



March 31, 2005

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Reference: File Number 4-497

Dear Mr. Katz:

Thank you for the opportunity to provide feedback on our experiences in implementing the new internal control requirements under Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404"). I am responding as the Chief Financial Officer of Callaway Golf Company; we are an accelerated filer and have just completed our first annual report containing the required Section 404 reporting. I hope our feedback, combined with that of other registrants, will help decision makers understand the benefits and costs of Section 404 and seek for a better balance between the two.

I'd like to highlight two aspects of the evaluation of internal control over financial reporting required under Section 404 which I think are important to a cost/benefit discussion: (1) the high degree of subjectivity involved with this evaluation, and (2) the significant costs involved. I'd then like to offer some suggestions for your consideration and that of our lawmakers in Congress.

**Evaluating effectiveness of internal control over financial reporting involves a high degree of subjectivity.**

We all want companies to operate with effective internal controls, yet I suspect that many who read annual reports do not understand that there is no *Manual of Internal Controls* that precisely defines all of the processes that every company must have in place in order to claim effective internal controls; there is no one-size-fits-all solution when it comes to this topic. Even coming up with a definition of internal controls for purposes of the Sarbanes-Oxley Act appeared, from the outside looking in, to have been somewhat of a challenge; it took the Commission almost a year from the date the Sarbanes-Oxley Act was signed into law to publish a final definition of the subject of Section 404 – internal control over financial reporting. And it is our experience that this defined term is open to a great deal of interpretation when reduced to practice. Implementing Section 404 requires layer upon layer of subjective judgment, which I fear the public does not understand or appreciate.

I could devote pages to outlining the various subjective evaluations that go into the exercise of evaluating internal control over financial reporting, but let's focus on one



aspect of the subjectivity underpinning this evaluation – that of assessing risk. Through all of the stages of our evaluation – from determining which business units/business processes/systems to include in the evaluation, to determining which controls are key controls that require testing, to evaluating control deficiencies – we performed risk assessments. These risk assessments entail evaluating the *significance* and *likelihood* of risks to misstating financial statements, and inherently require a significant degree of subjective evaluation.

Our own evaluation of internal control over financial reporting included hundreds of risk assessments. I think it is important to consider the high degree of unavoidable subjectivity involved in these Section 404 evaluations and the related independent audit reports when assessing the “benefit” side of the cost/benefit equation.

#### **The significant costs involved.**

You have no doubt read many of the statistics that have been compiled and published concerning the costs of complying with Section 404. Here are some of our costs. As a point of reference, Callaway Golf reported net sales of \$934 million and a net loss of \$10 million for 2004.

- Internal costs – for the initial evaluation effort only – approximated \$1 million; these costs comprise over 16,000 internal hours of work plus other direct costs, including consulting costs.
- Independent auditor fees related to the Section 404 attestation work came in at \$765K – or 112% of independent auditor fees for the financial statement audit, exclusive of the Section 404 attestation work. We have been told not to expect a significant reduction in independent auditor fees for this attestation work in the coming year.

It does not stop there. There are many other costs not outlined above that we have made no attempt to quantify – such as the internal costs of ongoing compliance, once initial evaluations have been performed. Such costs include increases in personnel and additional time devoted to internal control testing and reporting for all “in scope” business areas, processes, and systems.

Further, it has become a major challenge to find and retain audit professionals with the experience and qualifications required to perform ongoing internal audit work, let alone supplemental work required of Section 404. A month ago, we posted an audit position on the Monster board which, in the past, would have generated between 80 – 100 hits; this time, it generated three hits. We have found that the wage structure required to attract qualified audit professionals has increased 30% from three years ago and this upward trend does not appear to be leveling off. We are noting even more dramatic increases in consulting fees in this field – particularly in the arena of IT audit professionals. There appears to be somewhat of a bidding war being waged for these limited audit resources by public accounting firms, registrants, and other enterprises with audit needs. This hits



the registrant in two ways – directly in the costs it must pay to recruit and keep talent, and indirectly in the fees it must pay to public accounting firms for their audit and Section 404 attestation work.

And as to the fees paid by registrants for the Section 404 attestation work performed by their public accounting firms, there is little or no market pressure for these fees to be reasonable or for the underlying work to be performed efficiently; we must rely on the commitment to competence and professionalism of the individual firms and practitioners involved. There aren't enough qualified public accounting firms to generate meaningful competition, and therefore registrants have little choice but to pay for any amount of work the public accounting firm determines it must perform at whatever rates the firm determines it will charge.

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Are the costs of compliance with Section 404 worth the benefits? So far, I haven't described the benefits to our company of complying with Section 404, and there are some benefits – such as:

- It has helped reinforce the “ownership” of internal control over financial reporting throughout our organization.
- The company benefits from the synergies of performing self-evaluations of internal control by cross-functional teams of knowledgeable employees; such evaluations are generally quite thoughtful and lead to a better understanding of the process and implementation of meaningful improvements.
- The requirement for performing ongoing monitoring of certain key controls by responsible parties helps underscore the continued importance of maintaining internal controls.

While these are good benefits, we believe the costs of achieving these benefits under the current requirements of Section 404 compliance are grossly inappropriate; we believe these benefits can be sustained with far less cost by removing or reducing some of the no value or low value components of the current requirements. For example, we saw no benefit to the company and little benefit to the public in requiring that our public accounting firm (including its satellite offices, concurring partners, and national offices) conduct its own subjective evaluation of internal control over financial reporting and of our evaluation. We believe it may be useful to receive assurances that the company has in place a reasonable evaluation process. We do not believe it is useful to have yet another party layer its own subjective evaluations and duplicative tests on top of those performed by the company to arrive at its own subjective conclusions.



There is a wide spectrum of adjustments that lawmakers and regulators can make to the current Section 404 requirements in order to more closely align costs with benefits. Significant cost reduction can be achieved with little or no dilution of benefits by reducing the required independent auditor attestation work, as these are highest dollar/lowest return costs. Reducing these requirements may range from full-scale elimination of required independent auditor attestation to significantly reducing the scope of the independent auditor attestation (e.g., focusing on sufficiency of management's process, or allowing selective or rotational testing of key controls).

Thank you for encouraging candid feedback on this important topic. I hope our comments and observations are useful to the roundtable discussion and that the collective voice of those who have experienced the compliance costs of Section 404 will help drive changes that improve the cost/benefit equation to the benefit of shareholders and the public.

Very truly yours,

A handwritten signature in black ink, appearing to read "Bradley J. Holiday".

Bradley J. Holiday  
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