

Overview of Sarbanes Oxley Act 2002



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Sarbanes-Oxley Act 2002



- The cases of corporate failure in the US have been under intense debate at all levels.
- A series of studies/ investigations were conducted to look into the depth of the malaise.
- Leading to collapse of corporate giants, role & responsibility of different constituents of the corporate governance mechanism.
- The consequent various corrective & preventive measures to be taken.

Objective of the Act



Sarbanes -Oxley Act of 2002, provides for:

- Improvement in quality & transparency in financial reporting.
- Independent audit & accounting services for the listed companies.
- Creation of Public Accounting Oversight Board.
- Increased corporate responsibility.

Roles & Responsibilities



As per the cases reported in “U.S.”, focus on the role & responsibilities of the following:

- Board of Directors
- Management
- Audit Committees
- Compensation (remuneration) Committees
- Auditors
- Financial Analysts
- Credit Rating Agencies

Important Issues Highlighted



- Adequacy or otherwise of the corporate governance mechanism.
- Ensuring effective corporate governance in spirit rather than in letter.
- System of internal control, checks & balances
- Functioning of Audit Committees
- Conflict of interest at all levels i.e. regulators, management & auditors.
- Independence of auditors, financial analysts, etc. & the related issues, such as, appointment & fixation of remuneration of auditor, provision of non-audit services.
- Making accounting & auditing effective.
- Effective compliance & auditing.
- Effective compliance of Accounting Standards

Important Issues Highlighted



- Implications of pressures on earnings on financial accounting & reporting
- Audit & reporting on continuous basis
- Accounting & disclosures requirements to match the complex financial transactions in a technology-driven economy.
- Effective mechanism for tracking & punishing corporate frauds.
- Expectation gap in the role & responsibility of auditors.
- Regulation of accounting & auditing profession
- Role & responsibility of the management, including qualifications of the CFO & key accounting personnel.
- Setting up of internal mechanism for ethical compliance & addressing ethical alarm.
- Compensation package, which leads to undesirable practices to prop up earnings / share prices

Period of Keeping Audit Working Papers



- The New Act provides that each public accounting firm shall prepare & maintain audit work papers & other information related to the audit report, for a period of not less than 7 years.
- The New Act amends the United States Code that requires an accountant who conducts the audit of an issuer to maintain all audit or review working papers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded.
- In India, under the Chartered Accountants Act, 1949, the members are required to maintain their working papers in relation to any attest function for a period of 10 years.

Auditing Quality Control & Financial Standards



- The Board has been empowered to establish or adopt standards proposed by professional groups of accountants designated or advisory groups.
- These standards are formulated & issued by the ICAI. It is reiterated that the ICAI is a statutory body set up under an Act of Parliament viz the Chartered Accountants Act, 1949. On the other hand as stated, in the US, this was being done earlier by a voluntary associations i.e. AICPA.

Concurring & Second Partner Review



- The New Act provides for review of audit report by a concurring or a second partner.
- ICAI has from time to time suggested to the Government of India to introduce the concept of joint audit in relation to certain categories of enterprises.
- Such a provision is expected to be much more rigorous than what is contemplated in the new Act.

Scope of Quality Control Standards



- The New Act seeks to define the scope of quality control standards, internal accounting control & in regard to issuance of audit report.
- In India, the quality control standards issued by ICAI cover all the aspects stated in the new Act.
- As regards the internal accounting control, the requirement already existed in India as a key audit requirement through specific assertion in the audit report required to be given under Section 227(4) (a) popularly known as MAOCARO, 1988.

Penal Provisions for Auditors



- The New Act provides for sanctions on the auditing firms which includes temporary or permanent revocation of the firm or the person associated with the firm, censure & civil monetary penalty.
- It provides for a liberal view i.e., instead of award of punishment, as above, the member may be required to undergo required professional education & training.
- In India, the Chartered Accountants Act, 1949 provides for censure or removal from the practice, permanently or for a particular period.
- There is no provision for imposition of civil monetary penalty. This is not required as well in view of the civil & criminal action contemplated is the relevant Act like the Companies Act, SEBI Act or under Common law.

