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The Evolution of SOX and its Impact on the Board

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A look back over five years under the most sweeping legislation affecting business since the Depression.

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It is fair to state that the Sarbanes-Oxley Act of 2002 (SOX), as well as the activities leading and pursuant to SOX, have had a dramatic impact on boards. Over the past five years, public companies have had to tackle such buzzword-concepts as board independence, reform, corporate governance, compensation, liability, and compliance. There have been several significant changes post-SOX—such as the need for independent members, a greater workload, higher risk, and increased costs—but also positive gains for public companies through greater transparency in financial reporting, stronger internal controls, and renewed investor confidence.

This article attempts to look at the origins of SOX, the climate which created it, and what must be done now by boards of directors in reaction to new SEC guidance and Public Company Accounting Oversight Board (PCAOB) standards.

The Revolution Begins

Five years ago, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002—one of the most significant changes to the securities laws since they

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Two Lafayette Centre
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were enacted more than seven decades ago. At that time, the country was outraged about the deterioration of trust in corporate America, and (unlike today) SOX had nearly unanimous support from Congress. What began as a reaction to the bankruptcy of Enron, and the ultimate collapse of one of the (then) Big Five public accounting firms, soon evolved into a larger corporate credibility issue and provided political impetus for corporate and accounting reforms. Investor concerns were fueled by almost daily revelations of perceived corporate misbehavior and very real accounting irregularities, including the situations at Adelphia, Tyco, ImClone, and WorldCom, just to name a few.

SOX was initially aimed directly at the accounting profession as a way to get the firms back to auditing and away from doing consulting projects for their clients—an issue that Washington perceived as the root cause of all the trouble. Much of SOX addressed regulating the accounting profession, creating the PCAOB to monitor the profession's activities which had previously been self-regulated. Rules were revised to further limit the type of services independent auditors could provide to their public clients, eliminating several revenue streams based on lucrative consulting fees from audit clients.

SOX also placed more power and responsibility on corporate boards, and a stronger focus was put on management's relationship with the independent auditors. SOX requires that the independent auditor be hired by, and report directly to, the audit committee of the board of directors—which now must be composed of independent directors, at least one of whom must have a financial background. All of the services performed by the independent auditors have to be approved by the board, which in many cases has extended limits on those services beyond SOX requirements.

The biggest challenge to the success of SOX revolves around two paragraphs of the Act, known as Section 404, which require management to assess internal controls over financial reporting (ICFR) and to have independent accountants audit those controls annually. The cost of compliance has certainly been well above what anyone could have estimated.

The Changing Role of the Board

SOX highlighted the critical role that boards of directors are expected to fulfill in regard to a company's strategic direction and risk management strategies. As a result, boards need to prepare a written mandate explicitly acknowledging their responsibility for stewardship for:

- Satisfaction (as is practically feasible) with the integrity of the CEO and senior management and their ability to create a culture of integrity throughout the company.
- Adoption of a strategic planning process, and approval, at least on an annual basis, of a strategic plan.
- Appointment of independent auditors and monitoring of their performance.
- Evaluation of a risk management process, including the management of appropriate systems to manage and mitigate risks.
- Succession planning for the senior management team.
- Adoption of a company-wide communications policy.
- Oversight of internal control and management information systems.
- Development of a corporate governance approach, including principles and guidelines.

The Domino Effect

What the government failed to consider in enacting such sweeping legislation without proper planning was the "domino effect"—the idea that each decision impacts other decisions made. Blaming the accountants for the collapse of corporate confidence may have been politically popular, but it was hardly the complete answer. The government oversimplified the problems, and the legislation addressed limited issues. No one thought about the cost or the impact of the law on business, as no studies were done prior to enactment and no clear standard as to a definition of deficiencies was developed. In fact, the PCAOB's biggest concern was that the Big Four firms would let their clients off easy and would be reluctant to be tough on the companies that paid their fees—an understandable position in light of the Enron debacle and the collapse of Arthur Andersen.

To ensure that the larger firms would do their job, the PCAOB conducted a preliminary review of the work performed by various large accounting firms and interviewed partners about their knowledge of their clients. These actions were a warning to the accounting profession that the PCAOB would not tolerate anything less than a thorough audit of the effectiveness of a company's ICFR, and it was expected that many large corporations would have deficiencies. The warning was heeded, and the result was a very thorough audit of compliance with Section 404,

Director Summary: In light of the recent approval of the new PCAOB auditing standard (AS5), the author looks back on the creation of the Sarbanes-Oxley Act and its cascading effects. He examines the changing roles of audit firms and boards and offers advice to companies looking to initiate or improve the Section 404 compliance process.

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which resulted in higher compliance costs than were anticipated by Congress.

In addition, several other audit firm revenue streams were affected by the legislation, including tax and transaction-related advice and services. Some of these services were prohibited by SOX, while other prohibitions were mandated by corporate boards of directors as measures to remove any doubt about the independence of their external auditors. This had a profound impact on the accounting industry.

