changes, such as information system enhancements and acquisitions.
- Computer controls should be embedded into the approach to derive the most efficient and effective work program.

KEY ISSUE — HAVING THE RIGHT LEADER

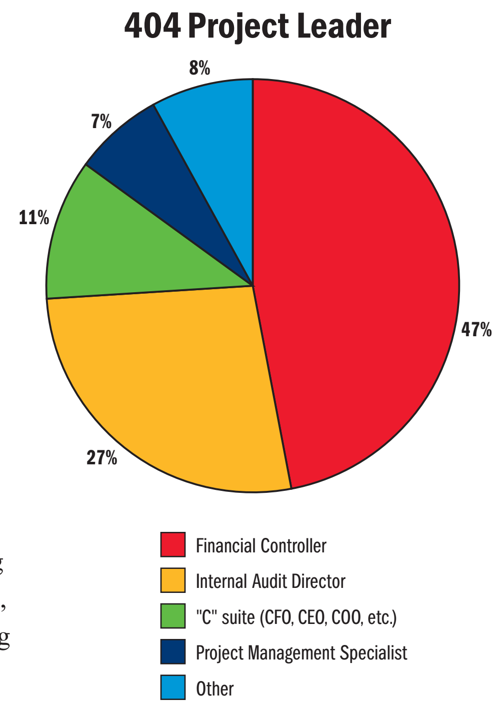
Selecting the right leader for the overall Section 404 project can mean the difference between its success and failure.

Findings

There are a number of potential skill sets companies looked for in their Section 404 project leader. Most important was a solid understanding of financial controls. As a result, 47% of companies opted for someone from the Controller's function to be the project leader. The Section 404 project also comprises an objective assessment of controls, an activity that is core to the role of Internal Audit. The survey results show 27% of projects are led by the Internal Audit Director.

Ernst & Young Observations

The ultimate choice of the project leader will depend on a number of factors, including availability, knowledge of financial controls, project management and leadership skills, and, most important, level of respect within the organization and commitment to setting the "tone at the top."

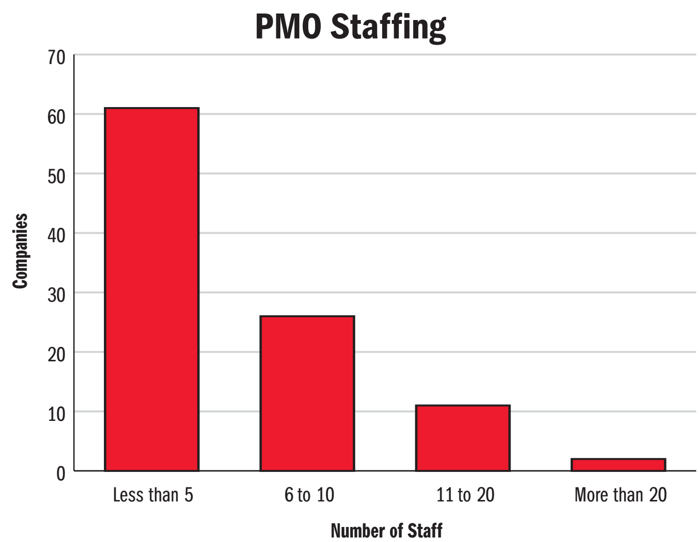


KEY ISSUE — ESTABLISHING A CORE PROJECT MANAGEMENT OFFICE (PMO)

The PMO will carry out detailed planning, manage the project teams, direct communication, and enhance company buy-in to ensure deadlines are met and the work is appropriate. What is the right size for a PMO?

Findings

Most core PMO teams are relatively small. Sixty percent of the companies in our survey had between one and five members in their core PMO teams. All of those teams, however, were supplemented with additional resources, usually from an external Section 404 advisor, often with several full-time staff, particularly in the initial months of the project.



Ernst & Young Observations

Most organizations keep the core PMO team compact, with experienced project management, financial controls expertise, and often an IT component. The core team is often supplemented with additional specialist resources as required.

The core PMO team may be at its largest during the early phases of the project, when the PMO is preparing detailed plans. However, tight project management throughout the process remains an important responsibility of the PMO for, among other reasons, ensuring quality and avoiding "scope creep."

The most common structure has control over the project centralized within a PMO.

- Provides a consistent view of the significant accounts, processes, and locations to maximize approach efficiency
- Supports decentralized approach as to business unit responsibility for documentation
- Establishes the parameters for testing and evaluation, which generally is done by project team members, often qualified auditors assigned to each region or country
- Allows for better management and assessment of pilot exercises during the planning stage

Making It Happen — Decentralized Projects

Challenges

- Inconsistent approach and deliverables
- Business Units fail to deliver
  (Poor quality, time slippage, suffering from initiative overload, patchy/inconsistent support at local level, etc.)
- Lots of noise, but no action from the center can erode buy-in
- Inefficiencies from work being performed without a consistent, common plan
- Lack of external auditor clarity across all locations – differing views on materiality impacts the size of the project

Managed Through

Critical Success Factors

- A flexible approach that can be responsive to different business needs – test using pilots
- Early communication of clearly defined key definitions and required minimum standards
- Engage business units in providing details of work already done, identifying hot spots
- Early identification of business units unlikely to be included in program scope (materiality)
- Early agreement of roles at initial steering committee meeting
- Engage with external auditors early but not before ready
- Consistent communication of "why" as well as "what" has to be done to maintain buy-in
- Maximum use of common templates and project guidelines to support business units
- Foster an environment of honesty about capability and availability of business unit resources

