

# Experience Sharing – Sarbanes Oxley (SOX)

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**Name**

**Company & Industry**

**Expectations from session**

# Agenda

**Events leading to SOX**

**What is SOX**

**Changes due to SOX**

**Control environment**

**Indian context**

**Way forward**

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**Events leading to SOX**

**What is SOX**

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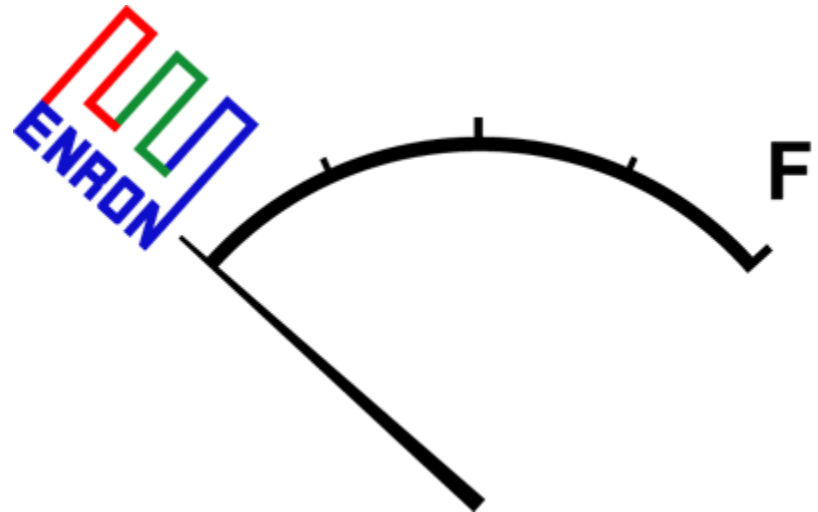
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# What prompted SOX?

- Sarbanes-Oxley was passed in the wake of a number of notable corporate accounting scandals including Enron and WorldCom



# Remember the Headlines

Online NewsHour

a NewsHour with Jim Lehrer Transcript

## COLLAPSING GIANT

November 29, 2001

After this background report on the fall of energy giant Enron, energy experts discuss the collapse of the largest trading firm in the United States.

**As today's closing bell sounded on Wall Street, shares of Enron traded at 36 cents, continuing a spectacular fall for a giant that only months ago was worth more than \$80 a share. Once a poster child for the economic boom of the '90s, Enron is now on the verge of bankruptcy. At Houston headquarters, some of the company's 21,000 employees feared for their jobs.**

# Enron case

- Stock price was \$90 in August 2000 - 7th largest company
- Filed for bankruptcy on December 2, 2001 after restating accounts - stock price 60 cents
- Most highlighted event - relations with limited partnerships (SPEs)
- Executives got personal gains being on both sides (CFO-> \$ 30 mn)
- Failed to disclose the extent of these relations (off-balance sheet and related party transaction)



Paper shredder: **\$100**

Debt hidden in off-balance-sheet subsidiaries:  
**\$500 MILLION**

Stock cashed in by executives while encouraging employees to keep buying: **\$1.3 BILLION**

Sitting it front of a congressional committee and claiming ignorance of any wrongdoing with a completely straight face: **PRICELESS**

*There are some things money can't buy.  
Integrity is one of them.*

<http://politicalhumor.about.com>

# Enron case

- **Special Committee founded to investigate the events, noted failures all levels of monitoring within the company including board**
- **Gatekeepers such as lawyers (Vinson & Elkins), rating agencies severely criticized**
- **Some investment banks after the event alleged aiding and abetting the securities fraud**
- **Enron's both internal and outside auditor Arthur Andersen, indicted to obstruction of justice, shredding of Enron-related documents**
- **The whistle-blower, vice president of Enron until resigned, Sharon Watkins, letter to the top of Enron highly emphasized by media**



# Remember the Headlines



MSNBC-TV

## SEC files fraud charges against WorldCom

Bush vows investigation into scandal

June 26 — WorldCom Inc., the nation's No. 2 long-distance company, REVEALED late Tuesday that almost \$4 billion of expenses in 2001 and \$797 million in the first quarter of 2002 were wrongly listed on company books as capital expenses, thus not reflected in its earnings results.

President Bush vowed to “hold people accountable” and the Securities and Exchange Commission filed fraud charges against the telecom company.

