SOX at 20:

The enduring legacy of the Sarbanes-Oxley Act

Introduction

The US proudly has the deepest and most liquid public capital markets in the world. One key factor underpinning this success is the strength of the US regulatory framework, which inspires confidence among investors — from Main Street to Wall Street. Twenty years ago, a series of financial reporting scandals severely shook this confidence. The US Congress responded with the Sarbanes-Oxley Act of 2002 — known to us today as "SOX" — which aimed to strengthen investor confidence and restore trust in the capital markets.

Following the enactment of SOX, the public company auditing profession transitioned from a period of self-regulation to a new, independent regulator and stepped up its engagement with investors, audit committees, boards of directors, educators, academics, policymakers and others who had an interest in high-quality auditing. In the ensuing two decades, these efforts have yielded demonstrable gains in audit quality, the reliability of financial reporting and investor confidence, all made possible by the continuous commitment and significant investment by all members of the financial reporting ecosystem. Today, SOX is viewed around the world as a strong and effective framework for increasing the transparency and reliability of financial reporting, deterring corporate fraud and promoting audit quality.

At Ernst & Young LLP, we recognize the groundbreaking and enduring impact of SOX and acknowledge that maintaining investor confidence in financial reporting requires relentless work and attention. The audit profession must always focus on our mission of serving the public interest and the importance of audit quality. We also must continue to evolve in step with new opportunities and challenges, including market innovations, a complex global business environment, and dramatic shifts in the workforce and technology. One of the strengths of the regulatory framework set forth in SOX is its comprehensive consideration of the ecosystem that enables high-quality financial reporting and the various stakeholders who contribute — from companies, their audit committees and boards, auditors and our regulators. At our firm, we are committed to serving the public interest. We also are committed to fully engaging with our stakeholders and building on the foundation SOX established to fulfill the goals of the legislation, which are even more relevant and vital today.

Julie

Julie Boland
EY US Chair and Managing Partner
and Americas Managing Partner

John King
EY Americas Vice Chair -
Assurance

The Sarbanes-Oxley Act: a corporate reporting milestone

In July 2002, Congress passed the Sarbanes-Oxley Act of 2002 (SOX)[1] with strong bipartisan support. Passage of the Act was a watershed moment, overhauling oversight of financial reporting and the regulation of the audit profession. Further, the Act's establishment of independent audit oversight has rippled around the world.

Since its enactment, SOX has provided a robust framework for deterring corporate fraud, increasing transparency and promoting complete and accurate financial reporting in the public capital markets. Among its provisions, SOX created the Public Company Accounting Oversight Board (PCAOB or Board), thereby ending self-regulation in the audit profession; strengthened the independence of the audit; empowered independent audit committees to oversee audits and financial reporting; and strengthened executive accountability around the financial reporting process. These mutually reinforcing elements of the Sarbanes-Oxley Act remain key pillars of financial reporting in our capital markets today, supporting investor protection and serving as a model for the world. These reforms continue to support trust in financial reporting.

This publication highlights some of the key elements of SOX and how they work together to strengthen investor protection and confidence around financial reporting.

Key components of SOX

1. **Accountability for financial reporting** – SOX placed explicit requirements on management to increase accountability for financial reporting quality, including:
   - Public company management must assess the effectiveness of internal controls over financial reporting[2]
   - For larger companies, auditors also must attest to the effectiveness of internal control over financial reporting[3]
   - Top executives of public companies must certify financial reports[4]
2. **Oversight of the audit**
   - Audit profession-wide oversight: creation of the PCAOB – SOX created an independent body to oversee the public company audit profession[5]
   - Company-specific oversight: independent audit committees – SOX required each listed company to have an audit committee with authority to oversee its external audit
3. **Auditor independence** – SOX strengthened the independence of the audit through mutually reinforcing mechanisms including:
   - Limitations on non-audit services that may be provided by audit firms to their audit clients to reduce conflicts of interest, enforceable by both the U.S. Securities and Exchange Commission (SEC) and PCAOB
   - Audit committee preapproval of all non-audit services provided by the external auditor
   - Rotation of certain key audit partners every five years

[1] Sarbanes Oxley Act of 2002, H.R.3763, 107th Congress, accessed July 2022

[2] SOX Section 404(a) | [3] SOX Section 404(b) | [4] SOX Section 302

[5] The PCAOB also has authority to oversee the audits of broker-dealers. That aspect of the PCAOB's authority is outside of the scope of this paper and so is not further discussed.

