
Sarbanes-Oxley

Shock news – SOX is working

Sarbanes-Oxley rules are improving the quality of financial disclosure, despite criticisms, says *Tim Leech*. Accounts produced under less stringent audit regimes should get lower grades.

Companies and governments that continue producing financial accounts under the older, less reliable financial disclosure and audit regimes should be penalised for the lower quality of their information compared with what's now being produced by US listed companies. External auditors should grade their opinions on financial statements from A, indicating top quality, through B down to C or worse. Grade C would point, for instance, to the lower quality of financial disclosure on offer from most European stock-exchange listed companies.

Under the tough Sarbanes-Oxley corporate governance regime, the US listed companies to which it applies are now starting to produce the most reliable external financial disclosures in the world. They should be rewarded for their efforts.

Stream of criticism

Since the Sarbanes-Oxley Act (SOX) was passed in 2002 there's been a steady stream of criticism from a wide range of players. The business community claims the additional costs caused by SOX sections 302 and 404 are choking off much needed risk taking and profit creation. Section 302 requires the management of a publicly quoted firm to satisfy themselves in a formal visible way that their systems controls are reliable. Section 404 requires a firm's auditors to report on the reliability of management's assessments of the controls.

The Europeans, led by a very vocal Digby Jones, director general of the Confederation of British Industry, claim that SOX is yet another example of American imperialism and arrogance.

"Globalisation does not mean Americanisation, and although the US is trying to behave like a free market, it has a long way to go," Jones was quoted as saying in January.

Directors of US listed companies are threatening to quit boards in droves to avoid the heightened accountability and personal liability. Chief financial officers,

controllers and tens of thousands of employees working on SOX compliance projects are wilting under the heavy initial SOX compliance workload.

There is no doubt that SOX has some serious technical faults and is very expensive.

A White Paper I wrote in early 2003 and dozens of other technical papers by corporate governance experts have outlined numerous flaws in the way the legislation has been interpreted and deployed by the Securities and Exchange Commission (SEC), which regulates US stock markets, and the Public Company Accounting Oversight Board (PCAOB), the accounting industry watchdog body set up by SOX.

Profit management gamesmanship has been curtailed. Chief financial officers and chief executives are far more reluctant to push the limits of generally accepted accounting principles.

But the real problem for SOX detractors is that it is working. There's growing, irrefutable evidence for this, despite SOX's technical flaws and the need for improvement in some areas. And that's despite continuing and mounting overt and covert efforts to divert US politicians, the SEC and PCAOB from the path they embarked on in 2002.

Financial disclosures from US listed companies are more reliable. Profit management gamesmanship has been curtailed. Chief financial officers and chief executives are far more reluctant to push the limits of generally accepted accounting principles.

Restatements of previously published financial results have increased dramatically. Thousands of companies disclosed in 2004, and will disclose in 2005, serious deficiencies in the controls they operate to ensure investors and other

stakeholders are given reliable financial information.

The most profound result is that external auditors in the US and in countries where US listed companies are domiciled are producing significantly more reliable opinions on published financial statements than other external auditors around the world. This will reshape corporate governance and the external auditing profession.

More reliable than elsewhere

It means that audited financial statements for US listed companies are now, on balance, more reliable than those being produced for companies listed in London and on European exchanges. The financial statements of US listed companies are now also generally more trustworthy than those of US private companies and those in the public sector, the not-for-profit sector and for public companies in other countries that have not yet adopted a SOX-like regime.

More certainty that financial statements are true and reliable should translate to a lower cost of capital and higher share prices for US publicly-quoted firms. Financial disclosures by companies in countries not adopting a SOX regime are now, on balance, less reliable. Companies in non-SOX regime countries will face a decision – adopt a SOX-like regime or pay a risk premium for capital.

Grade-A opinions

What can be called Grade-A external auditor opinions are coming from the SOX 302/404 regime. Because of the extra work and care required from both management and external auditors, these opinions do cost more. But they come with a higher degree of comfort that the numbers and disclosures are reliable.

The Grade-A reports are still far from perfect. They could be further improved and the cost of producing them reduced. But all users of financial statements

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should be alerted to the difference in audit opinion quality. The external audit standard setters inside and outside the US should force external auditors to warn readers in simple, unambiguous language that audit opinions provided on financial statements under non-SOX 302/404 regimes are less reliable and more risky.