# Worldcom case

- **June 25 2002 - WorldCom confessed that it had overstated its income by \$3.8 billion; files for bankruptcy**
- **Stock plummeted to an all time low of just 5 cents from \$16.00 and over \$60.00 a few years ago**
- **Similar cases were reported e.g. Tyco, Adelphia, Global Tellink**
- **Many other smaller examples of “dot com” booms that turned out to be investor busts**

# Arthur Anderson case

- Biggest auditing firm
- World com & Enron auditor
- Played role of both external audit and consulting
- Destroyed Enron documents after hearing of the SEC's investigation into the one billion dollars of debt that was carried "off-the-books"



# The Year of the “Perfect Storm”

- Unethical Behavior
- Fraudulent Activity
- Downturn in the Economy
- Massive Business Failures
- Audit Failures
- Election Year

***Result: The most significant legislation affecting the accounting profession since 1934***



# How Did US Congress Respond?

**July 2002 –  
Sarbanes – Oxley Act**

# Sarbanes-Oxley - The Response

**Drafted by Sen. Paul Sarbanes and Rep. Michael Oxley**

**To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws**

- **Corporate Responsibility**
- **Enhanced Disclosures**
- **Penalty Enhancements**
- **Corporate and Criminal Fraud**
- **Conflicts of Interest**
- **Public Company Accounting Oversight Board or PCAOB  
- Federal Regulation of Auditing Firms**



**“To deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders.”**

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# Sarbanes-Oxley Act of 2002

- Enacted July 30, 2002 (nine months after first announcement of Enron problems)
- Applicable to *“Issuers”* as defined in the SEC Act of 1934 (approximately 15,000 public companies)
  - Companies required to file periodic reports with the SEC
  - Companies with more than \$1,000,000 in total assets and at least 500 shareholders
  - Companies who have registered securities with the SEC
  - Companies that are *“in registration”*
  - Plus the accounting firms that provide auditing services to them



# The Scope of the Act

- **The scope of the act focuses on:**
  - **Internal controls**
  - **Compliance and reporting**
    - **Transparency**
    - **Accuracy**
  - **Governance**
    - **Accountability**
    - **Responsibility**
    - **Avoidance of conflict of interest**

# The Details of Act

- Title I – Public Company Accounting Oversight Board
- Title II – Auditor Independence
- Title III – Corporate Responsibility
- Title IV – Enhanced Financial Disclosures
- Title V – Analyst Conflicts of Interest
- Title VI – Commission Resources and Authority
- Title VII – Studies and Reports
- Title VIII – Corporate and Criminal Fraud Accountability
- Title IX – White-Collar Crime Penalty Enhancements
- Title X – Corporate Tax Returns
- Title XI – Corporate Fraud and Accountability



# Section 302 & 404

- **Sec 302 - Corporate Responsibility for Financial Reports**
  - Requires management sign-off on disclosure controls
  - **Certification** of completeness and fair presentation required from principal officers (CEO and CFO)
- **Sec 404 - Management's Assessment of Internal Controls annually**
  - Report from management on effectiveness of internal control over financial reporting
  - **Attestation** to management's report by external auditors

# Section 301

- **Requires the Audit Committee to:**
  - Be independent.
  - Directly oversee the Company's external audit firm.
  - Establish procedures for handling complaints about accounting or auditing matters.
  - Procedures to receive and address "whistle-blower" complaints
  - Have authority to hire advisors.
  - Be adequately funded.
  - Except for board of director fees, audit committee members may not accept consulting, advisory, or other compensatory fees
  - At least one financial expert serving on its audit committee & to be independent of management (sec 407)

# Section 302

- **Requires CEOs and CFOs to personally certify in Quarterly financial Reports that they:**
  - Know of no material financial misstatements.
  - Designed internal controls to discover misstatements.
  - Evaluated internal controls within last 90 days.
  - Presented their conclusions about effectiveness of internal controls.
- **Disclosed to external auditors and Audit Committee:**
  - Any significant deficiencies or material weaknesses in design or operation of internal controls.
  - Any fraud involving people who have a significant role in internal controls.
- **Indicated in their report whether any significant changes in internal controls have occurred since their evaluation**
- **Focuses on financial statement, fraud related and disclosure controls**