4. **Audit enhancements and governance** — SOX established requirements aimed at improving the quality of audits:
   - PCAOB oversight of audit quality, including setting audit standards and conducting periodic inspections of public company audit firms
   - Audit committee focus on audit quality and enhanced auditor-audit committee communications
5. **Additional investor protection provisions** — SOX as a whole is designed to protect the interests of investors. In addition to the provisions listed above, the Act also put in place measures to uncover and address wrongdoing relating to financial reporting and hold corporate executives and auditors accountable, where necessary. These include:
   - PCAOB's audit-focused enforcement program
   - SEC whistleblower protections

Accountability for financial reporting

SOX took steps to place explicit accountability for accurate financial reporting on company executives. These included an enhanced focus on internal control over financial reporting and mandatory certifications by top executives regarding financial reporting.

Internal control over financial reporting

SOX emphasized the importance of Internal Control over Financial Reporting (ICFR). Effective ICFR helps ensure that the financial statements are put together using accurate and complete information. While public companies have long been required to maintain effective systems of internal controls pursuant to the Foreign Corrupt Practices Act of 1977, SOX requires them to annually evaluate their financial internal controls and to publicly disclose the results of that assessment. This includes whether there were any material weaknesses in controls that may not prevent or detect a material misstatement in the financial statements. This evaluation takes two forms:

- Public company management must assess and report on the effectiveness of the company's ICFR, providing transparency to investors regarding financial reporting quality.
- For larger companies, the external auditor must attest to and publicly report on the effectiveness of ICFR,[6] providing investors with an independent view of management's assessment. In turn, the PCAOB oversees auditors' ICFR-related activities, including through inspections and standard setting.

CEO and CFO accountability

The Sarbanes-Oxley Act also clearly defined and placed responsibility for the quality and accuracy of a company's financial statements with its CEO and CFO. SOX mandated that these executives certify the following facts (among others) for each annual and quarterly report:

- They have reviewed the report.
- Based on their knowledge, the financial information included in the report is fairly presented.
- Based on their knowledge, the report does not contain any untrue statement of material fact or omit a material fact that would make the financial statements misleading.
- They acknowledge their responsibility for establishing and maintaining internal controls over financial reporting as well as disclosure controls and procedures.
- They have evaluated the effectiveness of these disclosure controls and procedures and disclosed any material changes in the company's internal controls over financial reporting.

[6] SEC rulemaking and legislation subsequent to SOX (e.g., the Dodd-Frank Act and the Jumpstart Our Business Startups (JOBS) Act of 2012) have delayed or eliminated the requirement for certain companies, including non-accelerated filers and emerging growth companies, to comply with Section 404(b). The Laws that Govern the Securities Industry (investor.gov), accessed May 2022. See also Spotlight on Jumpstart Our Business Startups (JOBS) Act (sec.gov), accessed May 2022.

These requirements emphasize top executives' accountability for their companies' financial statements and related controls. To enhance the significance of these certifications, SOX mandated stiff penalties for executive officers who certify that financial reports comply with the various regulatory requirements while knowing that they do not. Such penalties include potential SEC enforcement action, forfeiture of bonuses and profits or criminal penalties such as fines or imprisonment.[7]

Oversight of the audit

PCAOB

What is the PCAOB?