Inspection



- Under the new Act, the Board has the power to periodically inspect the public accounting firm. Inspection in regard to a firm which audits more than 100 companies may be on an annual basis.
- This is analogous to the provision of peer review mechanism in India.
- The System in India provides for independent review i.e.,(review by independent reviewers appointed by the Institute and not on firm on firm basis).
- The earlier mechanism in US (firm on firm basis) proved to be highly inadequate.

Extending Jurisdiction Over Foreign Accounting Firms



- The New Act provides that foreign public accounting firms that prepares an audit report with respect to the listed companies in US shall also be subject to same set of standards as prescribed in respect of US firms.
- In case some components of the company has been audited by the foreign firm, registered public accounting firms, the working papers of such foreign firms shall also be made available to the firm & the Board.
- In India, under the new auditing standards, currently under exposure for public comments, the Institute has provided that in such cases the Indian auditor shall assess the professional competence of the other auditor & may review his working papers.
- Foreign accounting firms have entered in India through the circuitous route of the Reserve Bank of India's approval having not been able to register with the Institute of Chartered Accountants of India.
- As understood, such firms are providing audit related services in circumvention of the law & are outside the purview (regulator or ethical) of all the authorities.

Accounting Standards Setting Body



- The Board has been empowered to recognise Accounting Standards developed by the bodies which fulfil certain conditions.
- The agency earlier setting accounting standards was a private one & recent events proved inadequacies thereof.
- It may be noted that under 210A of the Companies Act, 1956, National Advisory Committee on Accounting Standards (NACAS) is responsible for making recommendations to the Central Government for prescription of accounting standards. The basic accounting standards are formulated by ICAI.
- The position in India is much more stringent in terms of legal requirements vis-a-vis proposed US position.

Adoption of the Principle-Based : Accounting Standards



- The Board would carry out a study for adoption of a principle-based accounting system for financial reporting.
- The Accounting Standards promulgated in India follow closely the pattern laid down by the International Accounting Standard Board (earlier International Accounting Standards Committee) which are principle based rather than rule-based.
- The adoption of principle based standards is always considered much superior because it gives an element of flexibility to assess the appropriateness of accounting treatment in particular set of circumstances.
- In that regard, the India has been much ahead vis-a-vis US.

Non - Audit Services



- The New Act has prohibited certain types of services for being rendered by an auditing firm to the same audit client.
- The Board has been empowered to provide exemption on case to case basis from the prohibition.
- In India, many of these services like book keeping accounting, designing of any system which is subject matter of the audit, internal audit, brokering, investment, advisory, investment banker services, are already prohibited for the auditing firm.
- In regard to services other than these, the ICAI was first in the world to impose a cap on fee for non-audit services.
- There is no leverage available in India for exemption on case to case basis.

Audit Partner Rotation



- The New Act provides for rotation of lead audit partner every 5 years.
- The proposal is aimed at ensuring independence of the auditor.
- The ICAI has already made a suggestion to the Government to introduce the system of the joint auditor & also a mechanism for fixation of auditors remuneration independent of the management, this would be far more effective than what is now contemplated in the US.

Audit Committee



- The New Act provides for reporting by the auditor to the audit committee, on critical accounting policies & practices to be used, discussions with the management officials & other material communication with the management.
- The term "audit committee" has also been defined.
- In case there is no audit committee, the entire Board of Directors would act as an audit committee.
- The provisions of the Companies Act, 1956 & the listing requirements prescribed by the SEBI cover the above intent explicitly or in board terms.
- Audit Committee have been made responsible for the over-sight of the work of auditor.
- There could be a case for elucidation at best & provision that all the members of the Audit Committee should be independent.
- Further, in India, the constitution of audit committee is mandatory & the functions cannot be assumed by the Board of Directors.

