The Sarbanes-Oxley Act at 15

Building a better working world

Contents

Opening letter

As the 15th anniversary of the Sarbanes-Oxley Act of 2002 (SOX or the Act) approaches, we at EY believe it is important to reflect on the dramatic, positive change in the accuracy of financial reporting and quality of auditing in the United States since its enactment. On 30 July 2002, in the wake of a series of financial reporting scandals on a scale that rocked the financial markets, the Sarbanes-Oxley Act was signed into law — following passage by an overwhelming majority in the US Senate and House of Representatives — in an effort to restore public confidence in the reliability of financial reporting.

The law set out to accomplish this daunting goal by establishing a new accountability framework for financial reporting. Perhaps the most dramatic change brought about by the law was with respect to the audit profession: by calling for the establishment of the Public Company Accounting Oversight Board (PCAOB or Board), Congress brought an end to self-regulation of the audit profession. In addition, the law put in place a requirement for independent audit committees to oversee the financial reporting process, thus aligning their goals with those of investors and auditors. SOX also established the requirement for corporate executives to certify the contents of financial reports and significantly increased penalties for persons participating in financial fraud, among numerous other changes. We believe that the Act has been successful — financial reporting and audit quality have improved, to the benefit of investors and other stakeholders.

It is important to recognize that the Act's success is due in part to a willingness by Congress and other stakeholders to allow this regulatory framework to evolve. This flexibility is critical because certain elements of the Act have been criticized over the years and implementation has not always been smooth. In particular, Section 404(b) relating to internal control over financial reporting attestations has drawn criticism. Concerns about this provision continue to lead to regulatory and legislative actions to address them, including legislative changes enacted in 2012 through the Jumpstart Our Business Startups (JOBS) Act to lower regulatory costs for small and newly public companies. At the same time, it is important to recognize the benefits that Section 404 and the rest of SOX have brought investors and public companies, including decreased severity of financial restatements and increased investor confidence. Importantly, auditors, companies and regulators have shown that they can continue to innovate to address new challenges and opportunities within the SOX framework.

After 15 years, the events leading up to the passage of SOX are somewhat removed from current discourse and may even seem remote to some, having been overshadowed by more recent turbulence in the capital markets, including the 2008–09 financial crisis and the subsequent slow but steady recovery of the US and global economies. Over this time, investor confidence in the US public capital markets has continued to grow. We believe that this confidence is due in large part to the reforms put in place by SOX that continue to produce benefits in the US capital market. For this reason, as a new administration settles into office and begins to consider regulatory reform with Congress, EY believes it is important to keep in mind how SOX bolstered the landscape of financial reporting and public company auditing for the better, and in ways that have been replicated in other markets. This document is intended to provide an overview of key elements of SOX, changes that have occurred since its passage and new possibilities on the horizon.

We look forward to working with investors, the PCAOB and other stakeholders to build upon the strong foundation laid by SOX and meet the challenges of the next 15 years.

Stephen R. Howe. Jr

Stephen R. Howe, Jr.
US Chairman and Managing Partner
EY Americas Managing Partner

Francis C. Mahoney
EY Americas Vice Chair
Assurance Services

Principal components of the Sarbanes-Oxley Act of 2002

1. Established independent oversight of public company audits, funded via fees paid by public companies and SEC-registered broker-dealers

- Established the PCAOB, an independent regulator of auditors of public companies and broker-dealers
- Provided the PCAOB with inspection, enforcement and standard-setting authority

2. Strengthened audit committees and corporate governance

- Required audit committees, independent of management, for all listed companies
- Required the independent audit committee, rather than management, to be directly responsible for the appointment, compensation and oversight of the external auditor
- Required disclosure of whether at least one "financial expert" is on the audit committee

3. Enhanced transparency, executive accountability and investor protection

- Required audit firms to report certain information about their operations for the first time, including names of public company audit clients, fees and quality control procedures
- Required public company CEOs and CFOs to certify financial reports
- Prohibited public company officers and directors from fraudulently misleading auditors
- Instituted clawback provisions for CEO and CFO pay after financial restatements
- Established protection for whistleblowers employed by public companies who report accounting, auditing and internal control irregularities
- Required public company management to assess the effectiveness of internal controls over financial reporting (Section 404(a)) and auditors to attest to management's assessments (Section 404(b))
- Established the "Fair Funds" program at the U.S. Securities and Exchange Commission (the SEC or the Commission) to augment the funds available to compensate victims of securities fraud

4. Enhanced auditor independence

- Prohibited audit firms from providing certain non-audit services to audited companies
- Required audit committee pre-approval of all audit and non-audit services
- Required lead audit partner rotation every five years rather than every seven years

PCAOB

Perhaps the most fundamental change made by SOX was the establishment of the PCAOB, which ended more than 100 years of self-regulation by the public company audit profession. The PCAOB's authority encompasses public accounting firms that audit public companies or play a substantial role in such audits and those that audit SEC-registered broker-dealers. The PCAOB regulates these firms by:[1]

- Requiring that they register with it
- Establishing auditing and certain ethics standards
- Conducting audit quality inspections to assess firms' compliance with standards, SEC and PCAOB rules and identify audit quality issues
- Investigating allegations of wrongdoing
- Disciplining auditors of public companies and broker-dealers

> "As a statutorily established institution, the PCAOB has an overriding responsibility to serve the investing public by setting auditing and related professional practice standards, inspecting engagements and quality control systems against those standards, and, when necessary, disciplining auditors that fail to comply."
>
> **PCAOB Chairman James Doty**[2]

By the end of 2016:

2,013 audit firms from 89 countries were registered with the PCAOB.

- 900 firms were domiciled outside the United States.

The PCAOB had cooperative arrangements with audit oversight bodies in 22 other jurisdictions to facilitate inspections of non-US firms.

During 2016:

The PCAOB conducted inspections of 198 firms as well as portions of more than 780 audits.[3]

- This included inspections of the 10 annually inspected firms and portions of 320 of audits conducted by these firms.
- It also included inspections of 56 non-US firms located in 27 jurisdictions.

As part of its interim inspection program for auditors of broker-dealers registered with the SEC, the PCAOB conducted inspections of 75 audit firms and 115 audits of broker-dealers in 2016.[4]

1. Under Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB now has authority over the auditors of broker-dealers. This publication focuses on the PCAOB's regulation of public company auditors.
2. "Protecting the Investing Public's Interest in Informative, Accurate, and Independent Audit Reports," 9 December 2015, PCAOB website, https://pcaobus.org/News/Speech/Pages/Doty-AICPA-2015-keynote.aspx, accessed May 2017.
3. PCAOB 2016 Annual Report, PCAOB website, https://pcaobus.org/About/Administration/Documents/Annual%20Reports/2016.pdf, accessed May 2017.
4. Ibid.

SEC oversight of the PCAOB: The Commission has general oversight authority over the PCAOB, including in the following areas:

- Appointment of PCAOB members: The Commission has the authority to appoint PCAOB board members, in consultation with the Secretary of the Treasury and the Chair of the Federal Reserve. Two seats are to be occupied by individuals who are or have been certified public accountants.
- Opportunity to review rules and standards: The SEC has the opportunity to vote on PCAOB rules and standards before they take effect.[5] The SEC can vote to approve or disapprove PCAOB rules and standards but cannot amend them.
- Budget approval: The SEC must approve the PCAOB budget.
- Hear appeals: The SEC has the authority to review and modify final disciplinary sanctions imposed by the Board.

Standard setting

The PCAOB has the authority to set standards governing:

- How auditors conduct audits of public companies and broker-dealers
- Auditor ethics and independence
- Audit firm system of quality control

To develop its standard-setting agenda, the PCAOB has the ability to utilize information obtained from inspections as well as input received from stakeholders such as its Standing Advisory Group, which includes representatives from investor groups, the audit profession, public company board members and academics.[6]

Stakeholder outreach

The Sarbanes-Oxley Act contemplates the PCAOB engaging with stakeholders, including the audit profession and advisory groups, regarding its standard setting.[7] Accordingly, the PCAOB established the Standing Advisory Group (SAG)[8] in 2004 to assist the Board in carrying out its standard-setting responsibilities. It established the Investor Advisory Group[9] (IAG) in 2009 to advise the Board on broad policy issues and other matters related to the work of the PCAOB. Recently, the PCAOB also has engaged directly with audit committees, including through audit committee-focused publications.[10] The PCAOB has indicated that its objective in doing so is to help promote high-quality interactions between audit committees and auditors as well as help audit committees interpret PCAOB inspection findings and use them in supervising the external auditor.