Project Management – Key Lessons Learned

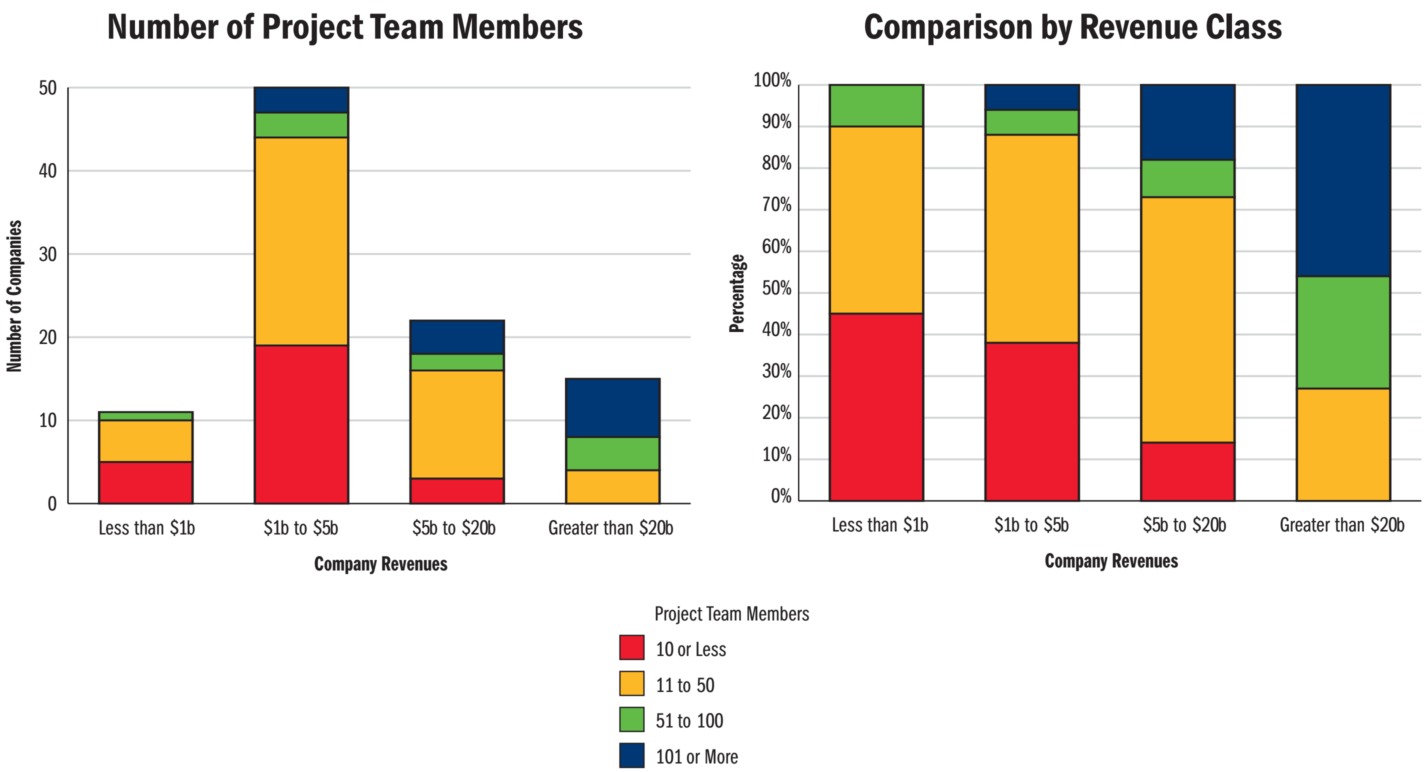
- Project management competencies are critical.
- Use risk assessment to determine higher risk/complex areas – flex the work plan accordingly.
- Section 404 is not just a documentation exercise; focus on the important risks and controls.
- Design the project to extract value (process improvements, consistent policies and controls, reduction of duplicate controls).

KEY ISSUE — WHAT IS THE RIGHT SIZE FOR A PROJECT TEAM?

The project team is made up of those who will champion the Section 404 project, often facilitating documentation at the local level, performing evaluations, and coordinating testing. Determining the right size for the company is a critical step in the planning stage.

Findings

Survey results show the average team is between 11 and 50 people. However, there are teams in excess of 100 people in all revenue categories, indicating that some relatively small organizations are dispersed and complex. Almost 50% of the companies in the greater than $20 billion range have in excess of 100 people on the project team. In this group, some teams comprised more than 500 people. Companies that have taken a distributed approach tend to have smaller project team groups. These numbers do not include the FTEs of third-party advisors.



Ernst & Young Observations

The size of the project team is largely driven by geographical and technological factors, the complexity of the business, the degree of existing documentation, the need for specialists, and the company's approach. We recognize that the challenge is in releasing to this process the number of required resources from other priorities and commitments that compete for their time, attention, and dedication.

To address this issue, we are beginning to see organizations forming scheduling teams that have high-level support for identifying and freeing up business unit personnel for the amount of time necessary to fulfill the requirements of this rigorous process.

Managing large teams can also be an issue. In addition to traditional techniques for managing large projects, various enablers such as virtual team rooms, electronic discussion boards, and real time e-collaboration on issue resolution are being used by leading organizations to ensure that even when teams are dispersed around the globe, they can continue to communicate and work effectively.

KEY ISSUE — WHO SHOULD BE PART OF THE PROJECT TEAM?

The project team will undertake many activities while working on the Section 404 project. These activities cross all processes and business units, and require specific technical expertise. Successful completion requires the right combination of skill sets of the team members.