- The PCAOB, established under the Sarbanes-Oxley Act, is an independent regulator of auditors of public companies and broker-dealers. Establishment of the PCAOB ended more than 100 years of self-regulation by the public company audit profession.
- The Board's mission is to "oversee the audits of public companies in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[8]
- The agency has inspection, enforcement and standard setting authority.
  - Inspection authority[9]
    - The PCAOB has the authority to inspect registered public accounting firms and individual auditors. The agency inspects the largest firms and publishes findings from those inspections every year. Through its inspections process, the PCAOB assesses an auditor's compliance with SOX, the rules of the Board, rules of the SEC and professional standards.
  - Enforcement authority[10]
    - The PCAOB has authority to investigate whether auditors are complying with its rules and regulations governing public company and broker-dealer audits and impose penalties if they are not.
  - Standard setting authority[11]
    - The PCAOB is responsible for establishing and updating standards on auditing, ethics, independence and quality control.

How is the PCAOB governed?

- The Board comprises five members appointed by the SEC in consultation with the Secretary of the Treasury and Chair of the Federal Reserve Board.
- Congress gave the SEC authority to oversee the Board. This includes:
  - Appointment and removal of Board members
  - Approval of the Board's budget, standards and rules
  - Hearing appeals of PCAOB inspection reports and disciplinary actions
- Congress specified that two of the five Board members — and only two — must be certified public accountants. PCAOB members also must work for the Board full time.[12]

[7] SOX § 304 requires CEOs and CFOs to reimburse issuers for bonuses and profits on the sale of the issuer's shares over the preceding 12 months if the issuer restates its financial statements because of misconduct. Section 954 of the Dodd-Frank Act of 2010 requires companies to establish policies to recover incentive-based pay of any current or former executives awarded over the three years prior to a restatement, regardless of whether there was misconduct. The SEC issued a reproposed rule in October 2021 that, if finalized, would carry out this requirement. "Reopening of Comment Period for Listing Standards for Erroneously Awarded Compensation," SEC reproposed rule, October 2021, SEC website, Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (sec.gov), accessed May 2022.

[8] About | PCAOB (pcaobus.org); see also SOX section 101(a); 15 USC 7211(a)

[9] Inspections (pcaob.org) accessed July 2022

[10] Enforcement (pcaob.org) accessed July 2022

[11] The Standard Setting Process (pcaob.org) accessed July 2022

[12] SOX Section 101(e); 15 USC 7211 (e)

Audit committees

What are audit committees?

SOX established a legal requirement for listed companies to have independent audit committees directly responsible for the appointment, compensation and oversight of the work of the external auditor. Oversight responsibilities under the Act include monitoring the auditor's independence and resolving any differences between the auditor and management regarding financial reporting.

Composition:

- Audit committee members must be independent of management and the company
- Audit committees must disclose whether they have a financial expert among their members, and if not, why not

Responsibilities include:

- Direct responsibility for the appointment, compensation and oversight of the work of the external auditor
- Receiving direct reports from the auditor regarding accounting and audit policies and other financial reporting-related matters
- Preapproval of all audit and non-audit services provided by the external auditor
- Engagement of advisors as needed to carry out duties
- Setting up a system to receive confidential and anonymous reports from employees discussing concerns about a company's accounting and auditing

Auditor independence

Independent audits have long been a cornerstone of the US capital markets. Auditors are charged with evaluating whether the financial statements prepared by a company's management are fairly presented in accordance with the relevant financial reporting framework. Given how many investors and other stakeholders rely on accurate financial reporting, the auditor's independence from management is critical to investor confidence in the audit's effectiveness and in financial reporting. Reflecting the importance of investor confidence in auditor independence, SOX put in place multiple tools to support and promote independence.

Oversight of auditor independence

PCAOB: SOX granted responsibility for setting public company auditor independence rules to the PCAOB, augmenting the existing authority of the SEC.[13] It also codified into federal law further limits on the types of non-audit services that audit firms can provide to the public companies they are auditing. SOX specifies that auditors cannot provide non-audit services such as bookkeeping, legal and expert services unrelated to the audit, appraisal or valuation services, and more to public companies they audit.[14] The PCAOB assesses compliance with independence rules as part of their inspections of firms registered with it. The PCAOB, as well as the SEC, can take enforcement action if a firm does not comply with independence requirements.

[13] The SEC also has authority to set auditor independence standards.