Conflict of Interest



- The New Act provides that an audit firm whose employee during the last one year was Chief Executive Officer, Chief Financial Officer, Comptroller, Chief Accounting Officer can not act as an auditor of that company.
- In India, however, the Code of Ethics implicitly provides that in case of post employment or other dealings of the auditor with the auditee whatsoever, it would be a normal presumption that the independence of auditor would get jeopardized.

Corporate Responsibility for Financial Reports



- Under the New Act the principal executive officers & the principal financial officers, or persons performing similar functions of each company filing periodic reports to the Securities and Exchange Committee are required to certify that
 - The signing officer has reviewed the report,
 - The report does not contain any untrue statement or omits a material fact &
 - The financial statements present a fair view.
- Such officers have also been made responsible for establishing & maintaining internal controls.
- Required to report on the effectiveness of the internal controls in the financial reports to the auditor & the audit committee.
- They are also required to disclose to the auditors & the audit committee any fraud that involves management or other employees.

Corporate Responsibility for Financial Reports



- In India, the financial statements are required to be signed by or on behalf on the Board of Directors of the company.
- Directors are required to issue a directors report-Director's Responsibility Statement (issued pursuant to section 217 (2AA) of the Companies Act, 1956).
- **The directors' Responsibility Statement states the following:**
- Preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;
- That the directors had selected such accounting policies & applied them consistently & made judgements & estimates that are reasonable & prudent so as to give a true & fair view of the state of affairs of the company at the end of the financial year & of the profit or loss of the company for that period;
- That the directors had taken proper & sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safe guarding the assets of the company & for preventing & detecting fraud & other irregularities;
- That the directors had prepared the annual accounts on a going concern basis.

Corporate Responsibility for Financial Reports



- The auditors of a company are required to report (under MAOCARO, 1988) whether that is an adequate internal control procedure commensurate with the size of the company & the nature of its business.
- In case the auditor gives a qualified/unfavourable answer to the question, the report also states the reasons for such qualified answer or unfavourable answer, as the case may be.
- It may be noted that the director's report is issued to the general public at large unlike “U.S.” where the certification of facts required by the New Act is done only in the filings before the Securities & Exchange Commission.
- Under Section 628 of the Companies Act, 1956 any person(s) who make a statement in any return, report, certificate, balance sheet, prospectus, statement or other document which is false in any material particular or which omits any material fact is punishable with imprisonment for a term which may extend to two years & is also liable to a fine.

Corporate Responsibility for Financial Reports



- Under the provisions of the Companies Act, the Central Government has the powers to conduct an investigation into the affairs of a Co. where an application in this regard is made by the members of the Co .
- It can suo motto conduct the investigation, if in the opinion of the Company Law Board, the business of the Co is being conducted with intent to defraud the creditors investors, members or other persons.
- Any person who, as a result of the investigation, is found guilty of any offence like fraud/malfeasance/misfeasance is liable to be prosecuted.
- Co., if found guilty, can also be wound up, proceedings against the company for recovery of damages or property can also be initiated.

Corporate Responsibility for Financial Reports



- The concept of 'principal financial officer' being responsible for the preparation & presentation of the financial statements has to be explicitly recognised which is not present in India.
- The institute has from time to time suggested to the Government to introduce the concept of Chief Financial Officer.
- The CFO should be a CA & should be responsible for the over-all preparation & presentation of the financial statements.
- It may be appreciated that the CFOs of almost all the companies which have went for bankruptcy in the “U.S.” were not Certified Public Accountants (Chartered Accountant in India).

Enhance Conflict of Interest Disclosure



- The disclosures are required to be made to the SEC in regard to loan, etc, to the Directors or the Executive Officer of the company.
- In India, the requirements under the Companies Act, are much more comprehensive.
- Schedule VI calls for disclosures and under MAOCARO a specific assertion by the auditor in this regard is required in the audit report.

Disclosure of Audit Committee Financial Experts



- The rule requires that at least one member of the audit committee should be a financial expert in the manner defined under the Rule.
- In India, under clause 49 of listing agreement provides that at least one of the members should have financial & accounting knowledge.
- Possibly the requirement in this regard can be made more specific.