5. If the SEC does not vote to approve, disapprove or institute proceedings to determine whether to disapprove a PCAOB rule within specified deadlines, the rule becomes effective. 15 United States Code (USC) § 78s(b)(2).
6. "Standing Advisory Group," PCAOB website, http://pcaobus.org/Standards/SAG/Pages/default.aspx, accessed May 2017.
7. SOX § 103(a)(4).
8. The SAG comprises representatives of investors, preparers, audit firms, boards, academia and others. "Standing Advisory Group," PCAOB website, http://pcaobus.org/Standards/SAG/Pages/default.aspx, accessed May 2017.
9. The IAG provides broad policy advice to the board, including on fulfillment of its investor protection mission. "Investor Advisory Group," PCAOB website, https://pcaobus.org/About/Advisory/Pages/IAG.aspx, accessed May 2017.
10. See, e.g., "Audit Committee Dialogue," May 2015, PCAOB website, https://pcaobus.org/sites/digitalpublications; and "Information for Audit Committees about the Inspection Process," 1 August 2012, PCAOB website, https://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf, accessed May 2017.

Over the past several years, some stakeholders have raised questions about the process used to establish the PCAOB's standard-setting priorities, as well as the length of time it takes to finalize standards and rules.[11] This has resulted in a number of changes that are currently being implemented (see "Revised PCAOB standard-setting process").

The PCAOB issues its standards in proposed form before they are finalized, providing a comment period for external stakeholders. Recent and current standard-setting projects include those related to auditor transparency, revisions to the auditor's reporting model, supervision of other auditors, auditing accounting estimates and fair value measurements, and the auditor's use of the work of specialists.

In addition to standard setting, PCAOB staff periodically issue practice alerts to draw attention to emerging audit issues or risks. Recent alerts have highlighted audit risks associated with the current economic environment and certain emerging markets.

Revised PCAOB standard-setting process

The PCAOB has recently undertaken changes in an effort to address concerns with the efficiency and effectiveness in its standard-setting process. According to the PCAOB, under its revised process, once it identifies a potential area for a new or revised standard, the PCAOB will place it on a newly created research agenda. For items on the research agenda, the PCAOB has indicated it will seek input from various PCAOB advisory groups and other stakeholders; conduct economic analysis of the costs, benefits and potential unintended consequences of potential PCAOB rule-making in that area; and explore alternative regulatory responses. If standard setting is viewed as necessary, the PCAOB suggests it also will consider multiple approaches to achieving the regulatory goal. Under the revised process, research projects should only be added to the PCAOB's standard-setting agenda once the PCAOB staff determines that rule-making is appropriate and an effective, efficient rule-making solution is identified.

In addition to ensuring enhanced input from stakeholders early on, the research process is intended to accelerate the pace of projects once they are added to the PCAOB's standard-setting agenda. As of 31 March 2017, the research agenda includes projects related to quality control standards, the use of data and technology in audits, the auditor's role regarding company performance and non-GAAP measures, and the auditor's consideration of noncompliance with laws and regulations.

Inspections

Under SOX, the PCAOB is required to inspect a registered audit firm at an interval based on the number of public companies that the firm audits. Firms that perform annual audits of more than 100 issuers are inspected annually, while other firms are inspected at least every third year. During inspections, the PCAOB staff typically looks at firmwide quality controls as well as a sample of audit engagements. The PCAOB indicates that it uses a variety of factors to select the audits it inspects, including its assessment of the risk that a public company's financial statements may contain a material misstatement.

Inspections are intended to provide an independent review of audit quality and highlight opportunities for improvement within audit firms, both at the individual audit level and with respect to a firm's system of quality control. Inspection results can be used to identify areas in which additional audit guidance, training, practice reminders or enhanced skills may be needed.

> "The PCAOB inspection process is rigorous and has helped us by identifying areas where we can continue to improve our performance."
>
> ***EY Audit Quality Report,***
> **December 2016**

11. See, e.g., "Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments," speech by then-SEC Chief Accountant James Schnurr, 8 December 2014, SEC website, https://www.sec.gov/news/speech/2014-spch120814js, accessed May 2017.

As part of each inspection, the PCAOB prepares a report, part of which is made publicly available. The public portion of the report cites audits where the PCAOB believes the firm failed to obtain sufficient evidence to support its opinion. The nonpublic portion of the inspection report includes concerns raised during inspections related to a firm's system of quality control. If an audit firm does not address those concerns to the PCAOB's satisfaction within one year, the concerns are publicly reported.[12]

The PCAOB's approach to inspections has evolved over time in response to factors such as inspectors' findings in the field and emerging risks. One area of change has been with regard to how audit engagements are identified for inspection. The PCAOB traditionally has used a risk-based approach, focusing resources on the most problematic audits. Recently, PCAOB board members and PCAOB staff have indicated that they are broadening their approach. Board Member Jeanette Franzel explained, "In recent years, we've been adding some non-risk based selections and random selections to the mix of inspected audits, while also studying how to use inspection results to provide a more comprehensive assessment of audit quality and to make statistically based inferences about audit quality. We refer to these collective efforts as our project on 'randomization.'"[13] The PCAOB also has increasingly focused on root cause analysis of audit deficiencies to address recurring problems (see "The PCAOB Remediation Framework" discussion for additional information).

The PCAOB Remediation Framework

Over time, the PCAOB has sought to provide additional transparency into its process for evaluating a firm's activities to address quality control findings identified through inspections. In 2013, it issued staff guidance related to this process, which highlighted five criteria PCAOB inspection staff apply when assessing a firm's remediation process, often referred to as the "remediation framework":

1. **Change** – does the remedial step represent a change to the firm's system of quality control that was in effect at the time the quality control concern was identified?
2. **Relevance** – is the remedial step responsive to and does it specifically address the quality control criticism described in the inspection report? Is a root cause analysis appropriate?
3. **Design** – is the remedial action designed to remediate the quality control criticism?
4. **Implementation** – was the remedial step implemented within 12 months? If not, has the firm made appropriate progress?
5. **Execution and effectiveness** – has the remedial step achieved the proposed effect that it was designed to have?

While this framework has not garnered the same attention that new PCAOB audit standards would receive, we believe it has had a significant positive impact on audit quality. The framework encourages audit firms to examine their understanding of the root causes of the identified quality control concerns. In some cases, this has led to additional investment and focus by firms on their processes to consider the root causes of identified deficiencies. Confronting root causes allows for the design and execution of more effective remediation activities, resulting in more timely improvements in audit quality. We believe that such improvements have been a key driver in the decreasing trend in inspection findings over the most recent inspection periods.

12. SOX § 104(g)(2).
13. "Innovative & Robust Audit Profession to Serve Investors and the Public Interest," speech by PCAOB Board Member Jeanette Franzel, 16th Financial Reporting Conference, 4 May 2017, PCAOB website, https://pcaobus.org/News/Speech/Pages/Franzel-speech-Fin-Reporting-Conference-5-4-17.aspx, accessed May 2017.

Enforcement

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.

"In the PCAOB's 14 years, our inspectors have examined many thousands of audits and found numerous examples of high quality auditing, including evidence of auditors requiring companies to change their accounting or improve their internal controls over the production of financial reports. These auditors are the unsung heroes who avert the scandals that don't happen. But our inspectors have also found and reported numerous instances in which firms' audit reports should not have been issued."

PCAOB Chairman James Doty[14]

"The Board's process for reviewing and studying the remedial efforts taken by firms in response to inspection findings is prompting many firms to more proactively manage quality."

Speech by PCAOB Board Member Jeanette Franzel[15]

"Enforcement gives teeth to the PCAOB's standard-setting and inspection activities, and provides an important means of making audit firms and professionals aware of potential trouble spots that appear more likely to trip up firms, ranging from independence violations to improper document alteration in connection with an inspection or investigation."

Speech by PCAOB Board Member Lewis Ferguson[16]

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14. "The Role of the Bar and the Audit in Shareholder-Director Relationships," 7 October 2016, PCAOB website, https://pcaobus.org/News/Speech/Pages/Doty-speech-Vanderbilt-10-7-16.aspx, accessed May 2017.
15. "Innovative & Robust Audit Profession to Serve Investors and the Public Interest," 16th Annual Financial Reporting Conference, 4 May 2017, PCAOB website, https://pcaobus.org/News/Speech/Pages/Franzel-speech-Fin-Reporting-Conference-5-4-17.aspx, accessed May 201
16. "Global Developments in Auditor Oversight," Sixth Annual Conferência Brasileira de Contabilidade e Auditoria Independente, 13 June 2016, PCAOB website, https://pcaobus.org/News/Speech/Pages/Ferguson-speech-Brazil-global-audit-oversight-06-13-2016.aspx, accessed May 2017.

