Internal Controls After Sarbanes-Oxley

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Pre-2002

- Since 1978, U.S.-registered public companies have been required to have reasonable systems of internal controls, and to keep accurate books and records (Section 13(b)(2) of the Securities Exchange Act)
- However, the SEC took a narrow view of the statute (see Exchange Act Rel. No. 17500, Jan. 29, 1981) and did not aggressively enforce the requirements
- Enron: dramatic internal controls failure

SOX's Statutory Requirements

- Section 302: CEO and CFO must attest to effectiveness of internal controls and report significant deficiencies to auditors and board audit committee
- Section 404: Management must assess the effectiveness of internal control over financial reporting, and *auditor* must attest to and report on that assessment

SEC Rule-making (2003)

- Rule 13a-15: imposes two separate internal controls system evaluations: “disclosure controls and procedures” and “internal control over financial reporting” (ICFR). ICFR must be evaluated based on a “suitable, recognized control framework” (e.g., COSO)
- Management’s assessment of ICFR effectiveness must include disclosure of any “material weakness” identified by management and any changes during the most recent fiscal period (Item 308 of Reg. S-K)

Auditor Attestation

- Rule 2-01(f), Reg. S-X: Auditor must “clearly state whether management’s assessment of the effectiveness of the registrant’s internal control over financial reporting is fairly stated in all material respects” and if not, why not
- Key negotiation point: what does “material weakness” mean?

PCAOB Rule-making

- Auditing Standard No. 2 (2004): auditor must search for "significant deficiencies," i.e., one or more flaws in ICFR such that "there is a more than remote likelihood" of a misstatement in the company's financials "that is more than inconsequential." In turn, a material weakness is one or more significant deficiencies that create a "more than a remote" likelihood that a material misstatement in the financials will not be prevented or detected.
- AS-2 became the *de facto* standard for management evaluation and reporting as well as auditor attestation

Costs

- Substantial increases in compliance costs and audit fees for the first group of companies to face requirements (“accelerated filers”) – immediate political controversy
- Increased delistings (“going private” and “going dark”) and avoidance of U.S. markets (Carney, 2006)?
- Costs decrease in 2006-07 for accelerated filers, but remain considerable (FEI, 2008)

Benefits and Other Consequences

- Evidence of better “quality” financial reporting (i.e., less abnormal accrual, more conservatism – see Doyle, Ge & McVay, 2007). Disclosure of material weaknesses is valued by the market (Hammersley, Myers & Shakespeare, 2008). For discussions of benefits, see Shakespeare, 2008; Coates, 2007.
- Increased managerial risk-aversion (Bargeron, Lehn & Zutter, 2008)?

Diagnosis

- Widespread perception that internal controls costs were excessive even assuming significant benefits, but why?
- One possibility: standards poorly or inadequately specified
- Another possibility: post-SOX “rent-seeking” by accountants, lawyers, consultants, etc. (Langevoort, 2006)

Regulatory Response: 2007

- SEC provides formal guidance giving issuer management more discretion in assessing financial reporting risk and designing an appropriate internal control response and creates a “safe harbor” for compliance therewith (Rel. 33-8809, June 20, 2007)
- PCAOB withdraws AS-2 and adopts new AS-5 (May 24, 2007)

Key Changes

- SEC guidance and AS-5 are coordinated (though not identical) to be “top-down” and “risk-based,” i.e., not a routinized inquiry into all transaction processes but rather an allocation of internal control resources to the places most likely to create risk of false or misleading disclosure. Explicitly “principles-based.”

“Material Weakness”

- Redefined to mean one or more deficiencies “such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis” (Rule 12b-2)

Smaller Issuers

- Cost concerns strongest (as is evidence of delistings, avoidance, etc.) with respect to smaller issuers
- SEC deferred internal control requirements for "non-accelerated filers." Such issuers must begin management reports on internal controls for fiscal years ending after Dec. 15, 2007. As proposed, auditor attestation will not be required until fiscal years ending after Dec. 15, 2009 (See Rel. No. 33-8889, Feb. 1, 2008)

Smaller Issuers (cont'd)

- SEC guidance and AS-5 both emphasize that ICFR in smaller, less complex companies can be less detailed
- PCAOB and COSO are developing additional guidance with respect to smaller issuers (see PCAOB press release, Oct. 17, 2007)

Alternative Hypothesis

- The 2007 changes will reduce costs *if* implemented as intended
- Auditors (and lawyers, consultants, etc.) have benefited from post-SOX regulatory environment and may be reluctant to embrace changes
- Liability risks – PCAOB discipline, SEC enforcement, private litigation – still significant threat

Auditors' Bargaining Power

- SOX increased auditors' bargaining power over management when disagreements arise over internal controls or financial reporting
- Audit committee (independent directors – often accountants, lawyers or financial executives (see Linck et al., 2008)) mediates (Rule 10A-1(b)(2))
- Officers may not "coerce, manipulate, mislead or fraudulently influence" any auditor (Rule 13b2-2(b))
- Diminished competition in audit industry

Conclusion

- Optimal regulatory strategy regarding internal controls is unclear. Risk of overregulation remains
- Corporate governance – more process, more caution
- Costs borne by shareholders, but are they the only intended beneficiaries? SOX (including but not limited to ICFR) may be a renegotiation of corporate governance on behalf of a broader range of public stakeholders, including the government (Langevoort, 2007)

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