Lessons Learned from the SOX EXPERIENCE

THE GOOD, THE BAD & THE UGLY
INTRODUCTION

Between 2001 and 2002, a series of major corporate frauds took place in the United States, costing investors billions of dollars and seriously affecting the US financial markets. These frauds, which included massive overstatements of profit and inflation of assets, were traced to weak internal controls and inadequate disclosure practices.

In reaction to these frauds, the US government passed the Public Company Accounting Reform and Investor Protection Act in 2002, more commonly known as the Sarbanes-Oxley Act (SOX). The Act was meant to improve public and financial reporting by making companies maintain stricter internal controls and holding management responsible. Japan and China enacted similar legislation in 2006 and 2008 respectively, and from these countries' experience with SOX, some lessons may be drawn.

In mid-2014, the Singapore Accountancy Commission (SAC) and Protiviti co-authored a point-of-view paper on the benefits and challenges that the US, Japan and China have experienced with SOX-related legislation. Following the paper's publication, the SAC and Protiviti co-organised a roundtable discussion on 25th August 2014, to examine the learning points Singapore may be able to draw from other countries' experience with SOX. Roundtable participants included finance leaders and experts from internal audit, external audit, and the legal profession, among others.

This report sets out the key points raised during the discussion.

The Singapore Accountancy Commission and Protiviti thank all roundtable participants for contributing their valuable insights.

"Singapore has a history of doing the right thing and sending the bar up. Do you do the minimum, or do you do more than is required? The only reason for doing more is because you get more value out of that, and investors would see that has created more certainty than the information they use."

- Mr Robert Hirth, Chairman, Committee of Sponsoring Organisations of the Treadway Commission (COSO) and Senior Managing Director, Protiviti

“Learning from international best practices ensures that the Singapore accountancy sector stays up-to-date and heads in the right direction. Also, these lessons from SOX can provide a good basis for further enhancing corporate governance in Singapore.”

- Mr Uantchern Loh, Chief Executive, Singapore Accountancy Commission
SOX essentially makes management responsible for establishing, maintaining and ensuring the effectiveness of internal controls over financial reporting. Research conducted by Protiviti in the US indicates that in relation to the costs and benefits of SOX, while the costs of SOX compliance are high during initial years, they will stabilise thereafter, and the benefits will increase as internal controls and the quality of financial reporting increase. However, the same research has also surfaced survey results where respondents have indicated that over time, the costs of compliance have risen while the benefits derived have decreased as compared to previous years.

Lessons Learned From Implementing SOX and Similar Legislation

Drawing on the collective experience of the US, Japan and China with SOX and similar legislation, 10 lessons applicable to issuers, regulators and policymakers can be listed as follows:

1. Make the legislation’s objective as clear and focused as possible
2. Issuers and auditors of financial statements should apply a top-down, risk-based approach
3. Management must identify where the risk of potential material misstatements may arise
4. In conjunction with (3), an adequate fraud risk assessment must be performed
5. To reduce the cost of compliance, focus on the key controls
6. All important risks and controls must be documented
7. “Tone at the top” is very important
8. Personnel evaluating controls in high risk areas must be objective and competent
9. Continuous improvement in financial reporting controls must be encouraged
10. Initial adoption is a major project and should be rigorously managed as such

Adapted from “The Impact of the Sarbanes-Oxley Act and Similar Legislation: Lessons Learned and Considerations for the Future”, a POV paper by Protiviti and the Singapore Accountancy Commission.

THE COSTS AND BENEFITS OF SOX

"SOX is not stopping us from growing the business. It's about how you interpret SOX requirements from a business perspective, making sure that people are more focused on controls, but not telling them that they are disallowed to do something because of regulations."

- Mr Ong Wee Gee, Vice President of Finance, Equinix Asia Pacific

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In general, SOX has been found to be beneficial relative to its cost, particularly to investors who find that it brings more certainty to financial information. There are cases, usually outside the US, where the cost outstrips the benefits, but this is usually due to over-application or misapplication of SOX requirements.

Certain companies, particularly those that operate across multiple jurisdictions or that have frequent dealings with international partners or clients, will find SOX more beneficial than costly. For example, US-based partners or clients may be more comfortable working with a company that complies with SOX.

In other cases, companies that are growing rapidly through mergers and acquisitions may find SOX a useful tool for homogenising internal controls across the business. This would be especially beneficial when the companies that have been acquired have very different controls and culture from the parent company.

