CHALLENGES IN IMPLEMENTATION OF SARBANES-OXLEY ACT

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Abstract:

In 2002 the US Congress passed the Law ,,Public Company Accounting Reform and Investor Protection Act" or Sarbanes-Oxley Act, named after its initiators, Senator Paul Sarbanes and Michael G. Oxley, member of the House of Representatives. The necessity of this regulation was due to huge financial scandals in the US, scandals that led to the collapse of the giants of the American economy. SOX was designed to eliminate vulnerabilities of corporate governance act that caused these scandals and have lowered the credibility of the US stock market and caused massive losses to shareholders. Requirements imposed by law have exposed companies to significant expenditure which generated pros and cons SOX, senior management of the companies arguing that this will lead to a decline in competitiveness of US companies internationally, to smaller profitsfor shareholders etc. . Sarbanes-Oxley Act suffered further changes in order to optimize the effects. The objective of this research is to identify the challenges that companies may face in order to comply with SOX.

Keywords:*Listed Entities, Financial Reporting, Internal Control, Internal Audit, Audit Committee, Corporate Responsibility, Benefits, Costs.*

Introduction

Corporate governance has received several definitions over time including: “the system by which companies are directed and controlled "[1] or “a set of relationships between the company's management, board, shareholders and other stakeholders"[2].

Evenif early '70s spoke of the concept of corporate governance[3], disregard of corporate governance principles (integrity, transparency and accountability) led to a resounding series of financial scandals in the UK, significant being: Guinness (1986), Polly Peck International (1989), Maxwell (1991), BCCI- Bank of Credit and Commerce International (1991). The reasons that led to these scandals were: falsification of accounting records and breaches of accounting law in force at that time, handling corporate actions, false financial statements, theft, fraud. Involved in committing such acts were often members of the entities’ leadership with the complicity of audit firms or stockbrokers. These corruption acts caused financial losses for shareholders and beyond, generating a wave of discontent among all stakeholders and especially loss of confidence in the financial data published by companies, the assurances

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[1]Cadbury Report, *Report of the Committee on the Financial Aspects of Corporate Governance*, 1992.

[2]Dănescu, Tatiana, Mihaela Prozan and Andreea Cristina Danescu. "Internal control activities: Cause and effect of a good governance of accounting reportings and fiscal declarations." Annales Universitatis Apulensis: Series Oeconomica 13.2 (2011), pag. 339.

[3]Ghiță,Marcel, *Corporate Governance*, Economic Publishing House, Bucharest, 2008., pag.9

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given by the firms that provided external audit or how public companies are run and having in the same time negative effects on the capital market. Thus it became evident to the parties that it was urgently necessary legislation or regulations or codes conducive to increasing the transparency of management, to limit the power of decision of a single person or group of persons found at the pinnacle of decision within the entities by implementing a system of governance that ensures a balance in decision making, to establish clear accountability associated with each leading positions and relationships between companies and their external auditors. The first code of corporate governance emerged in 1992 and was designed by Sir Adrian Cadbury, Cadbury drawing first recommendations regarding corporate governance, the most important being: the Board of Directors must have an Audit Committee; the Board of Directors must have in his composition nonexecutive directors and declaring compliance framework. CadburyCode was followed by a series of codes and reports: Paul Rutteman (1993), Code Richard Greenbury (1995), Report Ronnie Hampel (1995), the Combined Code (1998), Report Nigel Turnbull (1999), Code Charlie Mc Creevy [4] .

United States of America have also faced resounding financial scandals: Enron (2001), Allied Irish Bank (2002), WorldCom (2002), Merrill Lynch (2002), Xerox (2002), but a few companies that have contributed to the decrease of public confidence in the accuracy and reliability of financial statements issued and increased doubt regarding the correct representation of interests of shareholders by the management structures of listed entities. The adverse effects of financial scandals and public pressure have led to Sarbanes-Oxley Act.

Objectives of the study and research methodology

The objectives of the study are to identify the requirements of SOX that might translate into real challenges for companies to achieve compliance, the achievement of efficient corporate governance -neglected in some cases up to the moment of the adoption of the law - identification of how to ensure compliance with SOX affect the organization.

This presentation is documented in a theoretical synthesis and analysis on how the provisions of the Sarbanes-Oxley Act translate into challenges for listed companies. In order to achieve this objective were accessed databases, articles, studies and reports of organizations and interviews of prominent personalities in the field.