Strengthened audit committees and corporate governance

The Sarbanes-Oxley Act greatly expanded the responsibilities of audit committees, significantly strengthening corporate governance at many public companies.[17] SOX required the boards of companies listed on US stock exchanges to establish audit committees made up solely of board members independent from management. Because of SOX, audit committees, not management, are directly responsible for the appointment, compensation and oversight of the work of external auditors, who are charged with evaluating whether the financial statements prepared by management are fairly presented in accordance with the relevant financial reporting framework.

With respect to the composition of the audit committee, SOX codified and enhanced changes that the SEC and US stock exchanges had begun making in the late 1990s. In 1998, only about half of all public companies had fully independent audit committees. Many audit committees were reconstituted in order to meet independence requirements implemented by the SEC and US stock exchanges in late 1999. SOX went further and enhanced independence requirements by requiring for the first time that all listed company audit committee members be independent, meaning they could not be affiliated with the company or any subsidiaries, and they could not directly or indirectly receive any compensation from the company other than in their capacity as members of the board.

SOX also encouraged audit committees to have at least one member who is a "financial expert"[18] to serve as a resource to help the audit committee carry out its duties. This puts the audit committee in a stronger position to review and challenge financial statements, determine whether internal controls are appropriate and sufficient and, if necessary, mandate certain accounting actions to protect shareholder interests. Companies that do not have an audit committee member with financial expertise must disclose this in the annual proxy statement and explain the rationale for not having one. In 2003, only a small proportion of audit committee members were financial experts. Today, on average, 60% of S&P 500 audit committee members are formally designated financial experts.[19]

Evolution of audit committees over time

The composition of boards and audit committees has changed since the passage of SOX. While audit committee independence was mandated by SOX, boards in general have become more independent. Another change has been a higher average number of audit committee members who are identified as audit committee financial experts.

Audit-related board composition data — S&P 500 companies

	Independent board members	Independent audit committee members	Average audit committee size	Average number of audit committee financial experts
2016	85%	100%	4.3	2.5
2010	83%	100%	4.2	2.3
2006	79%	100%	4.0	2.0
2002[20]	70%	91%	4.2	N/A

17. Audit committees are made up of members of the board of directors and oversee the companies' accounting and financial reporting process. Securities Exchange Act § 3(a)(58).
18. 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).
19. Data is obtained from the EY Center for Board Matters' proprietary corporate governance database, which collects and analyzes data for more than 3,000 US public companies. EY Center for Board Matters website, http://www.ey.com/gl/en/issues/governance-and-reporting/center-for-board-matters/, accessed May 2017.
20. The source of the 2002 data is the Investor Responsibility Research Center.

To facilitate audit committees' oversight of a company's financial reporting, SOX required companies to provide audit committees with the resources and authority to engage independent counsel and advisors to help them carry out their duties. SOX also required audit committees to establish procedures for receiving whistle-blower complaints regarding accounting, auditing and internal control irregularities and to provide for the confidential and anonymous treatment of employee concerns regarding such matters. In addition, SOX enhanced the external auditor's required communications with the audit committee to include the following:

- 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
- Other material written communications between the auditor and management

These reforms significantly empowered audit committees, which began to take a more active role to carry out their increased responsibilities. For example, audit committees for the S&P 500 companies met five times a year on average in 2001.[21] The average number of meetings per year has nearly doubled to nine today. Audit committees also are disclosing that they are exercising ownership of the relationship with the auditor (see "Audit committee disclosures" for additional information).

> "Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting (ICFR), the quality of financial reporting, and the quality of audits performed on behalf of investors. The importance of the audit committees' work cannot be overstated."
>
> **Wesley Bricker,**
> **SEC Chief Accountant**[22]

> "As audit committees serve as the investors' principal interface with the auditor, investors expect audit committees to hold auditors accountable for their work and not to view the audit as merely a regulatory requirement."
>
> **Speech by PCAOB Board Member**
> **Steven Harris**[23]

21. Source: For data from 2005 through present, EY's corporate governance database, Center for Board Matters website, http://www.ey.com/gl/en/issues/governance-and-reporting/center-for-board-matters/, accessed May 2017; for prior year data, Investor Responsibility Research Center.
22. "Advancing the Role and Effectiveness of Audit Committees," University of Tennessee's C. Warren Neel Corporate Governance Center, 24 March 2017, SEC website, https://www.sec.gov/news/speech/bricker-university-tennessee-032417, accessed May 2017.
23. "Earning Investor Confidence," Canadian Public Accountability Board 2017 Audit Quality Symposium, 17 May 2017, PCAOB website, https://pcaobus.org/News/Speech/Pages/Harris-speech-CPAB-5-17-17.aspx, accessed May 2017.

Audit committee disclosures

One area of audit committee evolution post-SOX is voluntary disclosure regarding the audit committee's oversight of the auditor. While the Act strengthened audit committee oversight of financial reporting, audit committee-related disclosure requirements were left unchanged. Currently, disclosure requirements for audit committees generally do not cover the breadth of their activities, including the responsibilities established under the Act. Current disclosure requirements also provide only limited insight into the manner in which audit committees act on behalf of investor interests in executing such duties.[24]

Voluntary disclosures increasing

In recent years, various stakeholders, including regulators and investors, have promoted greater audit committee transparency in order to gain more insights into the committee's important work.[25] A number of companies are responding to this desire for more transparency by voluntarily providing audit- and audit committee-related information.[26] (See table below.) Recognizing these developments, the SEC issued a concept release in 2015, Possible Revisions to Audit Committee Disclosures, to solicit views on whether there would be a benefit from greater transparency around the work of audit committees, and if so, how best to achieve it.[27] Most commenters supported exploring increased audit committee disclosures, although many preferred a voluntary approach, which SEC commissioners and staff at the time also supported.

Voluntary audit-related disclosures in 2016 Fortune 100 proxy statements[28]

Category of disclosure	Topic	2016 % of total	2012 % of total
Audit committee responsibilities regarding external auditor	Explicit statement that the audit committee is responsible for appointment, compensation and oversight of external auditor	82%	42%
Identification of topics discussed	Topics discussed by the audit committee and external auditor	6%	8%
Fees paid to the external auditor	Statement that the audit committee considers non-audit fees/services when assessing auditor independence	81%	14%
	Statement that the audit committee is responsible for fee negotiations	29%	0%
	Explanation provided for change in fees paid to external auditor	31%	9%
Assessment of the external auditor	Disclosure of factors used in the audit committee's assessment of the external auditor qualifications and work quality	50%	17%
	Statement that audit committee is involved in lead audit partner selection	73%	1%
	Statement that choice of external auditor is in best interest of company and/or shareholders	73%	3%

24. Audit committee reports currently must include statements that the audit committee has:
    - Reviewed and discussed audited financial statements with management
    - Discussed with the independent auditor matters required under PCAOB Auditing Standard 1301, such as significant matters that the auditor discussed with management and an overview of the overall audit strategy
25. For example, for several years, the pension fund of the United Brotherhood of Carpenters has sought enhanced disclosures from certain companies regarding the audit committee's ownership and oversight of the audit relationship. In addition, the Audit Committee Collaboration, comprising several US governance organizations, issued its Call to Action to urge companies to consider additional disclosures about the audit committee to help investors and other stakeholders better understand their important work. "Enhancing the Audit Committee Report," November 2013, CAQ website, http://thecaq.org/enhancing-audit-committee-report-call-action, accessed May 2017.
26. "Audit committee reporting to shareholders in 2016," Ernst & Young LLP, September 2016, EY website, http://www.ey.com/Publication/vwLUAssets/ey-audit-committee-reporting-to-shareholders-in-2016/$FILE/ey-audit-committee-reporting-to-shareholders-in-2016.pdf, accessed May 2017.
27. "Possible Revisions to Audit Committee Disclosures," SEC concept release, July 2015, SEC website, https://www.sec.gov/rules/concept/2015/33-9862.pdf, accessed May 2017.
28. The data for this report was gathered through the EY Center for Board Matters' proprietary corporate governance database, which collects and analyzes data for more than 3,000 US public companies. EY Center for Board Matters website, http://www.ey.com/gl/en/issues/governance-and-reporting/center-for-board-matters/, accessed May 2017. This table is excerpted from the EY publication "Audit committee reporting to shareholders in 2016," Ernst & Young LLP, September 2016, EY website, http://www.ey.com/Publication/vwLUAssets/ey-audit-committee-reporting-to-shareholders-in-2016/$FILE/ey-audit-committee-reporting-to-shareholders-in-2016.pdf, accessed May 2017.

"To be sure, the PCAOB and the audit profession have both come a long way since the enactment of the Sarbanes-Oxley Act. Audit quality has improved."