Findings

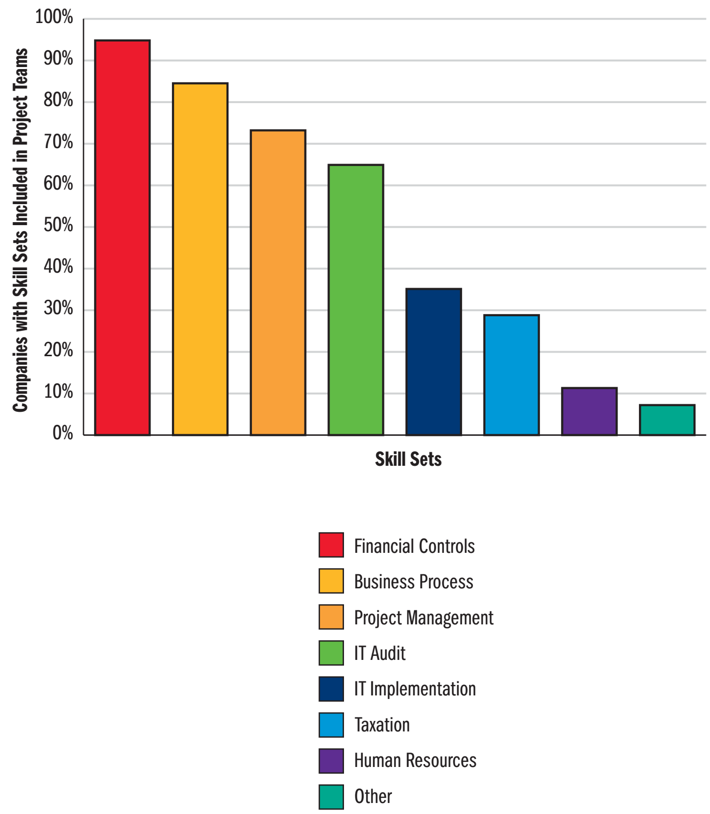
Not surprisingly, most companies surveyed rated financial controls expertise as an important skill. However, not all industries saw this skill as the most critical. In the Retail, Distribution, and Manufacturing and the Energy, Chemicals, and Utility sectors, process skills were considered more important. IT audit skills are heavily deployed within the Financial Services sector, reflecting their reliance on multiple IT systems. A growing number of companies are realizing the need to document their tax accounting processes — many for the first time.

Ernst & Young Observations

The need for people with deep financial controls and process expertise is clear. However, given the scale of the project teams, and the scarcity of these skill sets in many organizations, dealing with the resource issues early will be key to achieving success.

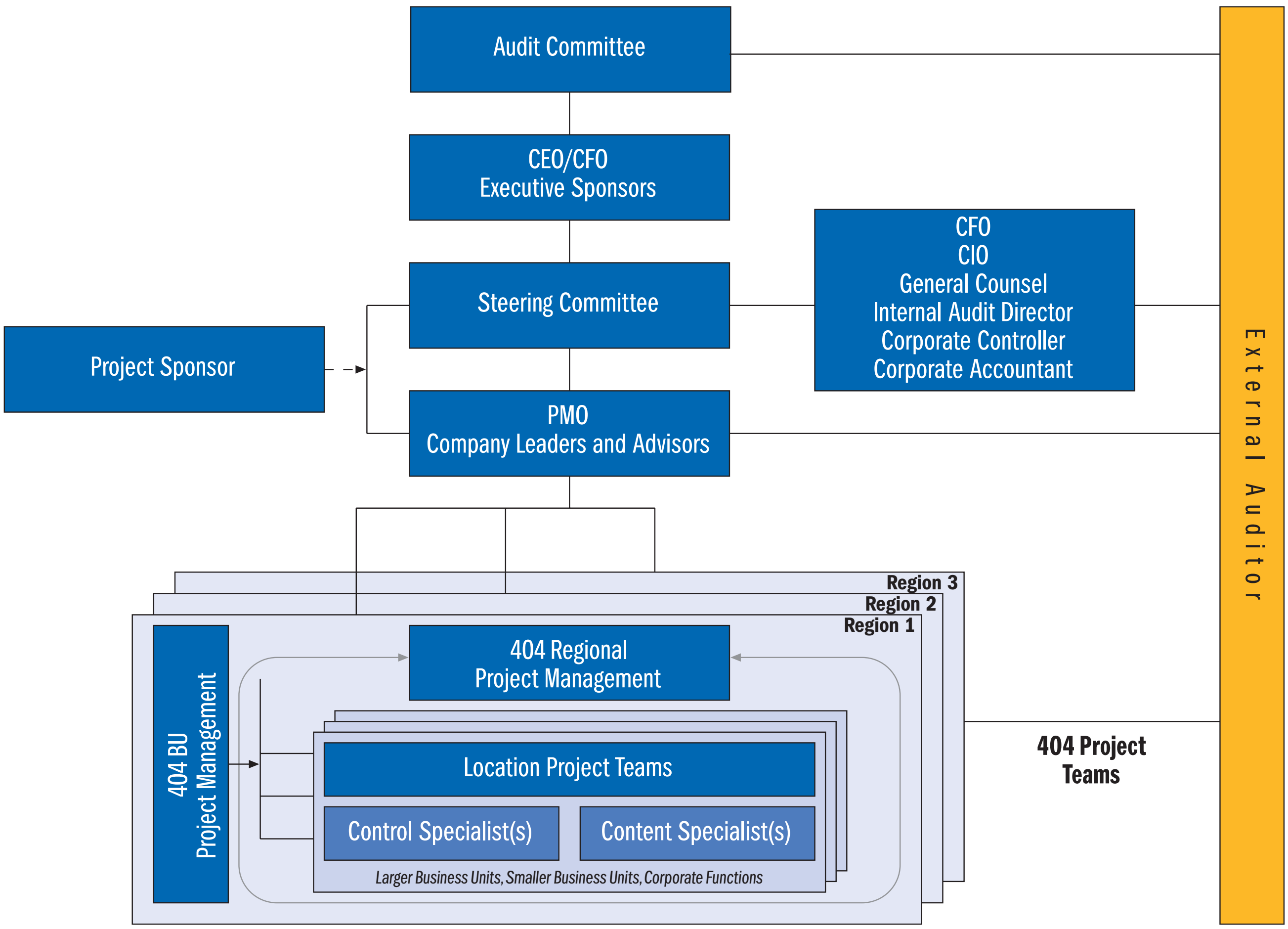
Companies should identify and procure the right resources as early as possible, and use full time rather than part time resources where possible to provide consistency and reliability. Companies can fill in gaps by providing training sessions to "up-skill" employees — for example, provide "auditing for the non-auditor"-type training to bolster the number of people capable of performing documentation and testing.