SOX compliance – a step toward credibility

Since the title of the Law can be seen that the law is focused on two main components: Law tracing details regarding the accounting system, accountability by executives and financial officers regarding financial statements and for the work done by the department of internal control. The Law also contains provisions regarding independent directors, provisions to avoid conflicts of interest or concentration of decision-making around small groups of executives, requires the establishment of audit committees exclusively of nonexecutive directors, setting up committees, appointing committees, remuneration committees, the application of corporate governance principles, outlines the limits regarding

[4] Ghiță,Marcel, *Corporate Governance*, Economic Publishing House, Bucharest, 2008, pag. 49.

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relations between the management and the external auditor and requires many other measures to protect investors.[5]

In taking the necessary steps to uphold the principles of corporate governance – integrity, transparency, and accountability – to ensure compliance with the rules established by the provisions of SOX, companies must find adequate responses to the many challenges that cannot be avoided, including :

- Increased costs;

Since the adoption, SOX has generated controversy, company managers arguing against the adoption of SOX due to higher costs of implementing the law. Although the law benefits are more difficult to quantify, costs can be quantified precisely, the Gordian knot seeming to be theimplementation of the provisions of Section 404- ,,Management assessment of internal control", section which involves forcing companies to reveal any weaknesses activity carried out by the department of internal control and audit thereof by a firm of external audit activity, considered expensive, which led to the exemption application of Section 404 by companies whose market capitalization does not exceed 75 million USD. In 2006, the SEC adopted a provision allowing newly listed companies to postpone the implementation of Section 404 up to 2 years, and in 2012 Congress extended this period for newly listed companies with market capitalization below 700 million USD, giving them five years for compliance with Section 404[6].

Also, the PCAOB has helped the companies in 2007 replacing Auditing Standard No.2/2004 withAudit Standard No. 5, which led to a reduction in costs by up to 25% per year according to a report by the SEC in 2009.

Costs incurred for testing the activity of internal control and financial audit costs have increased with SOX implementation, but remain difficult to quantify the exact weight. SEC estimated for year 2004 a cost of 91,000 USD per issuer regarding internal control but has not released a cost assessment regarding external audit. The only certainty is that these costs are directly proportional to the size and degree of decentralization of the companybut small firms pay more than larger ones as percentage[7].

Indirect costs are harder to quantify and can be generated largely by excessive concern by senior executives in order to avoid committing mistakes punishable by the Sarbanes-Oxley Act.

- Implementing a management of the internal control department under the responsibility of the executive management;

In order to achieve compliance with regard to the provisions of SOX, companies must have an effective internal control department, led directly by company leaders, whose activities fully cover all company' subunits. The most important component of the internal control department is the human resource, this activity requiring staff with high qualifications and competence.

[5]Ghiță,Marcel, *Corporate Governance*, Economic Publishing House, Bucharest, 2008 , pag. 50.
[6]John C. Coates, Suraj Srinivasan, "SOX after Ten Years: a Multidisciplinary Review", pag.8.
[7]John C. Coates, Suraj Srinivasan, "SOX after Ten Years: a Multidisciplinary Review", pag. 25.

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Also an effective management of the internal control activity should include the following[8]:

- being directly driven by company leaders (CFO or CEO);
- covering all processes that affect financial reporting, regardless of location;
- clearly defining the activities and objectives of the internal control department;
- continuously monitor the extent to which the company is assuring compliance;
- implement communication protocols to ensure effective information to senior management about the problems facing internal control activities and ways to remedy them;
- provide the technical means necessary to achieve desiderates;
- identify the hazards that could jeopardize the efficiency of internal control;
- executive must be a model in terms of involvement in achieving efficiency of internal control.

• Implementing a system of risk management;

An effective risk management program cannot ignore the measures that ensure[9]:

- identify and assess the impact of risks on the financial reporting process, to determine the activities or causes they generate;
- advice regarding how risks are disclosed and communicated;
- distribute control activities according to the specific risks of thecompany;
- enables prioritizing risks and provides a proper allocation of resources to comply;
- promotes an understanding of risks regarding financial reporting.

The existence of such a program demonstrates the efforts made by the company's management in order to achieve compliance. At the same time, the existence of such a program can contribute decisively to the identificationof risks and their effective approach.

• Identifying and monitoring inadequate controls associated with complex and unusual recording transactions;

Complex transactions such as mergers, acquisitions, valuation of assets and more can present significant risks to financial reporting. Errors can occur because of insufficient documentation, lack of experienced staff in recording these transactions and may lead to revision of the results reported by the company, which is considered a weakness of internal control activity and can negatively impact the report on the degree of compliance with Section 404 provisions or may cause obtaining an unfavorable opinion from the financial auditor.