Companies that had implemented SOX and subsequently de-listed have also benefited from retaining some of their SOX-compliant internal controls and management systems in promoting ownership of internal controls.

Not necessarily the most cost-effective way

“My main concern about SOX is that we spend a lot of money; we cure the flu, we cure the cough, but we don’t arrest the heart attack as shown during the global financial crisis and in some recent corporate frauds and scandals.”

- Mr Lim Ah Doo, Chairman, Audit Committee, Sembcorp Marine Ltd

Outside the US, it is doubtful whether SOX or similar legislation will be cost-effective. While the cost of implementing SOX varies between companies, it is often an expensive, resource-heavy process that may take some time to yield results. Furthermore, it may become more costly over time: Protiviti’s research indicates that as companies’ control structures mature, the costs of SOX compliance rise relative to the benefits, especially if external audit fees increase.

Besides monetary cost issues, adopting SOX has implications for the way in which companies and investors approach internal controls. Some companies may respond to the increased regulation by taking a tick-box approach to internal controls, in much the same way that some preparers deal with accounting standards. On the other hand, some investors may derive a false sense of security from seeing that a company is SOX-compliant and therefore neglect to undertake their own due diligence.

It should also be noted that SOX covers internal controls, and not accounting issues. Many of the corporate scandals that SOX was enacted to address had actually stemmed from issues not related to internal controls deficiencies.
Points of difference

“SOX is good, but it can’t solve some problems.”

- Mr Lim Ah Doo, Chairman, Audit Committee, Sembcorp Marine Ltd

Firstly, many large publicly listed companies in Singapore are still family-owned, or have their ownership concentrated within a small group of key shareholders. This places a considerable burden on independent directors. Secondly, the CFO’s role is still not well defined in Singapore. Different companies have very different expectations of the CFO, and in some cases, the CFO’s scope may not be sufficient for him or her to fulfil the requirements imposed by SOX.

Thirdly, independent directors here tend to have responsibilities towards multiple boards simultaneously, often holding key positions – including chairman of the audit committee – on those boards. As a result, independent directors may find themselves overstretched and have difficulty performing the additional duties called for by SOX or similar legislation.

Finally, it should also be noted that SOX was at least partly politically motivated, having been passed during a period when the Standard and Poor’s 500 Index was dropping steadily and hundreds of thousands of American voters were facing the loss of their savings. While this does not in any way reduce the usefulness of SOX and similar legislation, it underscores that SOX may not be ideal for unmodified implementation in other jurisdictions.

It is important to bear in mind that SOX was formulated in the US context, with a focus on US-based companies. Requirements that are relevant to US stakeholders may not have similar bearing in other jurisdictions, and the experience of Japan and China suggests that if such legislation is considered, it needs to be tailored to the uniqueness of the business environment where it will be implemented.
Existing legislation is sufficient

"We have enough regulations in the country’s legislation, such that some people accuse us of being over-regulated."

- Mr Rohan Kamis, Managing Partner, Rohan, Mah & Partners Chartered Accountants

Singapore’s regulatory environment is already a stringent one, with emphasis placed on management and internal controls through the Code of Corporate Governance, and many of the concerns that SOX was enacted to address in the US have been covered here by regulations such as SGX listing rule 1207 (Rule 1207).

Currently, large and small companies alike are slowly moving towards greater parity in terms of internal controls. It is therefore debatable whether further legislation will improve the regulatory environment, or whether the burden it places on companies will outweigh its contribution. There are also concerns that if more legislation is introduced, it may have a negative outcome: business may be stifled, or companies will take a tick-box approach to compliance so as to minimise costs and end up concentrating on form rather than substance.

However, SOX does contain an offence element – the potential to prosecute – that Singapore’s current legislation may not be able to match, including a claw-back provision that specifically targets individuals who benefited from misbehaviour.
PRIORITISING THE IMPLEMENTATION OF EXISTING LEGISLATION

In the Singapore context, internal controls and the quality of financial reporting can best be improved by prioritising implementation above more legislation. Some areas that can be improved are the definition of the CFO’s role and an emphasis on company culture, among others.

The role of the CFO

"You have to state firstly that the company has to have a CFO and the CFO’s qualifications and role. It is a good thing to have both the CEO and the CFO sign off on the financial statements, but you have to first specify the requirement for the office and then define its responsibility."