Skill Sets of the Project Team



Most effective Section 404 project teams combine the controller's function with the internal audit function and other specialty areas within, and outside, the organization. Many organizations recognized the size and skill challenge and opted to team with outside firms to bring the financial controls, IT, tax, and other expertise needed to complete this project. We believe this "team of the future," when sponsored by one of the company's principal executives (e.g., CEO or CFO), is best suited to effectively manage the complexities of the Section 404 project, both for the initial management assertion and for ongoing assessment and reporting.

Sample Project Team Structure



People – Key Lessons Learned

- Required skills are not always resident to the degree required and located where needed (internal, external, technical, industry, or process).
- Management should be clear and explicit in determining the skill requirements needed at the outset.
- Executive time is critical and greater than most expect – educate finance and operational stakeholders on Section 404.
- Executive sponsorship is key to ensuring that the right resources are made available at the right time.

KEY ISSUE — WHAT TECHNOLOGY ENABLERS ARE BEING USED?

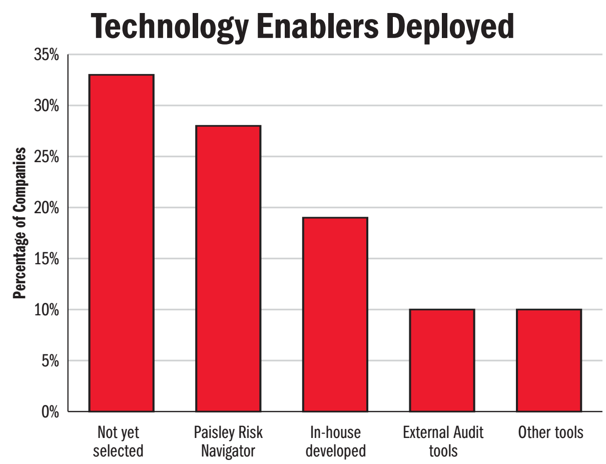
For many companies, the first critical steps will be the documentation and collation of information on accounts, assertions, processes, risks, and controls. Most companies, because of the sheer volume of information, do not have enough time or resources to complete their tasks without some form of technology support. Choosing the right type of enabling technology is a critical decision in the overall success of the project.

Findings

Most companies either have or will make a decision on technology. A large number of companies have not yet selected a specific vendor to provide technology support and are using basic word processing, spreadsheets, and flowcharting software until they make a company-wide decision. Of those companies, 64% are in the $1 billion to $5 billion range. The primary reasons that most have opted to wait are to understand what the major ERP vendors are going to offer and to better understand post-implementation requirements.

Of the companies surveyed that have made a selection, **Risk Navigator** from Paisley Consulting was the most often selected. Other companies have either built or converted in-house systems to the task, use external audit tools from Big Four firms, or a variety of other tools including **On Project**, **Open Pages**, **Handy Soft**, and **Movaris**.

Early indications show a majority of the companies are satisfied with their final selection.



Ernst & Young Observations

Leading companies are able to clearly articulate their approach and methodology prior to acquiring technology to enable it. Some early movers have had to switch out IT enablers mid-stream because their tools either did not meet evolving methodology requirements or did not adequately address the company's ongoing needs (post-year one).

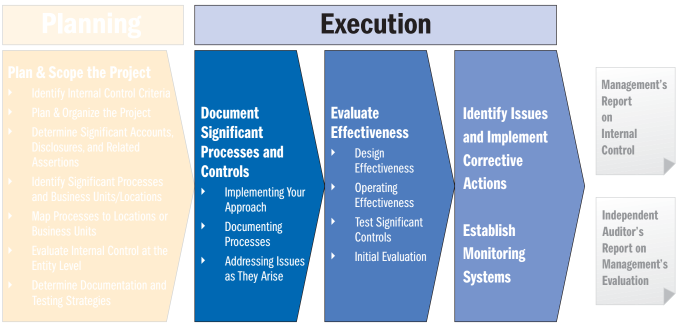
Technology is usually one of the items on the critical path for implementation. The effort and time needed to implement the selected technology, especially a distributed decentralized application, should not be underestimated. Best practices include allowing time for the inevitable technology glitches experienced in all software implementations, keeping any customization to a minimum until the project is mature, and the early involvement of the companies' IT departments.

In addition, when budgeting for technology, management needs to be aware of "hidden" license and implementation costs that may not be always be effectively communicated during early discussions with vendors.