# Section 404

- **Management assessment of internal controls annually**
- **Requires management to establish and maintain adequate internal controls and procedures for financial reporting.**
- **Requires that each annual report includes a statement:**
  - **Describing management's:**
    - ☞ **Responsibility for internal controls and procedures for financial reporting.**
    - ☞ **Assessment of the effectiveness of the controls and financial reporting procedures.**
- **External auditors to evaluate management's assessment of internal controls and to issue a report**
- **Focuses on internal control over financial reporting**

# Public Company Accounting Oversight Board

- **Established by SOX.**
- **Nonprofit agency.**
- **Responsibilities:**
  - **Register and inspect public accounting firms.**
  - **Establish standards for public accounting firms.**
  - **Enforce compliance with the act and rules of the board.**
  - **Investigate firms and impose sanctions.**

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# Benefit of SOX Compliance

- According to a survey entitled “Oversight Systems Financial Executive Report” conducted with 222 Corporate finance leaders:
  - 74 percent said their company benefited from SOX
  - 79 percent reported “significantly stronger” or “somewhat stronger” internal controls as a result of SOX
  - 46 percent said SOX compliance benefits the company by ensuring accountability
  - 75 percent said they would vote to keep Section 404 if they were members of Congress

# Benefits of SOX Compliance

- Positive influence on maintaining investor confidence (and long-term share price) through increased transparency and fewer surprises
- More timely and reliable financial reporting
- Improved overall control culture
- Better business risk information for Audit Committees and Management
- Enhancement of processes and the underlying control structure to drive operational effectiveness and cost efficiencies
- Improved Corporate Governance Process
- Back to the basics: strengthening foundational controls that had received less attention prior to SOX
- Alignment of IT with the business
- Elimination of outdated, redundant and ineffective processes and controls

# Costs of Sarbanes-Oxley

- In 2005
  - \$5.8 billion spent to comply → up 5% from 2004
- One company spent \$1.2 million on controls and found an employee who had stolen \$5,000
- **ALG** has spent about \$300 million per year to comply



# The Problem Continues Today

- A May 2, 2005 headline stated: “Audit flaws wipe \$2.7bn from AIG.”
- Discoveries of improper accounting at American International Group (AIG) are to knock \$2.7 billion off the value of the world's biggest insurer.
- AIG said it would restate its accounts for each of the last 5 years from 2000 onwards, lowering the company's value by 3.3%.
- It said it had found “material weaknesses” in its control systems and postponed filing its 2004 accounts.