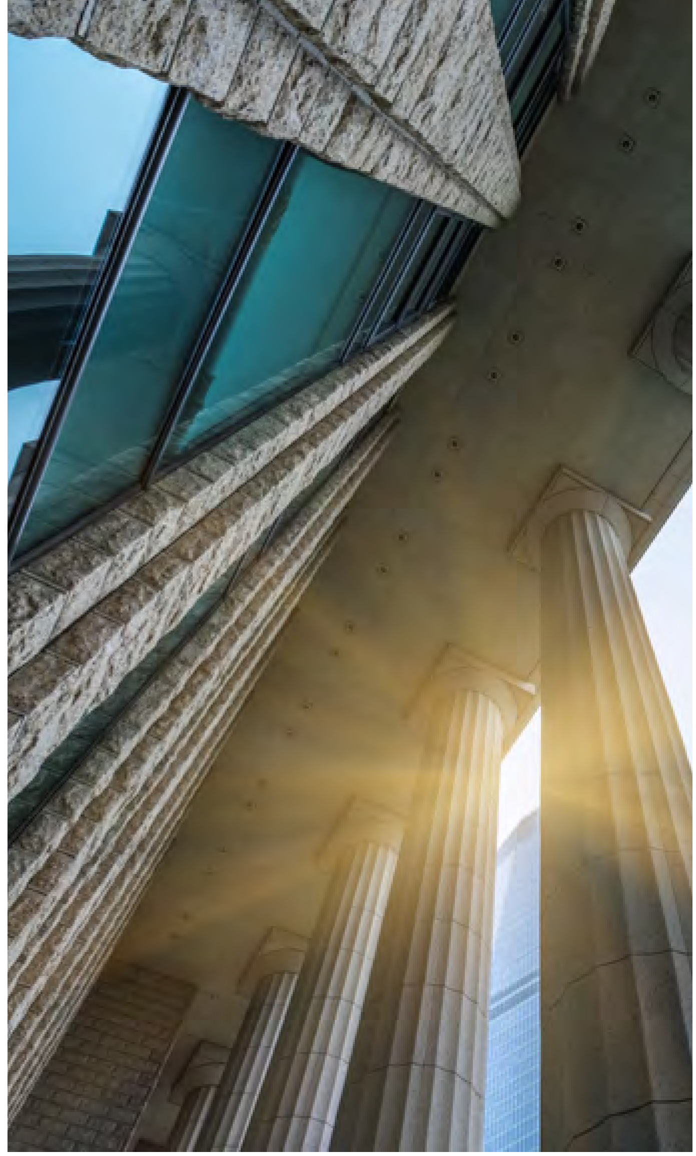
[14] SOX Section 201(g), 15 USC 78j-1(g).

Audit committees: SOX made independent audit committees,[15] rather than company executives, responsible for the appointment, compensation and oversight of the auditor. To be considered independent, audit committee members cannot accept fees from the company other than in their board capacity, and they cannot be an affiliate of the company, which SEC rules have defined to mean holding more than 10% of the equity of their companies. This independence helps strengthen confidence that audit committee members act in the best interests of investors.

As part of their oversight responsibilities, SOX requires audit committees to preapprove all audit and non-audit services provided by the external auditor. This means that an audit committee needs to be provided with the information necessary to determine whether the extent or nature of the non-audit services would compromise auditor independence, such as by creating too much familiarity or financial ties with the company.

Audit partner rotation

Another way that SOX helps protect auditor independence and objectivity is by requiring the mandatory rotation of certain key partners involved in audits every five years. This is intended to limit overfamiliarity with a company and management. Prior to the enactment of SOX, professional standards required the lead engagement partner to rotate every seven years.



Audit enhancements and governance

In addition to reinforcing auditor independence, SOX sought to enhance the quality of audits, another key element of investor confidence. The PCAOB and audit committees also play central roles in this through the PCAOB's oversight of the public company audit profession as a whole and audit committees' company-specific governance of external audits.