SEC Commissioner Kara Stein[29]

"Audits and investor protection have improved significantly, in my view."

PCAOB Chairman James Doty[30]

"75% of investors express confidence in audited U.S. financial reports."

The CAQ's 10th Annual Main Street Investor Survey: A Decade of Investor Confidence[31]

"It is clear that audit quality has significantly improved since the passage of the Sarbanes-Oxley Act and the implementation of audit regulatory oversight in the U.S. and around the world."

PCAOB Board MemberJeanette Franzel[32]

"81% of investors express confidence in independent public company auditors."

The CAQ's 10th Annual Main Street Investor Survey: A Decade of Investor Confidence[33]

29. "Statement on the Commission's Consideration of the Public Company Accounting Oversight Board's Proposed 2016 Budget and Accounting Support Fee," 14 March 2016, SEC website, https://www.sec.gov/news/statement/stein-remarks-open-meeting-pcaob-031416.html, accessed May 2017.
30. "PCAOB 2016 Budget Presentation to the SEC," 14 March 2016, PCAOB website, https://pcaobus.org/News/Speech/Pages/PCAOB-2016-Budget-Presentation-to-the-SEC.aspx, accessed June 2017.
31. September 2016, Center for Audit Quality website, http://www.thecaq.org/2016-main-street-investor-survey, accessed May 2017.
32. Ibid.
33. "Progress and Evolution in Audit Oversight to Protect Investors and the Public Interest," 15th Annual Financial Reporting Conference, 5 May 2016, PCAOB website, https://pcaobus.org/News/Speech/Pages/Franzel-progress-in-audit-oversight-Baruch-5-5-16.aspx, accessed May 2017.

Enhanced transparency, executive accountability and investor protection

Another core element of Sarbanes-Oxley was to clearly define and place responsibility for 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.

By making management executives fully accountable for their companies' financial statements and related controls, Sarbanes-Oxley set a clear tone for corporate responsibility and helped restore investors' confidence in financial statements. 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.[34] As a further step to help restore investor confidence in corporate financial statements, SOX required companies to have an auditor attest to the effectiveness of the company's internal controls over financial reporting (see additional discussion in the next section).

SOX established a number of other protections for investors, including:

- Establishment of the SEC's "Fair Funds" program: To supplement the financial relief available to victims of securities fraud, this program allows the SEC to add monetary penalties paid by those who commit securities fraud to the funds available for distribution to wronged investors.[35]
- Provision of accurate information to auditors: Public company officers, directors and persons operating under their direction are prohibited from manipulating, coercing, misleading or fraudulently influencing the external auditor.[36]
- Enhanced disclosures: Public companies are now required to provide enhanced disclosures in annual and quarterly reports regarding material off-balance sheet transactions, arrangements and obligations.
- Disclosure of material changes: Public companies are required to report material changes in the financial condition or operations of the company on a rapid and current basis.

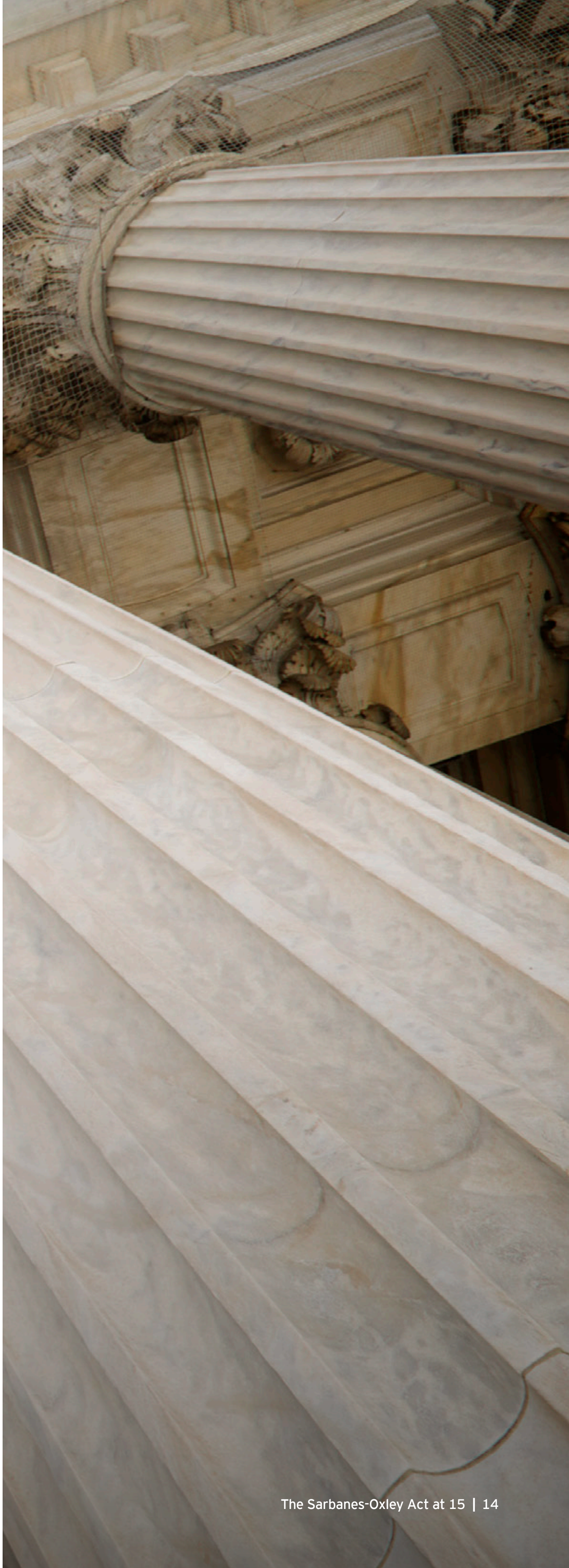
34. SOX § 304 requires CEOs and CFOs to reimburse issuers for bonuses and profits on the sale of the issuer's shares over the preceding 12 months if the issuer restates its financial statements because of misconduct. Section 954 of the Dodd-Frank Act of 2010 requires companies to establish policies to 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 proposed rule in July 2015 that, if finalized, would carry out this requirement. "Listing standards for erroneously awarded compensation," SEC proposed rule, July 2015, SEC website, https://www.sec.gov/rules/proposed/2015/33-9861.pdf, accessed May 2017.
35. Prior to SOX, these funds were paid to the US Treasury.
36. SOX § 303; the related SEC rule is 17 CFR § 240.13b2-2.

Establishment of the SEC Whistleblower Program

SOX established key protections for whistleblowers who report suspected fraud with respect to a public company's financial reporting. It also required public company audit committees to establish procedures for receiving whistle-blower complaints and to ensure that they are addressed confidentially and anonymously. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) 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 (OWB) in 2011.[37] The mission of the OWB is to "administer a vigorous whistleblower program that will help the Commission identify and halt frauds early and quickly to minimize investor losses."[38]

The whistleblower program authorizes the SEC to make monetary awards to whistleblowers who provide the SEC with original information about possible securities law violations that leads to a successful enforcement action.[39] The program awards amounts equal to 10%–30% of the monetary sanctions collected. Since the inception of this program, the SEC has awarded approximately US$153 million to 43 individuals through April 2017.[40]

Under the program, whistleblowers can provide information directly to the SEC or go through their companies' whistleblower reporting procedures. SEC rules prohibit companies from blocking employees' participation in the OWB program or from retaliating against employees who provide information to the SEC. The SEC's Division of Enforcement has actively pursued companies that try to circumvent these rules. For instance, the SEC has sanctioned several companies that included terms in their severance agreements precluding their employees from accepting any monetary award under the whistleblower program.[41]



37. 2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program, SEC Office of the Whistleblower, November 2016, SEC website, https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2016.pdf, accessed May 2017.
38. Ibid.
39. Ibid.
40. "SEC awards nearly $4 million to whistleblower," SEC press release, 25 April 2017, SEC website, https://www.sec.gov/news/press-release/2017-84, accessed May 2017.
41. SEC website, sec.gov.

Internal controls over financial reporting

Sarbanes-Oxley requires public companies to assess how effective their internal control over financial reporting (ICFR) is at preventing misstatements that could be material to the financial statements. 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 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.

SOX Section 404(a) requires management to report on the effectiveness of the company's ICFR, and Section 404(b) requires the auditor's attestation regarding its effectiveness. SEC rule-making 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).[42]

In recent years, SEC staff have emphasized the importance of effective ICFR in facilitating the preparation of reliable financial statements for investors. This has included increased activity by the SEC's Division of Corporation Finance to prompt companies to identify and disclose material weaknesses, as well as heightened scrutiny by the SEC's Division of Enforcement related to ICFR. The SEC staff has suggested that a focus on internal control over financial reporting will be even more critical given the pending adoption of significant new accounting standards (i.e., revenue, leases and credit losses) in the upcoming years.