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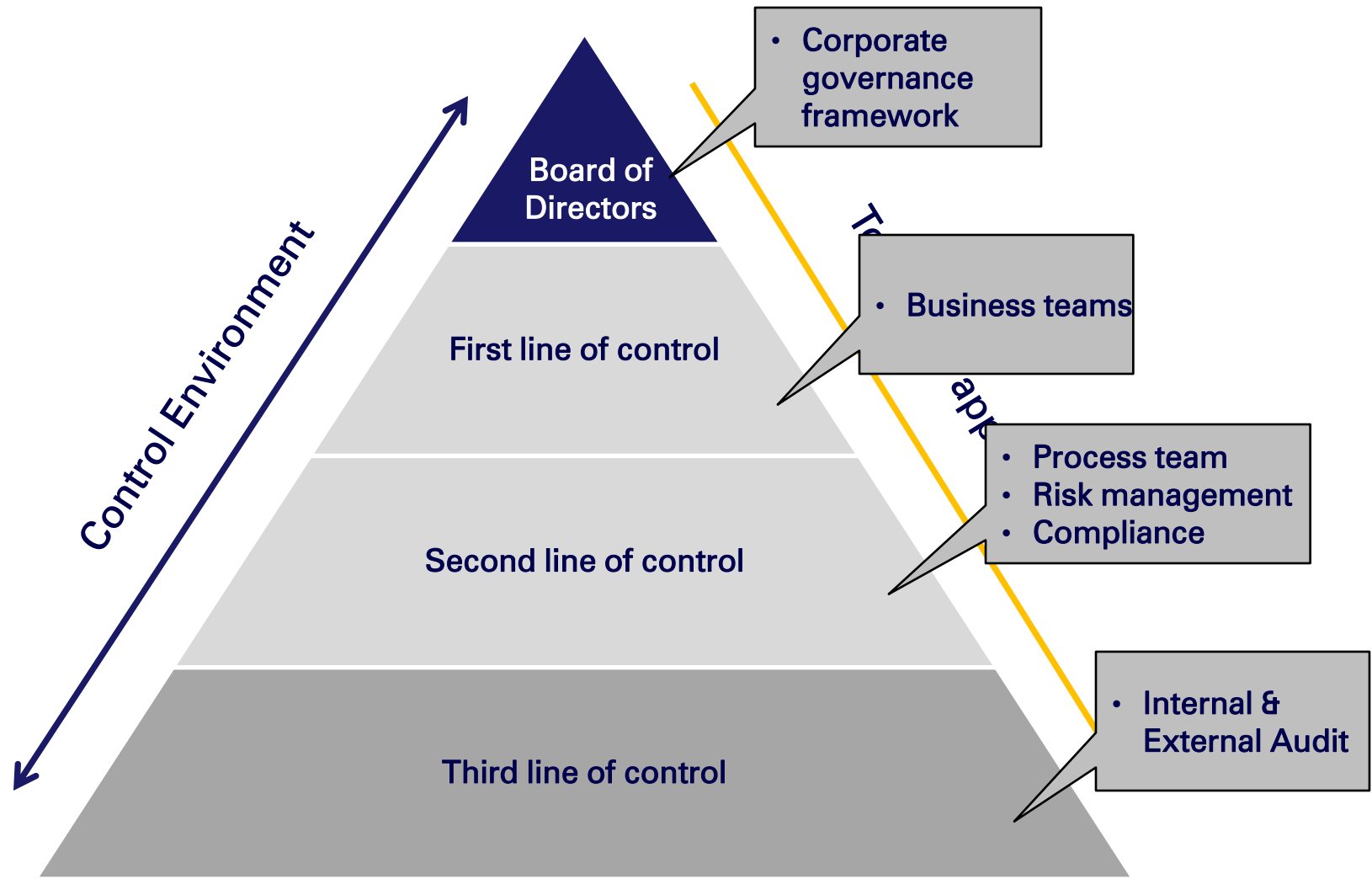
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# COSO Framework

- **SOX requires selection of a framework, however it does not mandate a specific framework**
- **COSO is the most frequently used framework**
- **COSO was developed to provide a framework to evaluate internal controls**
- **COSO requires that management assess risks to the reliability of financial reporting**
- **Control activities are then implemented to mitigate identified risks**

# Overall Control Architecture



Based on COSO framework

# Sarbanes-Oxley Compliance

## Documentation:

- **Code of Ethics**
- **Conflict of Interest Disclosures**
- **Ethics Issue Monitoring, Investigation and Resolution**
- **Disclosure Analysis and Reporting Control Process and Accountabilities**
- **Financial Reporting Control Process and Accountabilities**
- **Internal Control Policies, Procedures and Practices**
- **Assessments and Supporting Certifications**
- **CEO / CFO Certifications**
- **Audit Committee Reports and Disclosures to Auditors**



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# Corporate Governance in India

- **Companies Act, 1956**
- **Clause 49**
- **Industry level Corporate Governance norms**
- **New Companies Act**
- **SOX applicability for Indian Cos. listed in US**
- **Scams/ Fraud scenario**
  - **Satyam**

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I need the process that we follow for setting up new users...



Well, I normally just wait for the new users' supervisor to call me, and then set up the responsibilities I think he needs.



Did we document the process?



I think the implementation consultants had something...I'll have to go through the system documentation binders.



We were going to put it on the web but didn't get around to it, did someone mess up?



No, the Sarbanes Oxley team wanted to know how we can demonstrate adequate internal controls for system security and how we follow them...



# Points to ponder

- **Post SOX & Satyam scenario, do we have adequate focus on Internal Controls**
- **Do organisations look at controls in silo or is there an integrated approach**
- **Is SOX limited to documentation**
- **SOX essential pertains to financial controls – would fraud risk scenarios for other controls be prevented**
- **How to align risks like IT risks, market risks, reputational risks**

# Role in Proactive Risk Management

## Can SOX really identify the sleeping crocodiles?



# Conclusion

- **Control framework will need to evolve as follows:**
  - **Stay abreast of the ever-changing environment**
  - **Look at the big picture - organisation's mission, vision, values, objectives and strategies**
  - **Integrated approach to risk management**







**Thank you**

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