- Ms Annabelle Yip, Partner, WongPartnership LLP

Although the CFO’s role has been extensively discussed in recent years, it is still not clearly defined in many companies. In general, CFOs are recognised to be the chief preparers of financial statements, but beyond that, their duties vary hugely between companies and are often defined by what they themselves deem to be their responsibilities. In the same vein, a CFO’s skills and qualifications may differ just as greatly depending on what the company perceived to be necessary when hiring him or her.

Hence, if the CFO is required to take on additional responsibilities under SOX and similar legislation, a large number of considerations emerge. Aside from burdening the CFO with more duties that he or she may not have the time for, the CFO’s understanding of SOX also comes into question: not just in terms of qualifications, but also whether he or she is able to examine SOX from a business angle and implement it in a way that is sustainable for the business.

Companies therefore need to develop a clearer definition of their CFO/finance leader’s role, responsibilities and authority. This definition should be in line with the individual company’s business needs, and may include a re-examination of the qualifications their finance leader needs. They may also wish to reconsider their recruitment process for the finance leader. For example, companies that expect to operate in SOX-compliant environments may want candidates to have a working knowledge of SOX and related legislation.

“If you make the CFO sign off on the financial statements he or she will make it his or her business to understand them…that will solve the quality problem.”

- Mr Richard Lai, Group Chief Financial Officer, TEE International Limited
Adopting the COSO framework

"It does no harm for us to look at COSO and see what can be adopted, or how we can improve on what we are doing now."

- Mr Ong Wee Gee, Vice President of Finance, Equinix Asia Pacific

Many companies in Singapore do not currently follow any specific risk management or internal control framework, and could benefit from adopting the COSO Internal Control – Integrated Framework (see Appendix) even if SOX is not implemented here. It will give companies a common framework on which to work together, and help to strengthen their compliance.

The COSO framework is complementary to Rule 1207, is cited in the Risk Governance Guidance for Listed Boards issued by the Corporate Governance Council in 2012 and the Guidebook for Audit Committees in Singapore (Second Edition) revised in 2014, and considerable support is available for companies that wish to use it. However, more can be done to raise awareness of the framework. For example, an outreach programme could be developed to teach companies about COSO and how it can be used to assess the effectiveness of their internal controls.

Directors could also be trained to understand the framework and to have a better understanding of concepts such as risk management, corporate governance and succession planning. This would enhance the requirements described in the Code of Corporate Governance.

Company culture and awareness

"We say 'tone at the top', but it is important to understand how far has good company culture been addressed? In companies which are multinational or local, even an owner-managed company, if the culture is such that doing wrong things is not acceptable, SOX will be welcome and of great additional value."

- Mr S. Subramanian, Finance Director, Asia Pacific & Industrial Solutions, MOOG Inc.

Awareness is key to successful risk management and internal controls. If the staff of a company are aware that the regulations exist, understand why they should be upheld, and are conscientious about doing so, the company’s internal controls will be much more effective. This is closely related to the company's culture: a company that inculcates strong ethics into its staff and has an organisational culture that shuns fraud will be far more capable of complying with regulatory requirements and, by the same token, less likely to suffer a corporate scandal.

Similarly, it is useful for all staff, not only those directly involved in risk management, to have at least passing familiarity with the principles behind SOX and similar legislation. It is common for people to worry that internal controls may affect business operations, or that a company’s innovativeness may be stifled by compliance. However, this need not be the case. Commitment to competence is a key point of internal controls, and if a company’s staff have a working understanding of internal controls and are committed to competence, the company has much higher chances of not only avoiding fraud, but doing well.
Bringing in IA

"IA has to step up, continually improve its quality and be a viable option for businesses as a source of independent assurance and provider of a valued perspective on the effectiveness of risk management."

- Mr Tan Heng Jack, Senior Vice President – Internal Audit, Sembcorp Marine Ltd

Other than the CFO, the IA function may also need to shift its role to increase its effectiveness in regulatory compliance. IA in some organisations has taken a tick-box approach to its responsibilities rather than helping businesses identify and manage new risks. However, there is considerable room for IA to expand its role to become more risk-focused and adapt and evolve in-line with changes in the company’s business.