Anefficient process reporting of complex or unusual transactions must comply with certain requirements, including[10]:

- a monitoring carried out by specialists and senior management;

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[8] Deloitte: „Sarbanes-Oxley section 404: 10Threats to Compliance '', accessed at http://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-aers-assur-ten-threats-sep2004.pdf, page 2, retrieved on April 27, 2016.

[9] Deloitte: „Sarbanes-Oxley section 404: 10Threats to Compliance '', accesssed athttp://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-aers-assur-ten-threats-sep2004.pdf, page3, retrieved on April 27, 2016.

[10] Deloitte: „Sarbanes-Oxley section 404: 10Threats to Compliance '', accesssed athttp://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-aers-assur-ten-threats-sep2004.pdf, page 4, retrieved on April 27, 2016.

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- to follow complete documentedprocesses both in activity and in the accounting control;

- conduct an assessment of the risks inherent to each record;

- involve specialists to reduce the risk of errors.

- Ensuring effective control over the IT component;

IT component has become an important part of the reporting process, companies became dependent on their evolving technology that is becoming increasingly complex and difficult to maintain. For the first time, a law requires companies' detailed evaluation of this component. Remedy the shortcomings discovered requires an amount of allocated resources (financial, time) directly proportional with the implemented IT system complexity or lack of attention paid earlier for this component. Most times, deficiencies were caused by[11]:

- the development, implementation, maintenance and system management;

- data conversion and interface control system;

- security system, protocols and system administration;

- service providers.

- Companies' need to publish effective financial reports;

Regulatory developments and legislative changes in this area has experienced an upward trend in recent years, so for many companies is difficult to keep a pace with changes in the field and to ensure the accuracy of published financial information. The reason may be the lack of a rigorous system for collecting and organizing information sheets or faulty implementation of a control system of this process.

COSO components for effective work of internal control regarding financial reporting are:

- establishing specific actions for monitoring these activities by company's management;

- standardization and efficient communication of data collected;

- sequel procedures regarding the financial reporting process and associated controls;

- identifying the major transactions involving risks and requires staff with a high degree of skill and involvement of management;

- a periodical management training program.

- Implementing a comprehensive, documented and updated accounting policies and procedures;

The presence of a manual of procedures and accounting policies structured, continuously updated facilitates control activities and enable a better assessment of risks. Very large entities operating in the territory of several countries may face difficulties in terms of uniform application of its own practices and accounting procedures manual and because staff may be insufficiently trained or inexperienced regarding certain accounting

[11]*Deloitte: „Sarbanes-Oxley section 404: 10 Threats to Compliance''*, accessed at http://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-aers-assur-ten-threats-sep2004.pdf, page5, retrieved on April 27, 2016.

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operations[12]. And more, complete and timely registration of operations that may affect the reported results can be an impediment to achieve compliance with Sarbanes-Oxley requirements.

- Ensuring adequate evaluation of outsourced processes;

Outsourcing of processes that could significantly affect reported results raises the question of assessment by executive management of efficiency of internal control, including control of outsourced processes. Most often, contracts signed during the outsourcing of services does not clarify who is carrying out the responsibility for internal control activity, this being tacitly ledto those providing the services. If the companycannot obtain information about how the internal control activity is run in these companies, management cannot report objectively about its effectiveness. Also the external auditor may issue a qualified opinion that may adversely affect the company's image.

- Skills development of knowledge by board and audit committee'smembers of the concepts of risk and control;

Section 407,"Disclosure of Audit Committee Financial Expert" requires disclosure of the fact, whether or not, in the Commission of Audit of the issuer exist, at least, one financial expert and if not, this explanation fact. A financial expert is defined as: ,,a person has through education and experience as a public accountant or auditor or a principal financial officer comptroller, or principal accounting officer of an issuer, or from a position involving the performance similar functions is able to:

- understand the applicable accounting principles and financial statements;
- prepare or audit the financial statements;
- apply such accounting principles on accounting for estimates and calculations and reserves;
- understand the work of internal control and audit committee functions"[13].

The external auditor of the company is required to assess the efficiency of audit committee oversight process of preparing financial statements and how it oversees the work of the department of internal control regarding financial reporting.