Improper Influence on Conduct of Audits



- Under the New Act, it is unlawful for any person to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.
- This requirement of the New Act is a good move towards ensuring the independence of the auditors.
- Currently, there are no similar provisions under the Indian statutes.
- In generally the provisions are governed by the contract of employment & the general law of the Country.

Enhanced Review of Periodic Disclosures by Issues



- Under the New Act, the Commission is required to review the disclosures made by certain public companies falling in the criterion laid down by the New Act.
- Such review shall include a review of an issuer's financial statements.
- The ICAI has constituted a Financial Reporting Review Panel (FRRP) with the objective of reviewing the financial statements of certain enterprises.
- The main objective of the FRRP is to secure compliance with the accounting standards & to ensure that the financial statements give a true & fair view.

Authority of the Commission to Prohibit Persons from Serving as Officers or Directors.



- The Commission has been granted powers to issue an order to prohibit, conditionally or unconditionally & permanently or for such period of time as it shall determine, any person who has violated certain provision of the securities law in the US.
- Section 164 of the Companies Act, 2013 prescribes the disqualification for appointment director .
- The main purpose of the section is to restrain fraudulent persons from managing companies.
- It may also ne noted that in the case of default under the rules & regulations framed by the securities & Exchange Board of India, the Company & the person concerned may be penalized by fines.

The Act



- **The Act was signed into law on July 30, 2002**

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

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Section 302 -

CEOs & CFOs to sign off on the validity & accuracy of their companies' financial numbers & to certify the controls & procedures behind their financial reports.

Section 404 -

Organizations must ensure that the audit process behind their financial reporting is not only comprehensive & accurate, but that they can also meet strict quarterly timeframes for reporting on an ongoing basis.

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Section 409 -

Issuers are required to disclose to the public, on an urgent basis, information on material changes in their financial condition or operations.

Section 802 -

Imposes penalties of fines and/or up to 20 years imprisonment for altering, destroying, mutilating, concealing, falsifying records, documents or tangible objects with the intent to obstruct, impede or influence a legal investigation.

SOX- Act Section	Section 302	Section 404	Section 409
Key Questions for Executives Responsible for the Compliance	Who in the organization is responsible for ensuring the integrity & always-on status of finance & accounting systems?	Does the internal controls framework include business continuity planning & disaster recovery considerations?	How will potential “material changes” be monitored when the systems conducting the monitoring go offline?

Benefits of Sarbanes Oxley Act



To the Investors

- Companies have to reveal poor financial reporting practices that should be stopped.
- More trust in the financial statements of any company before deciding on any investments.

To the Companies

- Benefits from consolidated data store
- Benefits from ability to find data & create reports – business intelligence
- Side benefit: discovery of internal fraud & theft through tighter controls
- Result: positive shareholder value

Compliance



Identify all processes & systems that can have a material affect on financial results:

- Identify risks
- Document & test all related processes
- Document & test internal controls according to a recognized framework such as (COSO) – Committee of Sponsoring Organizations
- Ensure compliance of business rules & controls