Legislation such as SOX and Rule 1207 are specifically about expressing an opinion on the robustness of internal controls, which should fall under the purview of IA. For example, IA may carry out independent validation of the internal controls report and co-sign it alongside the CFO as a check on management’s opinion.
MOVING FORWARD:
WHAT IS MOST DESIRABLE FOR SINGAPORE IN THE FUTURE?

"SOX is an excellent tool to push accountability at the junior and senior level. My wish would be for a way to really quantify these benefits and demonstrate that value back to shareholders, otherwise it can be somewhat abstract."

- Mr Peter So, Vice President – Head of APAC SOX, Barclays Investment Bank

Singapore’s legislation is widely acknowledged to be more than adequate, but as the business and regulatory environment evolves, there is always room for suggestions to make it even better. Participants at the SAC-Protiviti roundtable listed a number of improvements they would like to see in the future.

1. **Make COSO the default framework** for Singapore companies to assess internal controls and their effectiveness.

2. **Streamline existing regulations.** Singapore needs less but more effective rules. Increasing the number of rules and thereby the cost of compliance is not a solution, nor is decreasing the regulations and compromising the quality of corporate governance.

3. **Find a way to simplify accounting standards in Singapore.** The objective of good corporate governance is to help companies to grow, and the mechanisms to improve corporate governance – including accounting standards, SOX and similar legislation – should therefore not impose an excessive burden on companies.

4. **Find a way to quantify the benefits of mechanisms such as SOX.** If the value of such benefits can be demonstrated to shareholders and companies alike, they will be more positive about adopting new frameworks or regulations.

5. **Increase the use of technology.** Companies could benefit considerably, in terms of cost effectiveness and efficiency, from having automated preventive controls. Technology could also be used to identify deficiencies, simplify data and analyse information related to internal controls.

6. **Broaden IA’s mandate.** IA in all listed companies should be mandated to act as the eyes and ears of investors and stakeholders.
Appendix – The COSO Internal Control – Integrated Framework

COSO stands for “Committee of Sponsoring Organizations of the Treadway Commission” and is a voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance. Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, it is an independent private-sector initiative often referred to as the Treadway Commission, which studied causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, the SEC and other regulators, and educational institutions.

The updated 2013 Internal Control – Integrated Framework was driven by the intent to benefit from experience over the period since the original 1992 Framework was issued.

The 2013 Framework defines internal control as follows:

“Internal control is a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.”

The updated Framework retains the three-dimensional cube, with objectives along the top relating to operations, reporting and compliance, representing the cube’s columns. Every organization establishes relevant objectives and formulates strategies and plans for achieving them. The side of the cube depicts that objectives may be set for the entity as a whole, or be targeted to specific divisions, operating units and functions within the entity (including business processes such as sales, purchasing and production), illustrating the hierarchical top-down structure of most organizations.

Source: Chapter 2 of the 2013 COSO Internal Control – Integrated Framework

On the face of the cube are the five components of internal control, representing rows of the cube. These components, i.e., Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities, support the organization in its efforts to achieve its objectives, and are relevant to an entire entity, meaning they operate at the entity level, as well as at all divisions, operating units, functions, subsidiaries or other subsets of the entity.

The cube depicts the direct relationship among the organization’s objectives (what the entity strives to achieve), the components of internal control (what is needed to achieve the objectives), and the operating units, legal entities and other structures within the entity (levels of the organization where the components of internal control operate). Each internal control component cuts across and applies to all three categories of objectives.

The COSO Framework emphasizes the importance of management’s judgment in evaluating the effectiveness of a system of internal controls. Determining whether a particular internal control is effective is a subjective judgment resulting from an assessment whether each of the five components of internal control operate together to provide “reasonable assurance” that the relevant objectives are met. To facilitate this judgment, the Framework provides principles for each of these five components, 17 principles in all, upon which management exercises judgment to determine the extent to which these principles are present and functioning in order to evaluate whether the components to which they relate are present and functioning.

About SAC

Established in April 2013 as a statutory body of the Singapore Government, the Singapore Accountancy Commission (SAC) is the lead agency in spearheading the development of the Accountancy Sector in Singapore.

About Protiviti

Protiviti (www.protiviti.com) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit, and has served more than 40 percent of FORTUNE 1000® and FORTUNE Global 500® companies. Protiviti and its independently owned Member Firms serve clients through a network of more than 70 locations in over 20 countries. The firm also works with smaller, growing companies, including those looking to go public, as well as with government agencies.

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