When I first began my auditing career 35 years ago, all of the (then) Big Eight accounting firms were using an integrated audit approach (a process that combined detailed testing of internal controls with testing of the year-end balance sheet). As the years passed, pressures on cost containment became paramount, and bidding wars ensued as the audit became more of a commodity.

The integrated audit approach was deemed inefficient, pushing firms to develop new approaches to reduce costs. The "new" audit approach helped reduce audit hours by greatly reducing the amount of time required to assess internal controls, and it was quickly embraced—leading to the reduction of both internal control system documentation and detailed internal control testing. Many accounting firms started to more aggressively pursue new areas for revenue enhancement, such as consulting and tax planning.

Since SOX eliminated many of these revenue sources, the accounting profession could no longer afford to treat its most important product, the audit, as a commodity and had to revise its pricing strategy to make audits profitable. Since in many cases the audit was the only work the independent auditor was performing for its public clientele, rate increases occurred, and the cost of doing an audit rose. In addition, the cost to have other services performed by another accounting firm rose significantly as the unbundling of services increased total costs. Since the public company's independent auditor was the only firm that could opine on the effectiveness of the company's ICFR, the cost to perform this work was also higher. The lack of definitive guidance and the inefficiencies of implementing a new standard under the pressure of the scrutiny of the PCAOB also added to the cost.

Delay, Delay, Delay

Industry began pressing the government to revisit SOX and amend it. The first delay of compliance with Section 404 of SOX occurred quickly when it became evident that the tasks to document ICFR and design audit procedures to comply with the standards developed by the PCAOB were greater than anticipated. Initially, compliance with Section 404 of SOX was scheduled for fiscal years ending on or after September 15, 2003, for companies with a market capitalization greater than $75 million (accelerated filers). This timing was first relaxed to fiscal years ending on or after April 15, 2004, and finally implemented for companies with fiscal years ending on or after November 15, 2004.

Initial implementation of SOX uncovered practical problems. The companies and the independent auditors seemed to get lost in the language of the PCAOB standard and preferred to err on the side of caution by documenting all the controls they could. In the absence of a standard for grading control deficiencies, the reports on control problems lacked consistency. Internal controls became an end rather than the means to the end; the cost to comply skyrocketed; and the loss in productivity squeezed profitability. As a result, the SEC and PCAOB started to provide more definitive guidance on how to comply with the standards.

The smaller public companies with market capitalization less than $75 million (non-accelerated filers) were starting to mobilize and press the SEC for more time to comply. Their initial compliance date was for fiscal years ending on or after April 15, 2005, and they successfully lobbied for extensions for fiscal years ending on or after July 15, 2006; July 15, 2007; and finally December 15, 2007.

The True Impact on Smaller Public Companies

Relatively speaking, the cost of compliance as a percentage of revenue is significantly greater for smaller public companies, just as the cost of compensating their CEOs is significantly greater. Despite the warnings of the SEC to use the additional time to improve the quality of their efforts to develop an effective system of ICFR, many smaller public companies have just simply delayed implementation. The small business community has continued to point out that cost is the primary reason why SOX needs to be seriously amended or eliminated.

The facts clearly point to a need for SOX implementation in smaller companies, since there is a higher incidence of fraud in smaller public companies than in larger public companies. In addition, there have been more

restatements by smaller public companies than larger ones—according to a Glass, Lewis & Co. survey on 2005 restatements, 59 percent were made by smaller public companies.

The onus is not limited to smaller public companies. Another Glass, Lewis & Co. survey concluded that as of May 2005, of the 366 companies (that is, larger public companies which supposedly had the resources to assess their controls) that received a qualified opinion on the effectiveness of their ICFR, 94 percent had previously certified their controls as effective as recently as the quarterly finding previous to the SOX 404 report.

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Assessing New SEC Guidance and AS5

The decisions in May 2007 by the SEC to unanimously approve its new guidance for management's assessment of ICFR, and by the PCAOB to approve its new auditing standard (AS5), are positive steps in gaining complete compliance with SOX. AS5 is intended to ensure that auditors are able to achieve efficiencies using sound judgment through the use of a top-down, risk-based approach. It will also provide scalability and flexibility in its approach to smaller public companies. Several key components include:

- Auditors will no longer be required to opine on management's assessment process on the effectiveness of ICFR, but will still be required to report on the effectiveness of ICFR. Thus, one less opinion needs to be issued by the auditor, and less work will need to be performed.
- Auditors can use the work of others in arriving at their conclusion of the effectiveness of ICFR. The more work that management performs, the less work the auditor will need to do. Also, there will no longer be a requirement for the auditor to obtain principal evidence.
- The focus of the audit should only be on the high-risk areas that will materially affect ICFR. Multi-location testing is refocused on risk rather than coverage, and there will no longer be a requirement to test controls for a large portion of a company.
- The auditor can use knowledge obtained in prior audits to reduce testing. Other audit techniques, such as performing a walk-through, may be sufficient for the external auditor in low-risk areas. There, focus will be centered on whether there has been a change to the system.
- The audit can be scaled for smaller public companies through less stringent documentation requirements; an assessment of controls to prevent management override; and an increased focus on IT application and general controls whenever unmodified packaged software is used. There will be no need to repeat testing of IT general controls if no changes have occurred.