The process of evaluating the effectiveness of a company's internal control over financial reporting has been subject to significant discussion during the past few years. ICFR has been a source of significant PCAOB inspection findings, which has led to significant remediation efforts by audit firms to address the identified deficiencies. SEC staff have raised concerns that the audit deficiencies may indicate issues in ICFR and/or management's assessment of ICFR.

> "Over the next several years, updating and maintaining internal controls will be particularly important as companies work through the implementation of the significant new accounting standards."
>
> **SEC Chief Accountant Wesley Bricker**[43]

> "The ICFR audit, performed by an independent, objective auditor, is an important driver of trust in the integrity of financial reporting and helps facilitate capital formation in U.S. markets."
>
> **Letter from the Council of Institutional Investors, Center for Audit Quality and CFA Institute to the House Financial Services Committee regarding the Financial CHOICE Act 2017, 1 May 2017**[44]

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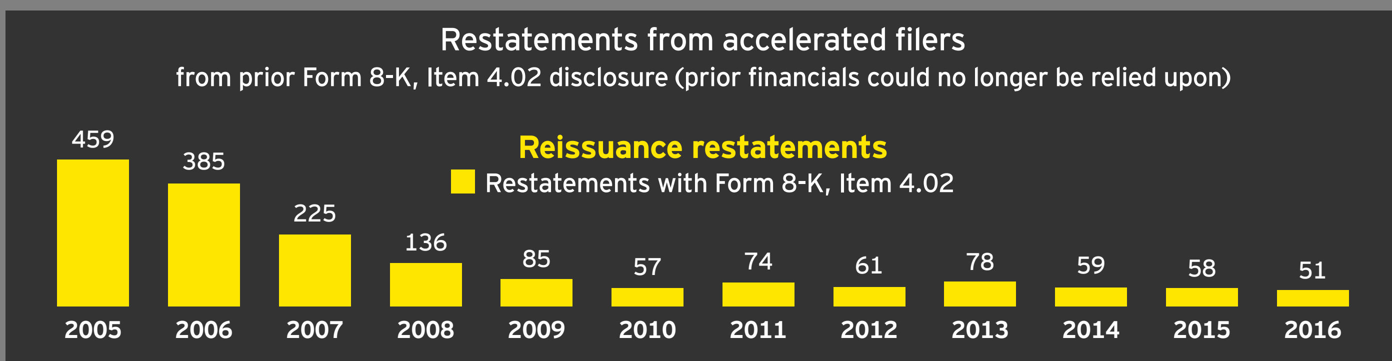
42. Dodd-Frank Act, SEC website, https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf; JOBS Act, SEC website, https://www.sec.gov/spotlight/jobs-act.shtml.
43. "Working Together to Advance High Quality Information in the Capital Markets," 2016 annual American Institute of CPAs National Conference on Current SEC and PCAOB Developments, 5 December 2016, SEC website, https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html, accessed May 2017.
44. CAQ website, http://www.thecaq.org/caq-cii-and-cfa-institute-submit-joint-letter-financial-choice-act, accessed May 2017.

For their part, preparers have raised concerns about how the auditor's assessment of management review controls is being executed, including the degree of precision needed in ICFR assessments as well as the level of required documentation. Preparers have indicated that the work that auditors require of companies with respect to ICFR appears inconsistent with the reforms developed by the SEC and PCAOB in 2007 that were intended to enhance both the effectiveness and efficiency of the assessment process.

As a result of the concerns, both the PCAOB and SEC performed outreach with preparers, auditors, audit committee members and others to understand the concerns and consider next steps. SEC and PCAOB staff have provided additional perspective on the nature and extent of evidence required to support ICFR assessments, and plan to monitor activities in this area to assess whether further activities would be appropriate. They also continue to emphasize the importance of effective ICFR in providing reliable financial reporting for investors.

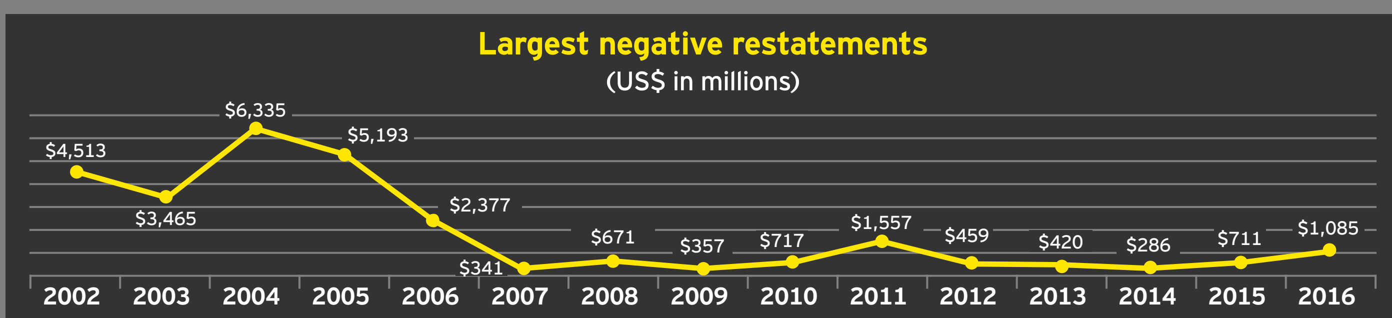
ICFR Impact

Enhanced focus on internal control over financial reporting may have driven a decrease in the number and severity of financial statement restatements since the SOX ICFR requirements became effective in 2004. As illustrated below, the number of reissuance restatements for accelerated filers dropped significantly since 2005 and has maintained a low rate in recent years.[45]



Source: Audit Analytics (2016 Financial Restatements: A Sixteen Year Comparison)

In addition, the severity of the largest restatements with negative impact on net income has significantly decreased since SOX 404 was implemented:



Source: Audit Analytics (2016 Financial Restatements: A Sixteen Year Comparison)

45. "Reissuance restatements" are the most severe type of restatement because they mean that a company's past financial statements can no longer be relied upon.

Enhanced auditor independence

Quality audits performed objectively by independent auditors support investor confidence in financial reporting. Sarbanes-Oxley strengthened auditor independence in several ways, including by restricting the types of non-audit services that audit firms can provide to the public companies they are auditing. Two additional ways that it reinforced auditor independence include requiring:

- Audit committee preapproval of all audit and non-audit services by the auditor, enabling audit committees to assess the cumulative impact of all services provided by the auditor on its independence. SEC staff have emphasized that management and audit committees need appropriate policies and procedures in place to evaluate and monitor non-audit services provided by the registrant's auditor in order to mitigate the risk that deviations in the scope of such services could impair independence.
- Mandatory rotation of key partners involved in audits, to limit overfamiliarity with a company and/or management, including:
  - The lead engagement partner every five years (prior to SOX, professional standards required rotation every seven years)
  - Concurring audit partner every five years[46]
  - Other audit partners who have significant responsibilities on audits every seven years

Since SOX, auditor independence has been a focus of both the SEC and PCAOB. The Commission and Board have emphasized the importance of auditors evaluating and applying the independence rules carefully and ensuring that partners and staff (including those providing non-audit services) receive training on the rules and follow them.

SOX prohibits audit firms from providing certain services to public companies they audit:

- Bookkeeping
- Financial information systems design and implementation
- Appraisal or valuation services or fairness opinions
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker, dealer, investment adviser or investment banking services
- Legal and expert services unrelated to the audit

46. A "concurring audit partner" (or "engagement quality reviewer" as defined in PCAOB standards) is a partner, independent of the audit team, whose role is to perform an objective review of the significant judgments made by the audit team and the related conclusions reached in forming an opinion on the financial statements. Engagement quality reviewers must provide their approval prior to issuance of an audit report.

Auditor oversight around the world

The PCAOB was one of the first independent audit oversight bodies to be created but now has numerous counterparts around the world. In 2006, 18 such bodies came together to establish the International Forum of Independent Audit Regulators (IFIAR) in order to share knowledge of the audit environment, promote collaboration and consistency in regulatory activity and facilitate cross-border cooperation. Today, IFIAR members span the globe, covering 52 countries. In 2017, IFIAR achieved an important milestone, establishing for the first time a permanent secretariat, which is located in Tokyo, Japan.