Technologies for Section 404 continue to evolve. Early entrants to the market have focused on the need to amass and manage the large amounts of data involved. Leading technologies in the future will link to existing systems and provide real-time process and control monitoring, allow full delegation of responsibility for controls to operating units, and offer readily assessable dashboard reports for management to quickly respond to issues as they arise.

IT Enablers – Key Lessons Learned

- Be clear on approach and methodology before selecting the tool to enable it.
- Understand the implementation costs and timelines in advance and ensure they are incorporated into the plan.
- Allow for slippage – it always occurs!
- Keep customization to a minimum in the early stages.
- Ensure all costs are disclosed in discussions with potential vendors.
- Involve your IT department early.



Execution

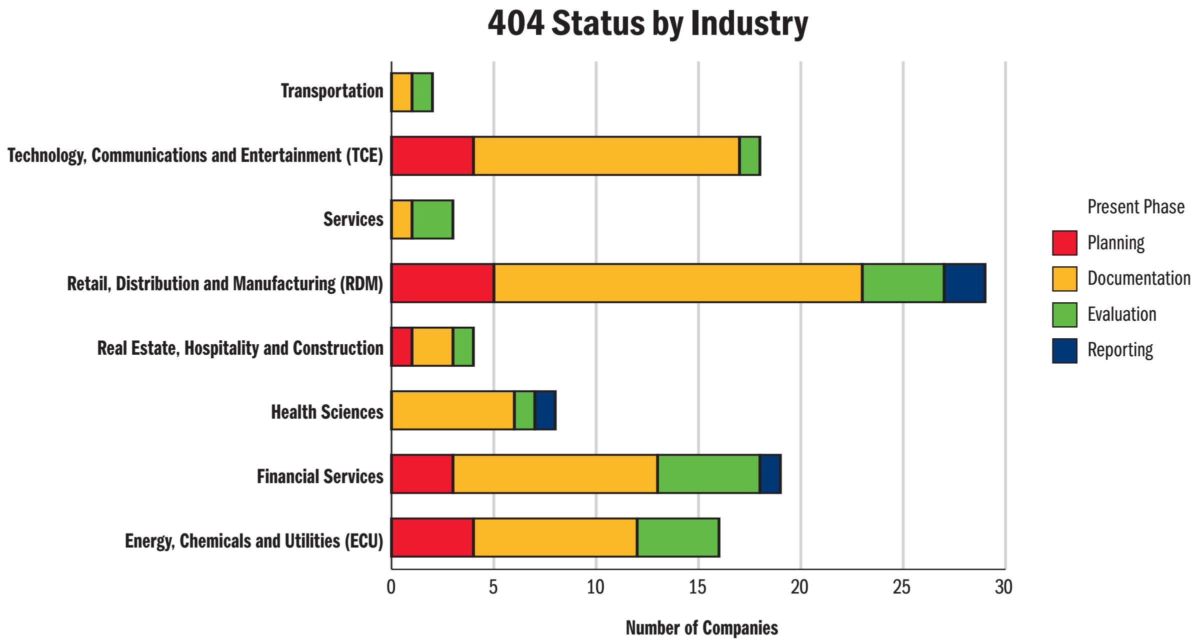
KEY ISSUE — WHERE ARE MOST COMPANIES IN THE PROCESS?

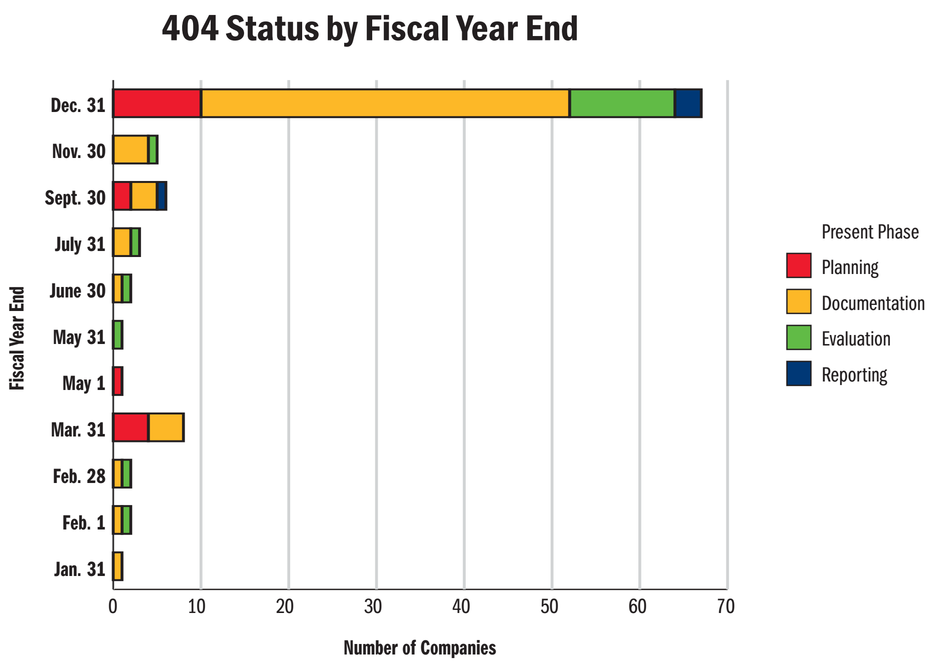
Am I ahead, behind, or on schedule? Where are other companies? The need for a "sanity check" is on everyone's mind.

Findings

Over half the companies we surveyed are completing their documentation. A number of foreign registrants are in the planning stage. Four companies surveyed are in the final or reporting phase and have conducted "dry runs" for 2003 to evaluate the effectiveness of their processes, although not all processes and locations may be complete. Of the 19 companies currently in the evaluation phase, more than half are also completing some form of dry run.