These key components are a clear departure from the more stringent rules that had been in effect under AS2.

The Positives and Negatives of SOX

The new post-SOX environment has created both risks and opportunities for boards and officers. Different factions point out positive and negative effects of the numerous aspects of SOX.

For example, some positives include improved investor confidence in the validity of the financial statements; elimination of concern over auditor independence; creation of a more meaningful and important role for the board of directors; and greater accountability for the CEO and CFO for their actions.

On the opposite side, some would point out that the negatives include the high cost of compliance; the increased cost of audits; and the dramatic increase of cost of directors and officers liability insurance—along with the need for additional coverage for outside directors.

In the end, I believe the positives have outweighed the negatives and that SOX has done what it was initially intended to do.

Ten Steps Directors Should Take Now

Now that the SEC has told the public companies that they must file on time and that no further delays will be granted, many companies find themselves ill prepared to meet the compliance challenge. If your company is among the majority that has not started a formal Section 404 compliance project, I recommend you propose the following:

1. Set up a planning meeting with the CEO and CFO to assess Section 404 readiness.
2. Assess the attitude of the CEO and CFO in undertaking the Section 404 compliance project. A positive tone at the top is essential to the successful implementation of a system of ICFR and will be critical to the efficient completion of the project.

Corporate boards should perform thorough self assessments, document their fiduciary duties, know best practices in corporate governance, and exhibit due care in the discharge of their duties in order to be effective on a sustainable basis.

3. Select a point person from the audit committee to closely monitor the SOX compliance project on behalf of the board of directors and to report to the full board periodically.
4. If the CEO and CFO cannot provide assurances that the company will be prepared to report on the effectiveness of the system of ICFR by year end, immediately begin the process of hiring an outside consulting firm to assist the company in meeting its compliance obligations.
5. In hiring an outside consulting firm, assess their knowledge of the new auditing standards and their capability to adapt their methodology to the new standards. Look for practical approaches to compliance. Competence, experience, and service are the most important qualities.
6. Meet with the Section 404 compliance team (CEO, CFO, CIO, department heads, consultants, etc.) and establish a timetable for project completion. Given the timing, monthly meetings are suggested.
7. Treat the project as a business process improvement exercise and not simply a compliance project. Most successful companies have achieved efficiencies as a result of the Section 404 compliance project by use of best practices, removal of redundant controls, replacing manual controls with IT controls, and streamlining inefficient business processes.
8. If the company has an internal audit department, review the 2007-2008 internal audit plan, and revise it to incorporate the internal audit department into the Section 404 compliance project. The independent auditors can use the work of the internal audit department to reduce their testing, and significant cost savings can be achieved. Consider expanding the internal audit department or creating one if it currently does not exist.
9. Educate board members on their fiduciary responsibilities under SOX, and make sure that corporate governance policies include a code of ethics, conflict of interest, whistleblower provisions, and other corporate governance best practices.
10. Do not procrastinate. Most companies underestimate both the amount of time the project will take and the resources necessary to complete the entire process. During their initial compliance year, the accelerated filers that waited until the last minute to hire outside consultants either could not hire their firm of choice or paid a premium to get their work done. Last minute hiring will likely be more expensive and will jeopardize timely compliance.

With the roles and responsibility of boards intensifying, boards of directors must address certain considerations. For example, the members of the board should possess specialized skills and understand the issues facing the company. This ensures that the board as a whole has the required level of knowledge and the ability to provide valuable insight in strategic direction and risk management.

Boards should focus more on policy and direction than on daily operations. Strong consideration should be given to developing subcommittees (audit, compensation, etc.) with members assigned based on their knowledge and experience, and board members should have the opportunity to increase their understanding of the company's business. Boards should also meet different business area heads including marketing, operations, legal, IT, and treasury. This will help obtain a better picture of strategy and risk.

Corporate boards should also perform thorough self assessments, document their fiduciary duties, know best practices in corporate governance, and exhibit due care in the discharge of their duties in order to be effective on a sustainable basis. A self-assessment process should be done at least annually and focus on the effectiveness and contribution of the board as well as the contribution of each individual director.

By embracing the revised guidance offered by the SEC and PCAOB and ensuring an integrated, aligned, and clearly focused board is involved and informed, the "challenge" of SOX can be overcome and effectively managed. ■

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