IFIAR has undertaken several significant projects to increase consistency and collaboration among its members as well as improve audit quality. An early IFIAR project was to develop global principles on independent audit oversight that its members should strive to implement. More recently, IFIAR members concluded a multilateral memorandum of understanding (MMOU) regarding cooperation on inspections and enforcement matters. The MMOU establishes a framework for members to share information with each other confidentially, facilitating oversight of cross-border audits and cooperation on multinational investigations. In addition, during the past five years, IFIAR has released annual Global Surveys of Inspection Findings, which compile inspection data from a number of its members around the world.[47]

IFIAR's Global Audit Quality Working Group (GAQ)[48] and the large individual audit networks meet regularly to discuss cross-border audit quality. One output of these discussions is that in 2015, the GAQ and the large networks set a target to reduce the number of listed public interest entity audits with at least one inspection finding by an aggregate 25% in the nine GAQ member countries over four years (by 2020). The GAQ and the networks also are engaged in dialogue on effective root cause analysis of inspection findings and implementation of actions to address them. The PCAOB is a member of the GAQ, and Board Member Lewis Ferguson is its Chair.

Growth of IFIAR membership:

2006 – 18 original members
Australia, Austria, Brazil, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Mexico, the Netherlands, Norway, Singapore, South Africa, Spain, Sweden, the UK, plus the US (observer)

2012 – 39 members
Abu Dhabi, Bulgaria, Dubai, Egypt, Finland, Greece, Hungary, Korea, Lithuania, Luxembourg, Malaysia, Malta, Mauritius, Poland, Portugal, Slovak Republic, Sri Lanka, Switzerland, Taiwan, Thailand, Turkey, the US (full member) (Mexico ceased to be a member)

2017 – 52 members
Albania, Belgium, Botswana, Cayman Islands, Croatia, Cyprus, the Czech Republic, Gibraltar, Indonesia, Jersey, Liechtenstein, New Zealand, Russia, Slovenia (Malta ceased to be a member)[49]

47. IFIAR website, www.ifiar.org, accessed May 2017.
48. GAQ members are the audit regulators in Australia, Canada, France, Germany, Japan, the Netherlands, Singapore, the UK and the US.
49. IFIAR website, www.ifiar.org, accessed May 2017.

Looking ahead: the next 15 years

Markets are constantly changing, and auditors, companies, regulators and other stakeholders must keep up in order to maintain their relevance and vitality. While we believe the Sarbanes-Oxley Act will continue to be relevant over the next 15 years, we expect that audit oversight and standard setting will evolve in light of the dynamic environment. Some of the areas in which we expect to see significant evolution are the use of technology in audits, corporate reporting and standard setting, to name a few.

Technological developments

Advances in technology, including the use of data analytics, are allowing businesses to track large volumes of information about their operations. These advances also enable the audit profession to increasingly use data and analytical tools to carry out audits, with the potential to enhance the quality and relevance of the audit. They may allow, for example, auditors to test entire data populations rather than conduct sampling-based testing. Auditors are also able to use data and statistical techniques to help identify factors that are associated with quality audits and to further improve responses to audit risk. As technology continues to evolve, it will be important for the PCAOB and audit profession to engage in dialogue about the potential impact on the audit, inspections and audit standards.

Corporate reporting

Corporate reporting is another area in which evolution will likely be a constant. Companies have begun voluntarily undertaking innovative approaches to make their disclosures more focused and effective. Technological changes may enable investors to more easily find the information most critical to their investment decisions through data tagging or other methods, and we should expect that. Integrated reporting and sustainability reporting, in addition to traditional disclosures provided by public companies, likely will continue to gain traction. Companies may also begin to report more about cybersecurity and non-GAAP measures.

> "Today, we live in an era of increasingly complex financial reporting, with expanded use of estimates in financial statements, and myriad new financial instruments and financing techniques. Auditing as a profession has changed accordingly, with parallel increases by audit firms in their use of technology, data mining, and analytics. Moreover, we are only at the beginning of what I believe will be a major transformation in how auditors do their job."
>
> **PCAOB Board Member**
> **Lewis Ferguson**[50]

50. "Global Developments in Auditor Oversight," Sixth Annual Conferência Brasileira de Contabilidade e Auditoria Independente, 13 June 2016, PCAOB website, https://pcaobus.org/News/Speech/Pages/Ferguson-speech-Brazil-global-audit-oversight-06-13-2016.aspx, accessed May 2017.

PCAOB standard setting

We expect PCAOB standards, as well as the standard-setting process, to continue to evolve. Topics on the PCAOB's research agenda and rule-making docket include changes in the use of data and technology in the conduct of audits, audit firm quality control systems, auditing accounting estimates and the use of specialists in conducting the audit. With regard to the standard-setting process, in recent years the PCAOB has innovated its approach, including by incorporating economic analysis in its rule-making and conducting its first post-implementation review of a standard in 2016. As discussed above, the PCAOB also is implementing a new process for selecting rule-making projects that involves first conducting research and obtaining extensive stakeholder input, setting the stage for high-quality standard setting.

Shift in PCAOB inspection focus

In the future, another area of potential evolution could be with respect to inspections placing greater focus on audit firm quality control systems. As Board Member Jeanette Franzel stated, "Another potential future change could involve evolution in the focus of inspection procedures between inspecting individual audits and testing of a firm's quality control system … In an optimistic scenario of a large firm improving its quality control system so that it is effective in preventing audit deficiencies — in other words if a large firm strengthens its quality control system to the point that it has very few or no Part I audit deficiencies in the individual audits inspected by the PCAOB — then it may make sense to increase the inspection focus on testing the firm's quality control system while potentially decreasing the number of audits inspected."[51]

51. "Progress and Evolution in Audit Oversight to Protect Investors and the Public Interest," speech by PCAOB Board Member Jeanette Franzel, 15th Annual Financial Reporting Conference, 5 May 2016, PCAOB website, https://pcaobus.org/News/Speech/Pages/Franzel-progress-in-audit-oversight-Baruch-5-5-16.aspx.

Withstanding the test of time

As we look to the future, one area of focus for both investors and policymakers is on long-term value creation. We believe this is only possible if there is confidence in financial reporting. This means that everyone in the financial reporting system must do their part: companies must fully disclose material information, auditors must exercise independence and skepticism when examining financial statements, and audit committees must provide diligent oversight of the financial reporting process.

We believe the foundation for investor confidence was vastly strengthened by the Sarbanes-Oxley Act of 2002. At the same time, we recognize the need for all market participants to continually seek to do more to earn that trust. From our perspective as auditors, we know that achieving and maintaining audit quality requires constant vigilance and effort, given the dynamism and complexity of companies, global markets, financial products and the business environment. We look forward to working alongside investors, companies, audit committees and regulators to use the strong foundation built by SOX to meet the coming challenges. In our view, its framework and key tenets continue to withstand the test of time.

Appendix: Key features of the Sarbanes-Oxley Act of 2002

On 25 July 2002, Congress passed the Sarbanes-Oxley Act of 2002 by a vote of 423-3 in the House and 99-0 in the Senate. On 30 July 2002, President George W. Bush signed the measure into law (PL 107-204).

The following is an outline of the major requirements of the Act, broken into five sections: (1) consequences for issuers; (2) audit committee requirements; (3) board and corporate officer requirements; (4) audit firm requirements; and (5) the major amendments to SOX since its enactment.

I. Issuers

The Act has the following consequences for issuers:

1. Issuers are subject to the Act: the Act defines "issuer" as any company whose securities are registered, whether the issuer is domiciled in the United States or elsewhere, and any company required to file reports under § 15(d) of the Securities Exchange Act of 1934 (§ 2).

2. Issuers must establish audit committees: the Sarbanes-Oxley Act effectively requires all listed companies, whether US or non-US, to have fully independent audit committees (§ 301).

3. The PCAOB can compel testimony and audit work papers related to an issuer: the PCAOB may require testimony or the production of documents or information in the possession of any registered audit firm or "associated person" of the firm relevant to an investigation. The PCAOB may also "request" documents and testimony from other persons, including issuers. If necessary, the PCAOB may request that the SEC issue a subpoena to assist it in its investigation (§ 105).

4. Issuers will be held responsible for associating with suspended or barred auditors: the Act prohibits an issuer from employing a person who has been suspended or barred from associating with any audit firm (§ 105).

5. Issuers are required to fund the operations of both the PCAOB and the Financial Accounting Standards Board (FASB): the Act authorizes the PCAOB to fund itself by requiring issuers to pay an "annual accounting support fee." Issuers also are responsible for funding FASB (§ 109).

6. An issuer may not engage its auditor for certain non-audit services: the Act statutorily prohibits eight specifically listed categories of non-audit services from being offered by audit firms to their public audit clients and authorizes the PCAOB to prohibit other non-audit services (§ 201).

7. An issuer's audit committee must preapprove all audit and non-audit services: before an auditor can provide audit services or any non-audit service to a public audit client, the audit committee of the client must approve (§ 202).