In order to eliminate the risk of non-compliance with the provisions of Sarbanes-Oxley, members of the audit committee must be familiar with the requirements of this law, to know the responsibilities of each actor involved in the process, to refer the discrepancies between data provided by the department of internal control, the data provided by the department of internal audit and data provided by the external auditor and take measures to eliminate or mitigate these discrepancies

- Auditing the management function;

One of the biggest challenges of internal audit departments is auditing the top-management. Many of the financial scandals of the past were caused by committing fraud at the highest level and even complicity with external auditors (Enron- Artur Andersen). Auditing a company, as a whole, needs to ensure a high degree of independence of internal

[12] *Deloitte: ,,Sarbanes-Oxley section 404: 10 Threats to Compliance"*, accessed at http://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-aers-assur-ten-threats-sep2004.pdf, page 7,retrieved on April 27, 2016.

[13] https://www.sec.gov/about/laws/soa2002.pdf,retrieved on April 27, 2016.

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auditors and major involvement of members of the audit committee in overseeing the work of this department. For adequate acomplishment of internal audit tasks, some companies require the purchase of an IT system, purchase that can be considered expensive by management. A challenge for internal audit department will be to demonstrate to the company's internal environment his ability to add value, in fact achievable by conducting internal audits of high quality and providing useful recommendations to the audit committee but also to the corporate responsibles[14].

• Developingof senior management experience in evaluating the work of internal control covering financial reporting;

Section 302 ,,Corporate responsibility for financial reports", provides that the Executive Director, CFO or other persons performing similar functions, to record at each annual or quarterly reports the following[15]:

- the report was reviewed by the signatory officer;
- signatories, based on their knowledge, ensure that financial carryovers do not contain misleading information or omissions leading to deceive users of accounting information;
- signatories ensure that the information presented in financial reports present a true picture of all operations carried out by the issuer during the period.

All these challenges involves significant increase in responsibilities for those who ensure corporate governance, the executive management, the audit committee regarding reporting and financial control, and penalties in case of non compliance requirements. The effects of lack of manager's experience or lack of recommendations from internal audit department can be mitigated by employing the services of external consultants who usually grow compliance costs of the company.

Conclusion

Financial scandals that rocked the financial world in both the US and UK, have lowered investor confidence in the leading mechanism of corporations, which caused the involvement of both: the senior management and audit firms in committing such frauds. Sarbanes-Oxley was intended to regain the confidence of investors in the capital market. Another goal of this law is to increase accuracy in terms of financial reporting process and transparency in the way that public companies are managed, especially in terms of a basic function of the management process, the control-evaluation.

Confronting the challenges identified above involves significant costs caused by the need for the employment of specialists or professional services in accounting, contracting audit services or consulting for the management and monitoring of companies or permanent insurance programs for training the management. These costs have caused companies to withdraw or postpone capital market listing approach for others. Many companies chose to

[14]Jared S. Soileau, The challenges and Effects of the Sarbanes-Oxley Act on the Internal Audit Profession, Louisiana State University, 2003 may 9, accessed at https://na.theiia.org/about-us/Public%20Documents/Sawyer_Award_2003.pdf, retrieved on April 27, 2016.

[15]*Deloitte: ,,Sarbanes-Oxley section 404: 10 Threats to Compliance''*, accessed at http://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-aers-assur-ten-threats-sep2004.pdf, page 8, retrieved on April 27, 2016.

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withdraw their shares from the stock exchange in New York and opted for the one in London. Thus, if by 2001 the number of new small issuers was around 250 per year in the period 2001-2003, their number decreased to 50.[16]

However, the requirements of this law are largely respected by the companies that have paid increased attention to practices that result in good corporate governance. Some companies have chosen to withdraw from the capital market and we agree with the words of Prof. Suraj Srinivasan: „Sarbanes-Oxley has cut off access to public funding for these companies, but the question is whether it was appropriate presence of these companies in the market capital at first ... but it might not be a bad thing restricting access to public funding for these companies, simply because loss of confidence in the capital market has major consequences for the entire economy."[17]

We find that SOX compliance is beneficial for companies even if it involves considerable costs, companies earning credibility, a significant reduction in risk and an increase of organizational efficiency.

Sarbanes-Oxley has been a model for other states and international organizations. So, in 2006, Japan adopted a similar law and also in 2006 the European Union adopted Directive 8th, with provisions that tend to harmonize with the provisions of Section 404 of SOX.[18]

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[16]John C. Coates, Suraj Srinivasan, „SOX after Ten Years: a Multidisciplinary Review", pag.78
[17]www.papers.ssrn.com/papers.cfm?abstract_id=2343108, retrieved on April 27, 2016.
[18]John C. Coates, Suraj Srinivasan, „SOX after Ten Years: a Multidisciplinary Review", pag.15.

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