There was no discernable difference in phases between the large and the small companies in the survey group. However, on an industry basis, financial services companies appear to be further ahead than their other sector counterparts.





Ernst & Young Observations

Many companies decided not to change their timelines following the extension of the implementation dates by the SEC. They have continued with full or partial dry runs for the 2003 year end. Foreign registrants can now learn from the experience of U.S. registrants, of which the vast majority have moved beyond the planning phase and are into execution.

KEY ISSUE — HOW TO LEVERAGE ENTITY-LEVEL CONTROLS?

How companies use a comprehensive evaluation of internal control at the top — entity-level controls that might have a pervasive effect on the organization — can have significant effect on the total level of effort.

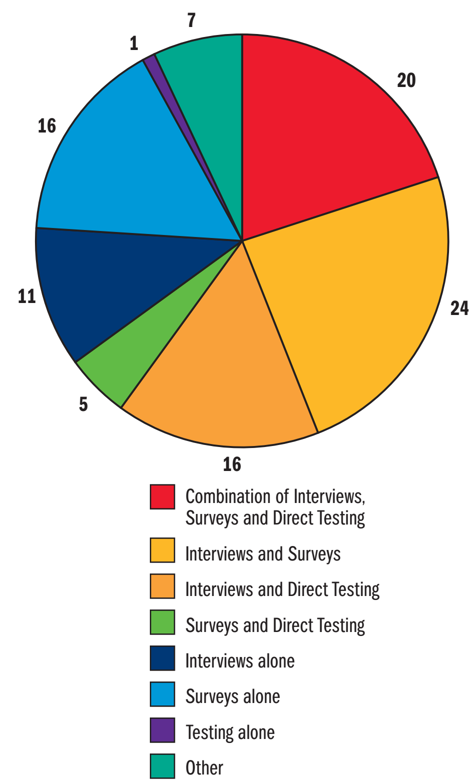
Documenting, evaluating, and testing internal control at the entity level does not by itself provide a complete perspective of internal controls of an entity. However, it is an important starting point because the assessment of entity-level controls can have a significant effect on the overall assessment of the effectiveness of internal controls and procedures for financial reporting at the transaction and account levels.

Findings

Our survey showed 43% of the teams surveyed plan some form of direct testing of the company's entity-level controls; 65% are employing surveys and 71% are interviewing senior management. Thirteen percent are employing other techniques.

Twenty percent of the project teams are combining all three techniques (testing, surveys, and interviews) to obtain a balanced view. Twenty-four percent are relying on a combination of interviews followed with surveys to assess that the controls are operating as intended; 5% of teams already have good documentation and are following up with surveys and testing to gather evidence that controls are operating; 28% of the teams are relying on only one technique.

Evaluating Entity-Level Controls



Ernst & Young Observations

The choice of techniques to evaluate entity-level controls will depend on the degree of documentation and the corporate culture. Interviews are the predominant means used by most teams to document controls. Surveys can provide an efficient means of assessing the depth of control consciousness in the company's culture and how widely policies and procedures have been disseminated and are understood. For key controls, some measure of direct testing provides greater evidence. We are seeing a growing trend among companies to formalize many of the committee-based control procedures, like budget meetings, by capturing and retaining committee minutes as supporting evidence. In general, a combination of techniques provides the strongest evidence, which becomes increasingly more important if planning to rely more heavily on entity-level controls.

KEY ISSUE — HOW TO APPROACH IT SYSTEMS?

Evaluating the information technology (IT) component of controls is proving to be the most difficult area. ERP packages, such as SAP, Oracle, and JD Edwards, along with legacy systems, make up the majority of systems among the *Fortune* 1000. However, companies are not experiencing the standardization of processes and controls that would result in an efficient process.

Findings

Forty-eight percent of the companies surveyed had multiple, complex systems. Only 8% had straightforward ERP implementations. Most companies (65%) plan to place reliance on IT controls in specific areas of their business.

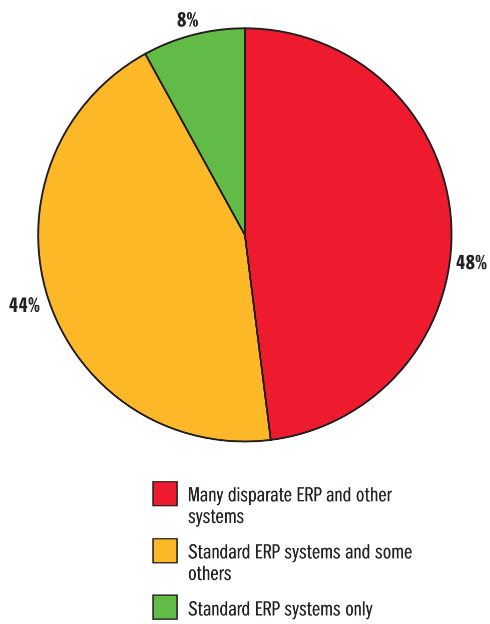
Ernst & Young Observations

Management is often faced with a choice: How much reliance should be placed on underlying automated prevent controls versus manual management review and reconciliation detect controls. The answer has a significant effect on resources and focus for the project. The greater your ability to rely upon computer controls, the more efficient the effort. But many companies do not have sufficient controls over changes to critical programs or access to data files and programs to allow for maximum reliance.