A simple Grade A, B and C system for external audit opinions linked to the likely reliability of the opinion would work fine. Grade B would be awarded where management has full responsibility for assessing and reporting control deficiencies to the audit committee and external auditors, but doesn't have a full audit of the basis for these conclusions. Grade C would be for the type of external audits being done currently on most European listed companies and on most non-US listed firms, not-for-profit companies, private companies and governments.

The following points are evidence for the success of SOX:

- **Restatements are up dramatically in the US.** The Huron Consulting Group released the results of a study on financial restatements in January that showed that the number of restatements to companies' financial results spiked 28% last year. The number one reason for the spike – the additional scrutiny and rigour imposed by SOX. Companies are starting to come clean that prior period disclosures were materially flawed. There does not appear to be a similar trend occurring in countries not under a SOX regime. This means either US companies have been bigger liars than the rest of the world or investors in other countries are still unaware of the extent that public companies listed in their domicile have stretched the truth about their financial status in the past.

- **Disclosure controls far worse than one would expect.** Over 500 US listed companies, including many with a primary listing in other countries, disclosed serious external disclosure control deficiencies in 2004. This number is expected to grow in to the thousands in 2005. In each instance where a major deficiency has been reported improvements will have to be made. The result of these improvements will be that the reliability of financial disclosures in the future will be even better. Just imagine how many companies in other countries

around the world currently have similar, seriously flawed, external disclosure controls but securities regulators and investors are kept in the dark.

- **The extent of the work required has been massive.** It is now very clear that very few public companies anywhere in the world had formally assessed the strengths and weaknesses in all of their external financial disclosure systems with much rigour prior to SOX. External auditors often chose to do very little disclosure control assessment and testing. This is why so much work has been required to meet the SOX/SEC/PCAOB expectations. Companies and other organisations not on SOX-like governance regimes can continue to avoid rigorous risk and control documentation and assessment of their disclosure controls – at least for now.

- **Credit agencies are recognising the importance of strong disclosure controls.** Moody's in October, Standard & Poor's in December and Fitch Ratings in January have all published papers acknowledging the importance of the new, improved SOX disclosure regime. What they haven't stated yet is the obvious conclusion that audited financial statements produced under non-SOX regimes are, on balance, less reliable than those that are. This will come soon.

- **Senior management and boards have radically increased their oversight diligence under the SOX regime.** Recent studies and reports on audit committee behaviour are unanimous that audit committees of US listed companies are meeting more frequently, getting radically better data on the state of internal control and asking better questions. Audit committee counterparts in public companies in other parts of the world still don't have the same incentives to improve their game.

The global investment community needs to recognise it's now working with more reliable financial disclosures from US listed companies than those produced elsewhere. The closer a country's disclosure governance standards are to the U.S. SOX 302/404 regime the lower the risk premium should be. An example is Canada. Canada is slowly moving to what may in the end be an even stronger form of SOX 302/404 governance over financial disclosures produced by companies listed on Canadian exchanges.

This will, in time, result in significantly more reliable disclosures than those produced under the previous Canadian and current European audit regimes but will be without the additional discipline imposed by the audit opinion required by SOX Section 404 for some time, perhaps as late as 2008. Perhaps Canadian audit opinions should be assigned Grade C+ or Grade B- status for now and audit opinions on financial statements produced in Australia, Asia and other countries – as well as Europe – that currently lack the rigour of SOX 302/404 type regimes should be Grade C audit opinions.

Others must react

External audit standard setters in other countries need to react. Readers of audited financial statements need to have a better understanding of the audit process used to arrive at an opinion. As long as users of the external audit opinions know the risks that accompany Grade A, B or C audit opinions, they can decide whether to invest and appropriately risk-rate the return premium and cost of capital. Although a Grade C audit opinion does not mean financial statements are incorrect it does mean there is less certainty that they are correct and reliable.

The axiom "no pain, no gain" also applies to reliable financial disclosures. It is important that U.S. listed companies and those in other countries that adopt similar SOX 302/404 regimes be rewarded for the pain and effort they must endure to increase the reliability of financial statement disclosures. They should also continue to fight for improvements to the current approach enacted by the SEC and PCAOB. Those countries that want to continue under looser and less reliable governance regimes should be able to do so, as long as users of financial disclosures are clearly told they are getting Grades B or C or worse. An efficient market that fully understands the difference between Grade A audit opinions and Grades B, C – or even D – opinions will do the rest.

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