8. Issuers must disclose approvals of non-audit services: audit committee approvals of non-audit services must be disclosed in SEC periodic reports (§ 202).

9. Issuers must wait one year before hiring an audit engagement team member to be the CEO, CFO, chief accounting officer (CAO) or equivalent: the Act provides that an audit firm may not provide audit services for a public company if that company's chief executive officer, controller, chief financial officer, chief accounting officer or other individual serving in an equivalent position was employed by the audit firm and worked on the company's audit during the one year before the start of the audit services (§ 206).

10. Issuers must provide audit committees with adequate funding: issuers must provide appropriate funding, as determined by the audit committee, for payment of compensation to the auditor and any advisors employed by the audit committee (§ 301).

11. Issuers must disclose off-balance sheet transactions: the SEC issued rules requiring that annual and quarterly financial reports disclose all material off-balance sheet transactions, arrangements, obligations and other relationships of the issuer that may have a material current or future effect on the financial condition of the issuer (§ 401).

12. Issuers must reconcile pro forma information with GAAP and not omit information that otherwise makes financial disclosures misleading: the SEC issued rules providing that pro forma financial information disclosures must reconcile with GAAP and not be misleading (§ 401).

13. Issuers may not extend loans to board members or corporate officers: the Act makes it unlawful for an issuer to extend a loan to a board member or executive officer that is not made in the ordinary course of business of the issuer and is not of a type generally made available to the public and on market terms (§ 402).

14. Issuers must disclose transactions involving management and principal stockholders: Section 16 of the Securities Exchange Act of 1934 was amended to require that changes in equity ownership by board members, officers and 10% stockholders must be reported within two business days after the day of the transaction. These "Section 16 filings" must be filed electronically and posted on the company's website (§ 403).

15. Issuers must make annual internal control reports: issuers must make reports that (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) contain an assessment as of the end of the most recent fiscal year of the effectiveness of the internal control structure procedures of the issuer for financial reporting. The auditor must attest to, and report on, management's assertion (§ 404).

16. Issuers must disclose whether they have adopted codes of ethics for their senior officers: the SEC issued rules requiring companies to disclose whether they have adopted codes of ethics for senior officers. If not, issuers must explain their rationale for failing to do so (§ 406).

17. Issuers must disclose the existence of a "financial expert" on the audit committee: the SEC issued rules requiring issuers to disclose whether or not (and if not, reasons therefore) the audit committee has at least one member who is a "financial expert" (§ 407).

18. Issuers must disclose information about "material changes" in real time: public companies must disclose in plain English and "on a rapid and current basis" additional information regarding material changes in their financial conditions or operations (§ 409).

19. The Act creates criminal penalties for obstruction of justice by destruction of documents: the Act creates criminal penalties for obstruction of federal agency or other official proceedings by destruction of records. The Act provides for up to 20 years in jail for knowingly destroying or creating evidence with intent to obstruct a federal investigation or matter in bankruptcy (§ 802, 1102).

20. The Act changes bankruptcy law regarding obligations incurred in violation of securities laws: the Act amends the federal bankruptcy code so that obligations arising from securities law violations cannot be discharged in bankruptcy (§ 803).

21. The Act creates longer statutes of limitations for securities fraud cases: the Act lengthens the statute of limitations for private federal securities fraud lawsuits from one year after the date of discovery of the facts constituting the violation and three years after the fraud to two years from discovery and five years after the fraud (§ 804).

22. The Act creates "whistleblower" protections for employees of issuers: the Act provides whistle-blower protection to employees of publicly traded companies when they disclose information or assist in detecting and stopping fraud (§§ 806, 1107).

23. The Act creates criminal penalties for defrauding shareholders of publicly traded companies: the Act provides that anyone who "knowingly" defrauds shareholders of publicly traded companies may be subject to fines and imprisonment of up to 25 years (§ 807).

24. The Act enhances penalties for white-collar crime: the Act increases jail time for conspiracy, mail and wire fraud, violations of the Employee Retirement Income Security Act of 1974 (ERISA), Exchange Act violations and retaliation against informants (§§ 902–904, 1106–1107).

II. Audit committees

The Act requires that audit committees:

1. Preapprove all audit and non-audit services: the Act provides that both auditing and non-audit services must be preapproved by the audit committee. The Act makes it "unlawful" for audit firms to perform eight specifically listed categories of non-audit services for their public audit clients and authorizes the PCAOB to prohibit other non-audit services. The Act specifically indicates that the performance of any other non-audit service by an audit firm for a public audit client is not prohibited, provided such services are "preapproved" by the client's audit committee (§§ 201–202).

2. Have the ability to delegate preapproval authority: the preapproval of non-audit services may be delegated to a member of the audit committee. The decisions of any audit committee member to whom preapproval authority is delegated must be presented to the full audit committee at its next scheduled meeting (§ 202).

3. Receive regular reports from the auditor on accounting treatments: an auditor must report to the audit committee on the critical accounting policies and practices to be used; all alternative treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments, and the treatment preferred by the auditor; and other material written communications between the auditor and management (such as any management letter and schedule of unadjusted differences) (§ 204).

4. Be responsible for oversight of the auditor: the Act provides that auditors shall report to and be overseen by the audit committee of a client, not management. The audit committee is "directly responsible for the appointment, compensation, and oversight" of the auditor's work (§ 301).

5. Be independent of the issuer: audit committee members must be independent. In order to be considered "independent," an audit committee member may not accept any consulting, advisory or other compensatory fees from the issuer or be an "affiliated person" of the issuer or a subsidiary thereof (§ 301).

6. Establish complaint procedures: audit committees must establish procedures for receiving and treating complaints regarding accounting and auditing matters, including complaints from those who wish to remain anonymous (§ 301).

7. Be given authority to engage advisors: Audit committees must have authority to engage lawyers and other advisors, as they determine necessary (§ 301).

8. Receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty: the SEC established rules for attorneys appearing before it that require them to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company to the chief legal counsel or the CEO. If management does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee (§ 307).

III. Boards of directors and corporate officers

The Act imposes the following requirements on boards of directors and corporate officers:

1. The board of directors must either form an audit committee or take on such responsibilities: the Act requires boards of directors to either form an audit committee or otherwise take on the responsibilities of one (§ 2).

2. The CEO and CFO must certify financial reports: the SEC established rules providing that an issuer's CEO and CFO must certify that periodic reports filed with the SEC are materially correct; that financial statements and disclosures "fairly present" the company's operations and financial condition in all material respects; and that they are responsible for evaluating and maintaining internal controls, have designed such controls to ensure that material information related to the issuer and its consolidated subsidiaries is made known to such officials and others within such entities, have evaluated the effectiveness as of a date within 90 days prior to the report, and have presented in their report their conclusions about the effectiveness of their internal controls. Further, they shall certify that they have disclosed to the auditor and audit committee all "significant deficiencies" in the design or operation of internal controls, including any material weaknesses, and any fraud, whether or not material, that involved management or other employees who have a significant role in the issuer's internal controls (§ 302).

   A separate criminal provision requires the signing officer to certify that each periodic report containing financial statements complies with securities laws and that the information in such report fairly presents, in all material respects, the financial condition and results of operations of the company. Failure to do so is a criminal felony, punishable by a fine of up to US$1 million and/or imprisonment of up to 10 years. A willful violation is punishable by a fine of up to US$5 million and/or imprisonment of up to 20 years (§ 906).

3. Officers, directors and others are prohibited from fraudulently misleading their auditors: the SEC established rules prohibiting any officer, director or person acting under their direction from taking any action to fraudulently influence, coerce, manipulate or mislead an auditor (§ 303).

4. The CEO and/or CFO must disgorge bonuses and profits after restatements due to misconduct: CEOs and CFOs must forfeit bonuses, incentive-based compensation and profits on stock sales if the issuer is required to issue a restatement due to misconduct (§ 304).

5. The SEC can bar "unfit" officers and directors: the Act gives the SEC authority to bring administrative proceedings to bar persons who are found to be "unfit" from serving as officers or directors of publicly traded companies. (Note: Under prior law, the SEC had to go to court to obtain such a bar, and the standard was "substantial unfitness.") (§ 305, 1105)

6. Officers and directors are prohibited from trading during pension "blackout" periods: the Act prohibits corporate officers and directors from trading company securities during a pension fund "blackout" period (§ 306).

7. The CEO or chief legal counsel must receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty: the SEC established rules for attorneys appearing before it that require them to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company to the chief legal counsel or the CEO. If management does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee (§ 307).

8. The Act gives the SEC authority to temporarily freeze the pay of corporate officers: the Act gives the SEC authority to seek a federal court order to temporarily freeze any "extraordinary payments" to corporate officers pending an investigation of securities fraud (§ 1103).