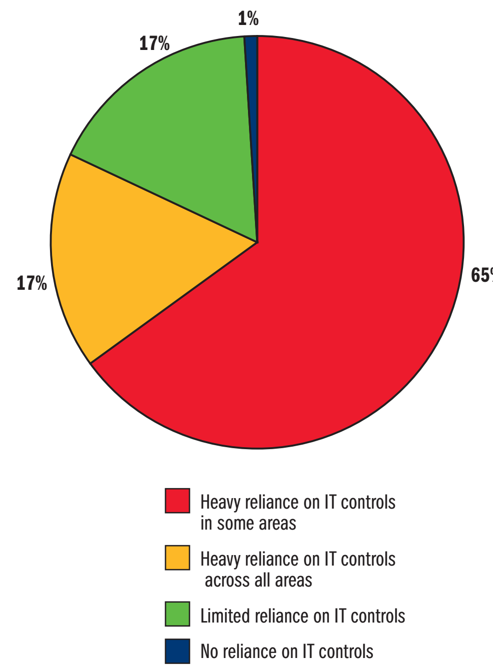
We have observed that many companies initially believed they have standard ERP systems but only later find that individual business units were allowed to modify the application template during implementation. Therefore, they cannot ensure standard ERP systems nor common controls across locations.

We anticipate most companies will focus on program change and access control testing and remediation in order to obtain greater reliance on system controls.

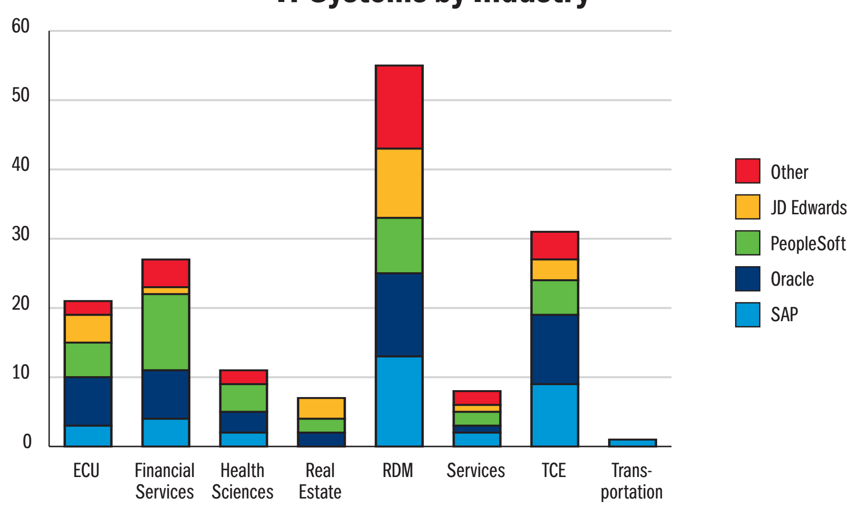
System Landscape



Reliance on IT Controls



IT Systems by Industry

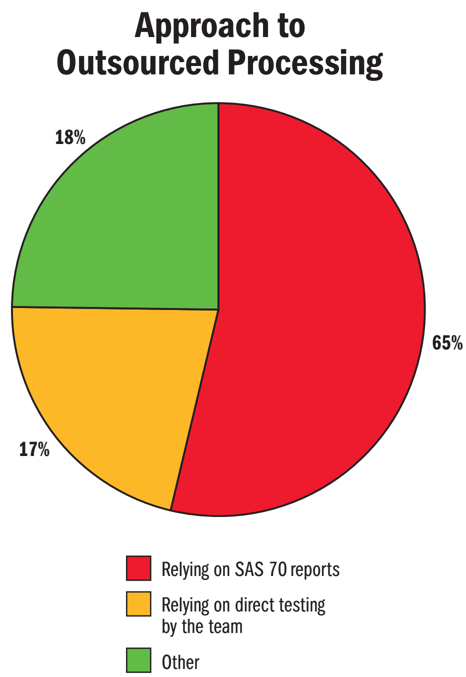


KEY ISSUE — WHAT IS THE RIGHT APPROACH TO CONTROLS AT THIRD PARTIES?

Project teams struggle with how to evaluate controls where third parties are processing transactions. Business process and other forms of outsourcing have become more the norm than the exception. While companies can outsource the processing itself, they still remain responsible for the controls over the amounts that will be recorded in their financial statement accounts. Many companies are asking how they can determine, cost-effectively, that the right controls are in place and operating, since they may not be familiar with the service provider's organization structure and its systems.

Findings

Auditors have long used a Service Auditor Report — an opinion based on Statement on Auditing Standards No. 70 (SAS 70) — to understand and potentially place reliance on processes and related controls of the service organizations that process transactions for the company. Sixty-five percent of project teams plan to use the same technique as part of their Section 404 evaluation. Of the 65% relying on SAS 70 reports, 21% are doing so in combination with other procedures, such as reviewing the controls they use over the inputs to the service organization and the outputs from it, or directly visiting the service organization site to review controls. Ten percent of project teams plan to rely exclusively on their own testing of controls.



Ernst & Young Observations

Historically management viewed its role as one to request a SAS 70 report from their outsourcing vendor and **if** received, forward it on to their external auditors, never having read it themselves. Going forward, we predict public company management will **not only read** next year's SAS 70 report, **but will also seek to influence** the scope and timing of the next SAS 70 report so that it provides a better basis, in part, for their Section 404 assertion.

Best-in-class public companies are cataloging all third-party relationships, risk rating those outsourced operations, analyzing the number and size of the transactions that are being processed, and then determining what information the outsourcer provides over its internal controls. Next, these companies are proactively challenging their service providers regarding the scope and timing of the SAS 70 reports and other information they are provided, in some cases requesting that the service organizations provide more timely or thorough information to better assist them with their Section 404 projects.

