Keeping Pace with INTERNAL CONTROL CERTIFICATION AT GUIDANT

SOX 404

By Ramona Dzinkowski

Companies all over the U.S. are now well into SOX 404 compliance. Section 404 of the Sarbanes-Oxley Act, passed in 2002, requires management to report on their internal control over financial reporting and auditors to attest to the accuracy of the management report. In the past several months, a wealth of experience has begun to emerge on documenting internal controls over financial reporting, the scope of this potentially huge project, and the execution and ongoing management of the internal control certification process. In this interview for *Strategic Finance*, Annette Such, director of Global Accounting and Policy at Guidant Corporation, discusses the process of internal control certification at her company and the challenges and lessons learned that can be applied to organizations of all sizes.

Annette Such

CORPORATION

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GUIDANT CORPORATION is a global manufacturer of cardiovascular therapeutic devices (pacemakers and defibrillators) and related products with $3.7 billion in annual sales and more than 12,000 employees worldwide. They have now completed more than 90% of their internal financial control documentation, including the Information Technology (IT) component of the exercise, in the U.S. and in countries abroad. Annette Such's responsibilities at Guidant include the worldwide consolidation, external reporting functions, SOX 404 compliance, and company-wide accounting policy. Such has been dedicated 100% to SOX 404 compliance for the last year.

RD: **Can you tell me what initial approach you were planning to take when you began thinking about how you were going to roll out the internal documentation process in all areas of your company?**

AS: Based on our risk and materiality assessment, we decided we needed to document processes at about 16 locations. The U.S. is the primary location; however, we took a very conservative approach on the amount of documentation and number of locations required. We think that set the right tone that internal controls are important.

RD: **Are you doing this in an ad hoc way, or did you have a particular strategy that you followed from the outset?**

AS: We have maintained our original strategy, which is 100% process-owner driven. Some companies had internal audit own it, some relied heavily on outside consultants. We decided to go with a 100% process-owner strategy. This required that we roll out a substantial education program to train people how to do the documentation and testing themselves, and we've stayed with that. We have four people who are considered the core team. These are four talented senior analysts and managers possessing a wealth of experience about our business and our processes. Those people are responsible for technical questions, coordination; they drove training; they promoted standardization of controls and processes. We spent a little more time up front than most companies and a lot of time on training and rolling this out to a very broad audience. We did this with the aim of optimizing and streamlining the ongoing certification process. We believe that we have raised the internal control awareness across Guidant with this approach.

RD: **Did you use external consultants at the outset?**

AS: We did in very small amounts. We believed that if we used consultants or internal audit too heavily at the outset, it would be more challenging in coming years to maintain the desired level of ownership and accountability. We used consultants mainly to help structure the project. We selected one of the Big 4 accounting firms to do that. We scoped the project on our own, and then the consultants trained the core team, gave us feedback on the scope, and helped us understand the testing. We used them for a few months as part of getting up the learning curve, and now we use them only for technical inquiries and benchmarking.

RD: **Did you find that it was difficult choosing the consultant?**

AS: Definitely. It was early May 2003 when we went through that process, and at that time our deadline was 12/31/2003 as the extension had not been announced. There was a little bit of panic going on in the marketplace. We chose to be very conservative on what we used our external auditor for, so we automatically excluded them. We actually went through a very extensive interview process focusing on tools. Because we have quite a few CPAs in-house, we felt fairly comfortable that the project only needed some direction and a tool to follow. So our initial assessment of a partner was based on tools.

We didn't want something extremely cumbersome as we have many data management tools already in-house. We didn't feel that we had time to integrate a new tool with our existing ones, so we went with a more basic database tool. We also felt that we and the firm we chose

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had similar philosophies on how to proceed. Their tool was relatively easy to implement. The tool and the professional fit with the consultants were our primary decision points. We have a strong international presence, which is very important to us, and that was the primary driver for not going with a local firm.

RD: **Can you explain senior management's role in the project?**

AS: Our CFO is the project sponsor. He established the tone early on by sending a company-wide message that 404 is a priority and that we need everyone to be involved. He maintained a strong presence in support of this project. We also have a Steering Committee composed of senior people from across the company, and it has both IT and internal audit representation. Our chief accounting officer is our Steering Committee chair. The Steering Committee initially met as an ad hoc group in early 2003 to work through SOX impact at Guidant and established the initial scope and resource requirements. Now the Steering Committee meets about once a month and provides key technical advice, approves the project objectives and approach, and also helps with resources as needed. The members are also involved in review as appropriate.

RD: **Has this exercise changed the roles within the financial function and the relationship between finance and the rest of the organization?**

AS: The roles are definitely more formal now than they were a few years ago. Within Finance, people can identify value they have received through this process. Some examples are more formal documentation or perhaps more clarity on roles in a few areas. Yet at a company that was focused on corporate governance already, like Guidant, I do not believe the benefits exceed the costs.

RD: **How has this impacted the role of the CFO?**

AS: The CFO has always been responsible for SEC compliance, and that hasn't changed. SOX has formalized the process of SEC compliance and improved the structure by which management assures itself that its internal controls are designed and functioning properly.

