Why did Sarbanes-Oxley (SOX) stand out?

Summary

The external auditor is one participant in the financial reporting ecosystem, which includes many other players such as companies' management, audit committees, regulators, standard-setters, and many others.

Internal controls that are effectively implemented and maintained with the appropriate oversight are fundamental to the production of high-quality financial reports. Accordingly, an external auditor's ability to conduct a high-quality audit is influenced by the quality of the internal control environment of the audited company and the effectiveness of the company's corporate governance. Internal controls are a part of an organization's business model and are not static; they evolve due to the dynamic nature of the modern world.

Current financial reporting focuses primarily on historical data. Stakeholders, including investors and members of the public, are calling for broader and more forward-looking disclosures as well as disclosures of non-financial matters involving the environment, society, and governance (ESG). Accordingly, companies' internal controls and corporate governance should expand to include non-financial matters as broader corporate reporting garners attention and even scrutiny. The appetite for non-financial information will also continue to evolve.

Advancing traditional financial reporting and future-focused corporate reporting requires the commitment and constructive engagement of all ecosystem participants.

- Corporate responsibility and audit responsibility are both critical factors in a strong financial reporting ecosystem.
- Strong internal control systems and corporate governance of the audited company support external auditors' ability to deliver a quality audit.
- Although many current reforms are focused on internal controls around financial reporting, this debate is expected to evolve rapidly to cover broader corporate reporting and the need for the related internal controls and effective corporate governance.
- It is important for companies to keep pace with this evolution to mitigate the risk of a mismatch between internal controls of the company and stakeholder expectations for corporate reporting.

The US Sarbanes-Oxley Act of 2002 Example

Many countries around the world have rules for entities as they issue initial public offerings and become "listed" on public securities exchanges. These rules place significant focus on a company's risk appetite, its risk management, and related controls environment. However, these areas and their related disclosures often do not receive as much focus after the entity's initial listing. Further, some enforcement regimes put greater emphasis on the work of a company's external auditor rather than on the company to which the financial statement belongs. Experience has shown that it is important to impose accountability and provide incentives, including to those who are preparing the financial statements and those charged with governance.

The US Sarbanes-Oxley Act of 2002 ("SOX") is a good example of a mechanism that features prominent and continued focus on internal controls after initial listings of public companies and illustrates how all participants of the financial reporting/corporate reporting ecosystem are linked and held responsible. SOX is focused on corporate and auditing accountability, responsibility, and transparency, and includes a strong emphasis on effective internal controls. SOX also provides protection for employees of publicly traded companies who provide evidence of fraud and prohibits companies from retaliating against employees who lawfully participate in an investigation or who file, or participate in, proceedings relating to fraud against shareholders. SOX has proven to be effective in improving the quality and integrity of financial reporting.

2017 marked the 15-year anniversary of the implementation of SOX. Based on a 2017 report from Audit Analytics, "*…after the implementation of SOX there was a massive increase in financial restatements that peaked at 1,851 in 2006. That number declined significantly to just 737 in 2015. We've also found that the financial impact on net income has also declined. Restatements of $3 billion to $6 billion (in USD) were made in each year between 2002 and 2006. Since 2008 only one year had a restatement that has impacted net income by more than $1 billion*."[1]

A 2017 study by the Center for Audit Quality (CAQ)[2] also noted that:

- 79% of CFOs feel that the overall quality of information in audited financial statements has improved since the enactment of SOX.
- 85% of CFOs believe the internal control over financial reporting (ICFR) audit function has either greatly (34%) or somewhat (51%) helped their companies.
- Three-quarters (74%) of financial advisors favor SOX. 82% feel SOX has improved the reliability of investment information.
- Top reasons for why the *[external]* audit helps companies include – building trust among stakeholders and customers (26%), helping to produce accurate financial reporting (21%), and making the financial reporting process more streamlined (21%).

This document (below) sets out key provisions of US SOX.

While several of the most well-known provisions of SOX relate directly to external auditors—including the creation of the PCAOB and audit of companies' internal controls over financial reporting—SOX took a holistic approach to enhancing the financial reporting system and contains a number of provisions addressing the role of management and those charged with governance. It is important to note that SOX was built on the existing system in the US, which already focused on various actors of the financial reporting ecosystem (e.g., the Securities Exchange Act of 1934 and related law).