PCAOB

The PCAOB has authority to set rules for how auditors conduct audits of public company financial statements and to require the firms to establish firm-wide systems of quality control. The PCAOB can adapt its standards and guidance to address areas where audit weaknesses may be found as well as other audit and market developments as appropriate.

The PCAOB also promotes high-quality audits by conducting periodic inspections of its registered audit firms. For firms with over 100 public company clients, SOX requires that these PCAOB inspections occur annually. Under the statute, inspections are designed to assess a firm's compliance with SOX, the rules of the SEC and PCAOB and professional standards in connection with the performance of audits, issuance of audit reports and related matters involving issuers.[16] PCAOB inspections have made a significant impact on audit quality by providing an independent review of audit quality and highlighting opportunities for audit firms to make improvements, both at the individual audit engagement level and with respect to a firm's system of quality control. Inspection results can help identify areas in which additional audit guidance, training, practice reminders or enhanced skills may be needed.

[15] Audit committees are made up of members of the board of directors and oversee the companies' accounting and financial reporting process. Securities Exchange Act of 1934 § 3(a)(58).

[16] SOX Section 104

Audit committee oversight of audit quality

As noted above, SOX gave explicit responsibilities to audit committees relating to the external audit, codifying audit committees' active role in overseeing the quality of audits and financial reporting. This means that, although the PCAOB may not examine a specific audit engagement through its inspection program annually, each listed company has an independent body overseeing the audit. SOX requires the external auditor to report directly to the audit committee and sets a baseline of what must be communicated with audit committees so that they are aware of key aspects of the audit, including:

- A discussion of all critical accounting policies and practices used by the company
- All alternative accounting treatments that have been discussed with management, the ramifications of the use of alternative disclosures and accounting treatments, and the accounting treatment preferred by the audit firm

To facilitate audit committees' oversight of the company financial reporting and the external audit, SOX requires companies to provide audit committees with the resources and authority to engage independent counsel and advisors.

Financial expertise on audit committees

SOX required the SEC to pass rules mandating that exchanges establish listing rules to encourage audit committees to have at least one member who is a "financial expert"[17] to serve as a resource to help the audit committee carry out its duties. The intent of this provision is to put the audit committee in a stronger position to review and challenge financial statements and determine whether internal controls are appropriate and sufficient. Listing rules now require companies that do not have an audit committee member with financial expertise to disclose this in the annual proxy statement and explain the rationale for not having one.