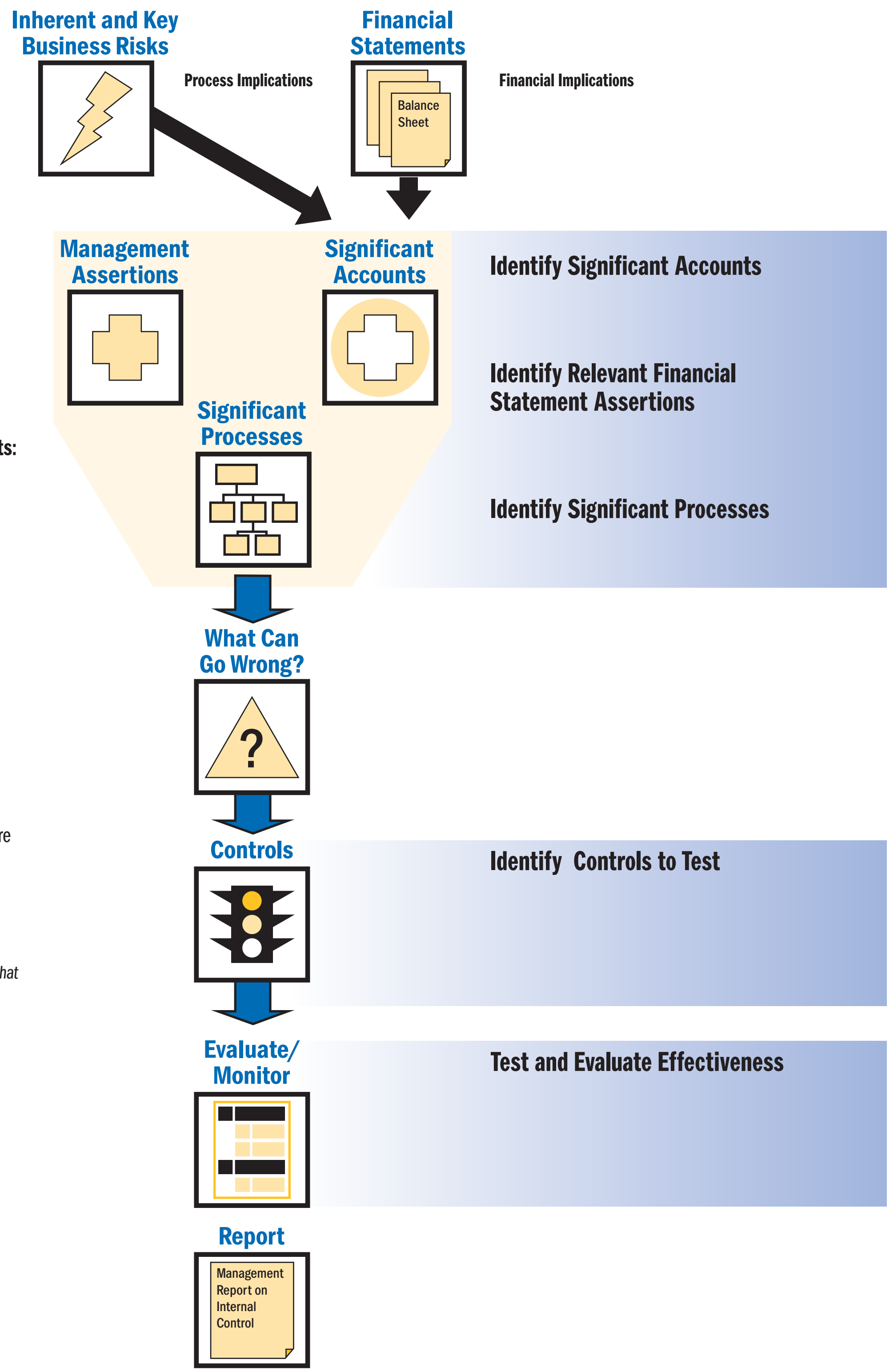
Best-in-class outsourcers are proactively managing public company expectations by soliciting feedback from their user organizations and their auditors and establishing plans for addressing the most common needs. One example of these needs surrounds outsourcers with public company year ends occurring throughout the year. The outsourcers have resorted to issuing semi-annual SAS 70 reports (i.e., for the period ended March 31 and September 30) covering a rolling 12 months. In contrast, outsourcers that have not yet been forced to build these obligations into their service contracts, or are not planning to meet these new requests in 2004, will have an increase in on-site audit visits from their public company customers and their auditors.

Documenting Controls Over Financial Reporting

Significant Accounts Selected Based Upon:
- Errors of importance*
- Size and composition
- Susceptibility to loss or fraud
- High transaction volume
- Transaction complexity
- Subjectivity in determining account balance
- Nature of the account

Financial Statement Assertions:
- Existence or Occurrence
- Completeness
- Valuation or Measurement
- Rights and Obligations
- Presentation and Disclosure

Processes That Influence the Significant Accounts:
- Flows of transactions
  - Routine
  - Non-Routine
  - Estimation
- IT processes
- Financial Statement Close Process



For Each Assertion Ask:
- Where are the points in the flow of transactions where errors can occur?
- Example:

  Accounts: Cash or Payables
  Process: Disbursements
  Assertion: Valuation

  What are the manual and programmed procedures to ensure that the amount of a check or transfer agrees with the amount approved for payment?

Controls That Prevent or Detect Errors of Importance* or Fraud:
- Who Performs?
  - Segregation of duties
- Control Dependent on IT?
  - Application control
  - Electronic evidence
- Company policies and procedures for:
  - Authorization of transactions
  - Safeguarding of assets
  - Asset accountability

* Errors that individually or collectively could have a material effect on the financial statements

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