IV. Audit firms

The Act's regulatory board provisions require audit firms to:

1. Be subject to oversight by an accounting oversight board: the Act established the PCAOB, which has broad powers over the profession. The PCAOB has five full-time members, appointed for staggered five-year terms. Two (and no more than two) of the members must be or have been CPAs. The SEC appoints PCAOB members (after consultation with certain other agencies) (§ 101).

2. Register with the PCAOB: audit firms that perform audits of public companies must register with the PCAOB. The registration form requires firms to disclose the names of audit clients; annual fees received from each issuer for "audit services, other accounting services, and non-audit services"; a statement of the firm's quality control policies; a list of all the firm's auditors and licensing information; information relating to criminal, civil, or administrative actions or disciplinary proceedings pending against the firm or associated persons in connection with any audit report; copies of any SEC reports disclosing accounting disagreements between the firm and an issuer in connection with an audit report; any additional information the PCAOB specifies as necessary or appropriate in the public interest or for the protection of investors; consent to cooperate in and comply with any testimony or document production request made by the PCAOB; and an agreement to secure and enforce similar consents from "associated persons" of the firm (§ 102).

3. Submit periodic reports: audit firms must submit annual updates of their registration to the PCAOB (or more frequently if the PCAOB determines it necessary) (§ 102).

4. Pay fees to the PCAOB: audit firms must pay registration fees and annual fees to the PCAOB to cover the costs of processing applications and annual reports (§ 102).

5. Comply with auditing and other professional standards: the Act requires the PCAOB to establish, or adopt by rule, "auditing and related attestation standards" as well as "ethics standards" to be used by audit firms in the preparation and issuance of audit reports. The Act indicates that the PCAOB may adopt standards proposed by "professional groups of accountants" (§ 103).

6. Comply with quality control standards: the Act requires the PCAOB to issue standards for audit firms' quality controls, including monitoring of ethics and independence, internal and external consulting on audit issues, audit supervision, hiring, development and advancement of audit personnel, client acceptance and continuance, and internal inspections (§ 103).

7. Submit to quality control inspections: the PCAOB must regularly inspect audit firms' audit operations (annually for large firms) to assess the degree of compliance by those firms with the Act, the rules of the PCAOB, the firm's own quality control policies, and professional standards relating to audits of public companies (§ 104).

8. Subject foreign firms to PCAOB regulation: foreign audit firms that "prepare or furnish" an audit report with respect to US registrants must register with the PCAOB and are treated the same as US audit firms for purposes of the Act (§ 106).

9. Secure the consent of foreign firms to PCAOB requests for documents if a domestic firm relies on its opinion: a domestic audit firm that relies upon the opinion of a foreign audit firm must "secure" the foreign firm's agreement to supply audit work papers to the PCAOB (§ 106).

The Act's legal and disciplinary provisions have the following consequences for audit firms:

10. Investigations and disciplinary actions: the PCAOB investigates potential violations of the Act, its rules, related provisions of the securities laws (and the rules), and professional accounting and conduct standards (§ 105).

11. Testimony and document production requests: the PCAOB may require testimony or the production of documents or information in the possession of any audit firm, "associated person," or any other person (including any client of an audit firm) if relevant to an investigation. All confidential information received by the PCAOB during an investigation may be furnished to the SEC, certain other federal regulators or (with the SEC's approval) to the Department of Justice, state attorneys general or state regulators (§ 105).

12. PCAOB sanctions, including suspension: the PCAOB may impose sanctions for noncooperation or violations, including revocation, suspension or limitations on an audit firm's registration, suspension from auditing public companies and imposition of civil penalties (§ 105).

13. State and federal prosecution after referral from the PCAOB: the PCAOB may refer investigations to the SEC, certain other federal regulators or (with the SEC's approval) to the Department of Justice, state attorneys general or state regulators (§ 105).

14. Sanctions for failure to supervise: the PCAOB may also impose sanctions upon an audit firm or its supervisory personnel for failure reasonably to supervise a partner or employee (§ 105).

15. Members of the audit engagement team must wait one year before accepting employment as an audit client's CEO, CFO, CAO or equivalent: the Act provides that an audit firm may not provide audit services for a public company if that company's chief executive officer, controller, chief financial officer, chief accounting officer, or other individual serving in an equivalent position, was employed by the audit firm and worked on the company's audit during the one year before the start of the audit services (§ 206).

16. Criminal penalties for destruction of corporate audit records: the Act creates a felony for the willful failure to maintain "all audit or review work papers" for five years. The SEC established rules on the retention of other audit records (paper and electronic) in addition to actual workpapers (§ 802).

17. Longer statutes of limitations for securities fraud cases: the Act lengthens the statute of limitations for certain private securities fraud actions from one year after the date of discovery of the facts constituting the violation and three years after the fraud to two years from discovery and five years after the fraud (§ 804).

The Act's internal procedure provisions require audit firms to:

18. Retain documents: pursuant to SOX, the PCAOB issued standards compelling audit firms to maintain for seven years "audit work papers, and other information related to an audit report, in sufficient detail to support the conclusions reached in such a report" (§ 103).

19. Submit audits to second partner reviews: the PCAOB issued standards requiring audit firms to have a second partner review and approval of each public company audit report (§ 103).

20. Rotate audit partners every five years: an audit firm must rotate its lead partner and its review partner on audits so that neither role is performed by the same accountant for more than five consecutive years (§ 203).

With respect to their public clients, the Act requires audit firms to:

21. Comply with PCAOB-issued internal controls testing standards: the PCAOB issued standards requiring auditors' report on their "findings" with respect to the audit client's internal control structure and the auditors' "evaluation" of whether the internal control structure and procedures "include a maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuers" (§ 103).

22. Attest to management's representations on internal controls: the Act requires management to assess and make representations regarding the quality of internal controls and requires audit firms to attest to and report on management's assessment (§ 404).

23. Cease offering certain non-audit services to public audit clients: the Act statutorily prohibits a number of non-audit services from being offered to public audit clients (§ 201).

24. Obtain audit committee preapproval for services: Before an audit firm can provide audit or non-audit services to a public audit client, the audit committee of the client must approve (§ 202).

25. Regularly report to audit committees on accounting treatments: audit firms must report to the audit committee on the critical accounting policies and practices to be used, all alternative treatments of financial information within GAAP that have been discussed with management officials, the ramifications of the use of such alternative treatments, the treatment preferred by the auditor, and other material written communications between the audit firm and management (§ 204).

26. Be responsible to the audit committee, not management: the Act provides that audit firms shall report to and be overseen by the audit committee of a company being audited, not management (§ 301).

V. Significant amendments to the Sarbanes-Oxley Act

The Dodd-Frank Act of 2010:

1. Exempted all public companies not classified as "accelerated filers" or "large accelerated filers" by the SEC from complying with § 404(b) of the Sarbanes-Oxley Act (§ 989G).

2. Expanded the requirement of domestic audit firms to secure a foreign firm's audit workpapers and also required the appointment of an agent for service of process in the US (§ 929J).

3. Authorized monetary awards to whistle-blowers providing the SEC with information that leads to a successful enforcement action. Confidential information supplied to the SEC by a whistle-blower may be furnished to the appropriate regulatory authority, the Attorney General of the United States, the PCAOB and others, at the discretion of the SEC (§ 922).

4. Expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined by the Securities Exchange Act of 1934 (§ 982).

5. Specified that civil money penalties for securities laws violations may be used to compensate victims without obtaining disgorgement from the defendant, as was previously required under the Sarbanes-Oxley Act (§ 929B).

6. Expanded the definition of "person associated with an [audit] firm" to include persons "formerly associated with an [audit] firm" for purposes of investigative and enforcement authority (§ 929F).

7. Authorized the PCAOB to provide foreign auditor oversight authorities with all confidential information received from an audit firm during a PCAOB inspection or investigation, at the discretion of the PCAOB and pursuant to certain qualifications (§ 981).

The JOBS Act of 2012:

8. Exempted all companies defined within the JOBS Act as emerging growth companies from complying with § 404(b) of the Sarbanes-Oxley Act (§ 103).

9. Exempted all companies defined in the JOBS Act as emerging growth companies from complying with any new accounting standard until such date that private companies must comply, if such standard applies to private companies at all (§ 102).

10. Exempted all companies defined within the JOBS Act as emerging growth companies from complying with any PCAOB rules requiring mandatory firm rotation or auditor discussion and analysis (§ 104).

11. Exempted all companies defined within the JOBS Act as emerging growth companies from complying with other new auditing standards unless the SEC determines that the application of such standard is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation" (§ 104).

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