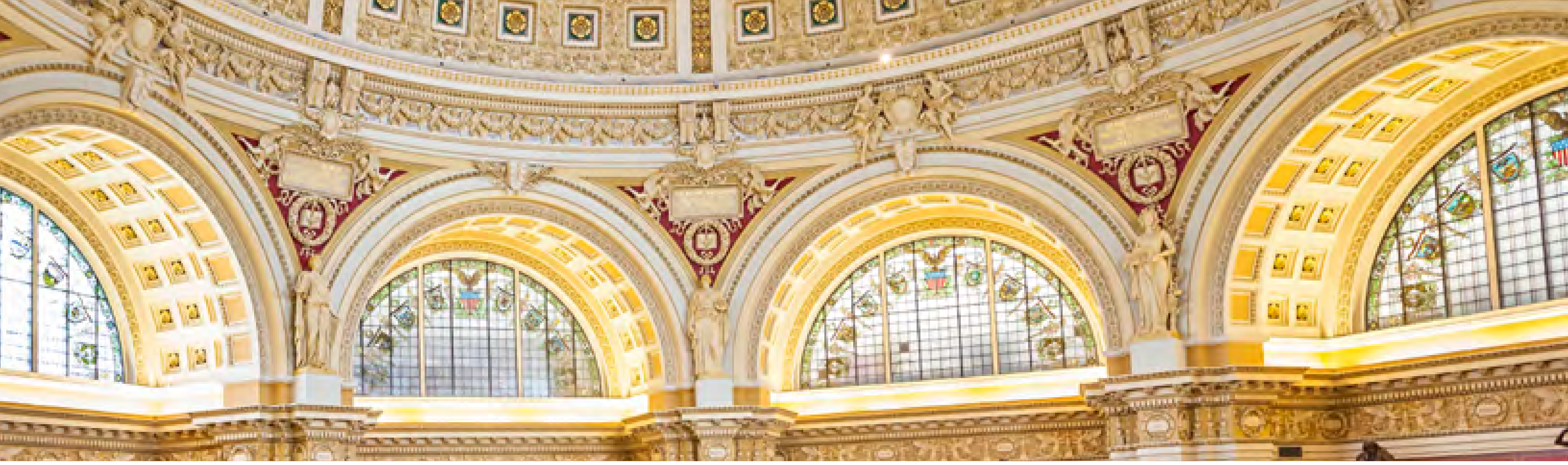
Investor protection

As a whole, the accountability framework put in place under SOX was designed to protect the interests of investors. This includes provisions related to financial reporting accountability, independent audit committees, independent standard setting and oversight of the firms by the PCAOB. SOX also put in place specific measures to uncover and address wrongdoing relating to financial reporting.

Audit-focused enforcement

SOX gave the PCAOB the authority to investigate potential violations of auditing standards and rules in addition to the SEC's existing authority. This PCAOB authority supplements the already robust authority that the SEC has to enforce all securities laws and regulations, including with respect to auditors and financial reporting.

[17] Generally, a financial expert is a person who, through education and experience, has an understanding of and experience in applying generally accepted accounting principles and preparing financial statements, experience with internal controls and procedures for financial reporting, and an understanding of audit committee functions. SOX § 407, 17 CFR 229.407(d)(5)(ii).



The PCAOB's enforcement staff investigates and sanctions individual auditors and audit firms for violations of laws, regulations and professional standards. The PCAOB's disciplinary powers include the authority to impose civil monetary penalties on individual auditors or the audit firm, temporarily or permanently revoke an audit firm's registration with the PCAOB (which would prevent it from performing audits of public companies and/or broker-dealers), place limitations on the operations of a firm or individual auditor and bar an individual auditor from association with registered audit firms. It also can punish firms and auditors that do not cooperate with PCAOB investigations and inspections and may refer matters to the SEC and other relevant authorities.

Establishment of the SEC Whistleblower Program

SOX created key protections for whistleblowers who report suspected fraud with respect to a public company's financial reporting. SOX also required public company audit committees to establish procedures for receiving whistleblower complaints and to ensure that they are addressed confidentially and anonymously. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 expanded the incentives for whistleblowers to report wrongdoings and directed the SEC to create a whistleblower program, which led to the establishment of the SEC's Office of the Whistleblower in 2011.[18] Since the inception of this program, the SEC has awarded approximately US$1.3 billion to 273 individuals who have helped bring wrongdoing to light through May 2022.[19]

Conclusion

The passage of SOX marked a watershed moment for financial reporting and the audit profession. The mechanisms put into place under SOX to support independent audits, strong financial reporting and accountability — including independent audit oversight and internal control over financial reporting — have been recognized by audit professionals, executives, investors and regulators around the world. Although the US financial markets have continuously evolved over the past 20 years, the enduring yet flexible regulatory framework that came out of SOX has allowed investor confidence — and through it, the capital markets — to thrive.

[18] 2021 "Annual Report to Congress on the Whistleblower Program" (November 2021), SEC Office of the Whistleblower (sec.gov) accessed April 2022.

[19] "SEC Issues Nearly $3.5m Award to Four Whistleblowers," SEC Press Release (sec.gov) accessed May 2022.

Contacts

Bridget Neill
EY Americas Vice Chair, Public Policy
Ernst & Young LLP
bridget.neill@ey.com
+1 202 327 6297

Steven Jacobs
EY Americas Director, SEC Regulatory Matters and Capital Markets Leader
Ernst & Young LLP
steven.jacobs1@ey.com
+1 202 327 6070

Shauna Steele
Director, Public Policy Regulatory Network
Ernst & Young LLP
shauna.steele@ey.com
+1 202 327 6118

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

US SCORE no. 16614-221US
2206-4062842
ED None

ey.com