RD: **Who are the process owners typically?**

AS: That is often delegated below the manager level. For example, the accounts payable supervisor is the accounts payable process owner for cash disbursements. The payroll supervisor would be the payroll process owner. But we made it very clear that managers and directors, who are a level above, need to sign off on and approve the documentation. That was necessary from a quality-control perspective.

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RD: **Can you describe the rollout?**

AS: We tried to be highly structured because we have so many moving parts. For example, we have more than 300 users in the internal control database. The process owner did all the documentation, and then we had our internal audit group review that documentation. This was done in the U.S. in 2003, and the intent was to validate our approach and ensure quality control since the SEC delayed the effective date. In many cases, our external auditor also reviewed the documentation and gave us feedback. The external auditor reviewed the judgmental areas directly. Process owners are responsible for the testing in their area on a quarterly basis. It has been a huge coordination effort with a huge project plan and calendar. This year our internal audit department is performing testing and review to support the external auditor's testing wherever allowed by the draft standard from the Public Company Accounting Oversight Board. Frequent and thorough communication is critical.

RD: **How much extra time do your people have to spend on the documentation process?**

AS: That varies by group. It also varies by the comfort level of the group on internal control. Those groups where English wasn't their first language received a lot more help from the core team. For any given area, we estimate that the additional time commitment is approximately one to two days on a go-forward basis for testing and reviewing the documentation. Documenting a new process or new affiliate would take additional time.

RD: **During the certification process, companies are required to attest to the internal financial controls of**

their outsourced services. How has Guidant dealt with that situation, and what are some of the issues that you've faced in that area?

AS: That has been a challenge. We started with a laundry list of our service providers. We requested Statement on Auditing Standards No. 70 ["Service Organizations"] (SAS 70) reports from those providers that were performing controls on our behalf and received six or seven SAS 70s back, mainly in the benefits areas. Alternative procedures if an SAS 70 isn't available are to visit the provider and provide tests of controls or hire someone to perform those tests or identify the controls that the service provider performs and design mitigating controls. An additional challenge in this area was the timing of those reports. Some of those reports aren't available until June of the following year, and that is much later than we are required to give an opinion to our shareholders. In those cases, we are investigating documenting additional processes in-house and monitoring any changes in the service provider, metrics, etc. It has been more effort than I anticipated.

RD: **What are your cost estimates to date, and how does the first year compare to what you expect to see down the road?**

AS: Consulting will be less than $200,000. We expect the audit fees to increase this year by some 80% on top of our current charges, excluding statutory fees. Then I hope it would drop, but I won't even speculate here. We have heard of up to 100% cost increases in other companies. There have been no additional IT costs since we've decided against buying any new systems at this time. From an HR perspective, we have hired two extra people fulltime, and the total time commitment internally, including these two new hires, was some 28,000 hours.

RD: **Are your external auditors familiar enough with your internal controls over financial reporting to do independent testing without substantial guidance or training?**

AS: They are. In my opinion they needed to be to do an effective financial statement audit. We release our year-end earnings report by every January 31. We release quarter results some 20 to 30 days after a quarter stop, so they have to have a controls-based approach already. They had already been reviewing our accounts payable system, our payroll system, etc.

RD: **What about the other countries that you are operating in? What were some of the cultural issues in those countries that you didn't anticipate, and how did the people respond to this exercise?**

AS: We have very strong entity-level controls over our smaller affiliates. We had very good engagement at all locations due to the early involvement of our executive management. These locations are very small, and their resources are tight, so they welcomed our assistance. In some countries we had to work through the cultural barriers where, for example, it isn't acceptable to admit that you don't understand or to challenge our recommendations. In Japan, which is a very large affiliate for us, we chose to spend three weeks there because we anticipated that challenge. We had to do a lot more hands-on. It took a lot more effort and a lot more planning; however, the result was highly successful, and that affiliate is now completing testing independently.

RD: **Many organizations are saying that 404 won't result in a dramatic change in internal controls over financial reporting. Others are saying that there were weaknesses in their control systems. What is your perception, and, on average, how effective do you expect this to be in improving corporate governance in the U.S.?**

AS: Some of the other things in the Sarbanes-Oxley Act—whistle-blower protection, independent audit committees, for example—may have been needed in other companies. The incremental cost, however, particularly from the audit firms for the attestation, is frustrating to me because we invested a great deal of time understanding our processes. We also have a very independent and very strong internal audit function. For us to still spend shareholder resources of that magnitude with our auditor I don't find value added. I wish there had been a better way to identify companies that had serious accounting and compliance issues. So 302, stiffer criminal penalties, strengthening the audit committee and board oversight, or requiring codes of conduct—those things are very good for some companies. But we were already doing all those things. So I struggle with the added value for us, and I struggle with the increase in audit fees. I don't think the draft standard has gone far enough to curb that. On the upside, however, we have raised internal control awareness throughout the organization. That was a good thing. ■

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