[1] https://blog.auditanalytics.com/the-impact-of-sox-on-financial-restatements/
[2] https://www.thecaq.org/wp-content/uploads/2019/03/caq_pulse_poll_cfo_perspectives_sox_2017-05.pdf

Key provisions of US SOX

Provisions addressing audit committees, CEOs, CFOs

- SOX introduced requirements for CEOs and CFOs to certify all quarterly and annual reports that information contained in those periodic reports fairly presents, in all material respects, the financial condition and results of the operations of the issuer. Knowingly false certifications are subject to criminal penalties.
- No officer or director of an issuer/company may fraudulently influence, coerce, manipulate, or mislead the company's independent auditor.
- In the event of an accounting restatement due to noncompliance or misconduct, CEOs and CFOs must return the bonuses and profits that stem from the sales of their company's securities[3].
- Audit committees are responsible for the appointment, compensation, and oversight of external auditors.
- All audit committee members must be independent of the company.
- Audit committees are authorized to engage advisors and to determine appropriate funding for audits.
- Companies must disclose whether their audit committees have at least one "financial expert."
- Companies must adopt a code of ethics that applies to the CFO, CAO, and controller—or, in the case that they have not done so, explain why.
- SOX gives the SEC[4] authority to prohibit persons from serving as corporate officers or directors based on certain violations.
- SOX further requires companies to disclose material changes in financial condition or operations on a "rapid and current" basis and disclose all material off-balance sheet transactions and relationships and prohibits companies from presenting pro-forma (projected, forward-looking) information in a misleading manner.

External auditors

- Prohibited from providing certain non-audit services to audited companies.
- Require audit committee preapproval of all audit and non-audit services.
- Lead audit partner to rotate every five years (no mandatory firm rotation in the US).
- Creation of the Public Company Accounting Oversight Board (PCAOB) to provide external audit oversight.
- SOX further contemplates the PCAOB's engagement with stakeholders, including the audit profession.

Internal controls[5,6]

- Management must assess the effectiveness of its company's controls over financial reporting. External auditor's attestation on the assessment made by management is also required.

SOX Section 404(a) requires management to report on the effectiveness of the company's internal controls over financial reporting (ICFR). Section 404(b) requires an external auditor attestation regarding ICFR effectiveness.

Section 404 of SOX has been the focus of much debate because of the incremental costs it bears on companies. Many studies have indicated that the greatest cost burden is the result of extensive audit compliance requirements. Although some argued that smaller companies are likely in most need for stronger internal controls, an exemption was enacted for some small companies and non-accelerated filers (companies with less than US$75 million in public "float"), that eliminated the SEC's requirement for them to comply with section 404(b).

SOX did not restrict many of today's "household name" companies to become traded on public securities exchange since 2002 while being subject to SOX requirements at the time of their initial public offering. Just opposite. Some examples include Tesla (2010), Facebook (2012), Twitter (2013), Moderna (2018), and Uber (2019). Others such as Amazon, which issued its IPO before 2002/SOX, grew from $4 billion in revenue in 2002 to nearly $400 billion in 2020.

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[3] SOX §304 requires CEOs and CFOs to reimburse issuers for bonuses and profits on the sale of the issuer's shares over the preceding 12 months if the issuer restates its financial statements because of misconduct. Section 954 of the Dodd-Frank Act of 2010 requires companies to establish policies to recover incentive-based pay of any current or former executives awarded over the three years prior to a restatement regardless of whether there was misconduct.

[4] The SEC is a federal agency led by a five-member Commission, nominated by the US President; only three Commissioners can be from the same political party. The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. SEC Division of Enforcement investigates and brings civil charges for violations of the federal securities laws in all of the areas of the SEC's jurisdiction.

[5] Per Section 13(b)(2)(B) of the Securities Exchange Act of 1934, companies are required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

- transactions are executed in accordance with management's general or specific authorization;
- transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
- access to assets is permitted only in accordance with management's general or specific authorization; and
- the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences"

[6] "SOX after Ten Years: A Multidisciplinary Review" - Harvard University (Suraj Srinivasan and John C. Coates)
"Sarbanes-Oxley Section 404: A Historical Analysis" - Le Moyne College (Mitchell Franklin)

Summing it Up

While a number of countries have implemented SOX-type measures (Canada, Germany, India, Japan, Israel, etc.), not many have taken as holistic an approach as was done under SOX.

Understandably, there is no one-size fits all approach to corporate governance, but one thing for certain is that corporate reporting and assurance will continue to evolve to meet market needs.

All participants have important and interdependent roles in the financial and corporate reporting ecosystems. This acknowledgment should be coupled with understanding the lessons learned from events that led to the development of SOX in the US as well as the results of its implementation. These are critical elements in the evolution of corporate reporting.

Connect with us

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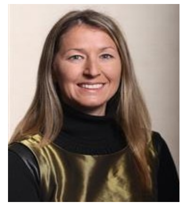

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Other helpful references

Support for financial reporting ecosystem roles and responsibilities and SOX-type reforms have been expressed by:

- Institute of Chartered Accountants in England and Wales (ICAEW)
- US Center of Audit Quality (US CAQ)
- Canadian Public Accountability Board (CPAB)
- American Institute of Certified Public Accountants (AICPA)
- Hong Kong Institute of Certified Public Accountants (HK Institute of CPA)
- South African Institute of Chartered Accountants (SAICA)
- Accountancy Europe:
  - Going concern
  - Fraud
- Certified Public Accountant Australia (CPA Australia)