COSO Framework

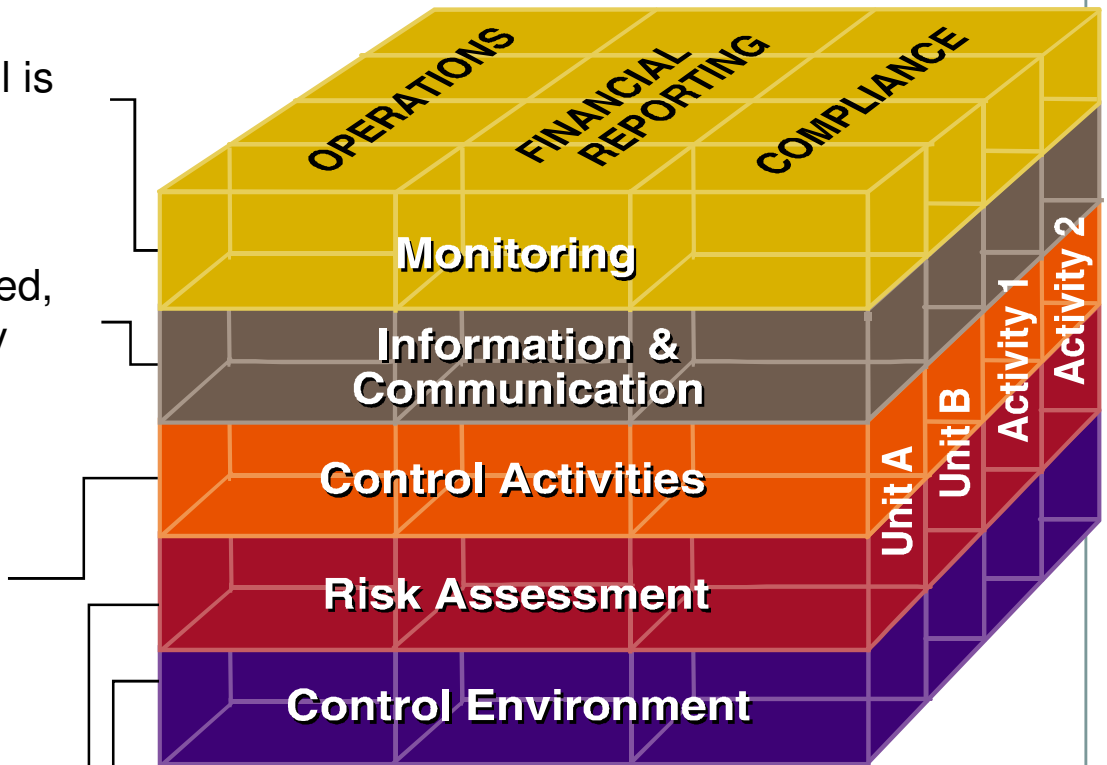


The overall system of internal control is monitored & improved.

How pertinent information is identified, captured & communicated internally and externally.

How the pertinent activities are designed, implemented & tested.

How the company sets objectives & manages risk



The overarching system of controls designed to govern business practices & behaviours.

Methodology



Plan Project

- Form Steering Committee
- Select Documentation Format
- Perform Risk Assessment
- Prioritize Processes to Document
- Identify External Auditor Expectations

Assess Control Environment

- Identify Corporate Governance & Management Controls
- Identify/Assess/Document IT General Controls

Conduct Pilot

- Document & Test Controls for 1-3 Processes
- Review Results w/Steering Committee
- Refine Approach

Project Roll-Out

- Roll-out to Centralized Processes
- Roll-out to Other Significant Locations and/or Decentralized Processes

Report Overall Results

- Report/Fix Any Control Deficiencies
- Cover Period to Yearend

Internal Controls



Measures Designed to provide reasonable assurance for:

- Reliability of financial reporting
- Effectiveness & efficiency of operations
- Compliance with applicable laws & regulations

Action

- Reduce time to compliance
- Enhance the procedures for financial reporting & business Processes
- Accommodate changes in regulations & procedures
- Monitor & Maintain control procedures
- Infrastructure for broader process automation

Final Words



- SOX 2002 has transformed the corporate landscape with new & complex mandates for corporate financial reporting.
- Public companies of all sizes will go through the same basic steps to achieve compliance.
- Organizations will require a technology solution that does not force them into a particular process or methodology.
- Selection of a tool that will allow to capture & enforce best practices around the collection & reporting of financial data.
- Best Practice-Easily adapt to individual approaches, provide long term flexibility while coordinating all of the moving parts, tasks, people & systems involved in compliance.
- Compliance is not a one-time event: it is an ongoing process where the initial audit is only the first phase, followed by ongoing enforcement of controls & process enhancement.
- Smart organizations will view SOX as an opportunity to establish corporate governance & process excellence in their financial processes & other key business areas.

Thank you



BY CA ABHIJIT SANZGIRI