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Verdoes, T.L.M.; Lycklama á Nijeholt, M.P.; Koster, H.

ARTICLE

Could the USA's SOX In-control Regime Serve as an Example for EU Member States?

TIM VERDOES, MAAIKE LYCKLAMA À NIJEHOLT & HAROLD KOSTER: ALL THE AUTHORS ARE ASSOCIATED WITH THE UNIVERSITY OF LEIDEN IN THE NETHERLANDS. MAAIKE LYCKLAMA À NIJEHOLT IS ALSO A LECTURER AT THE ROTTERDAM UNIVERSITY OF APPLIED SCIENCES. THIS ARTICLE DRAWS ON AN ACADEMIC REPORT ENTITLED VERSTERKING VERANTWOORDINGSKETEN [STRENGTHENING THE ACCOUNTABILITY CHAIN], WHICH WAS CO-AUTHORED BY THE AUTHORS AND PREPARED AT THE INSTRUCTION OF THE DUTCH MINISTRY OF FINANCE. THE DUTCH VERSION OF THIS ARTICLE WAS PUBLISHED IN ONDERNEMING EN FINANCIERING .2022/1.*

On 12 November 2021, the European Commission ('EC') published a consultation document on strengthening the quality of corporate reporting and its enforcement by addressing shortcomings in the underlying ecosystem. The duties of this EC initiative include examining the role that internal controls can play in achieving a high standard of reporting. The present article examines the existing in-control regime in the United States and whether that regime might serve as an example for EU Member States.

Keywords: internal controls, in-control statement, reporting standards, Sarbanes-Oxley Act

1. INTRODUCTION

On 12 November 2021, the European Commission ('EC') published a consultation document on strengthening the quality of corporate reporting and its enforcement by addressing shortcomings in the underlying ecosystem.[1] On the subject of corporate governance, the EC voiced concerns that boards of listed companies bear insufficient responsibility for the quality of their corporate reporting, particularly in terms of their controls and how to prevent fraud and going-concern risks. This is further exacerbated in some cases by the absence, or at least the rather weak position within the organization, of an audit committee. Other matters for concern are a lack of transparency about the activities of listed companies, and a lack of clarity regarding their supervision. The duties of this EC initiative include examining the role that internal controls can play in achieving a high standard of reporting.[2] The present article examines the existing in-control regime in the United States (hereinafter: 'US'), and whether that regime might serve as an example for EU Member States. It starts by discussing the relevant provisions. It then analyses the criticism that has been voiced on the regime and addresses its drawbacks and benefits. The article ends by presenting a series of conclusions.

2. THE STATUTORY IN-CONTROL REGIME IN THE US

In the US, the Sarbanes-Oxley Act ('**SOX**') is considered to be the largest overhaul of company law and financial law since the securities and exchange laws of the 1930s. SOX was introduced in part in response to the abuse that was occurring. Around the time that the US House of Representatives and Senate were debating SOX, the Enron affair was big news, and the downfall of *Word.Com* only added fuel. As a consequence, both the House and the Senate passed SOX almost unanimously. All manner of problems came to light during the hearings, including insufficient monitoring of auditing firms, conflicts of interest, insufficient independence of auditing firms, creative accounting, fraud and non-transparent reporting. The analysis and legislation covered not only those directly involved, but also other parties in the equity value chain, e.g., banks, investment analysts and rating agencies. One of the elements included in the SOX legislation is a statutory in-control statement.

The statutory in-control statement is governed by Sections 302, 404 and 906 SOX. Under section 302 SOX, CEOs and CFOs are required to issue a series of statements ('certify') in each of their company's annual or quarterly reports about the internal controls, their responsibility for and disclosures about those

* Emails: t.l.m.verdoes@law.leidenuniv.nl, m.p.lycklama@law.leidenuniv.nl, h.koster@law.leidenuniv.nl.

1 It has been suggested that the initiative is likely to take the form of a proposal for a directive, which will then amend Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and Regulation (EU) 537/2014 on specific requirements regarding statutory audit of public-interest entities.

2 For more information about internal controls, *see also* the UK Government's consultation document entitled *Restoring trust in audit and corporate governance*, published in Mar. 2021.

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internal controls. They must also certify that to the best of their knowledge the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of operations of the issuer.[3]

Under section 404 SOX, listed companies are required to include an internal control report in their annual reports, which:

1) states management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting[4]; and
2) contains an assessment, as of the end of the most recent financial year, of the effectiveness of the listed company's internal control structure and procedures for financial reporting.[5]

The annual report must also state which generally accepted accounting principles were used as a basis for that conclusion. Based on the SEC's interpretation, the COSO Internal Control – Integrated Framework (2013) is currently considered to be suitable, and as such many organizations use it as their frame of reference.[6] Material weaknesses in the internal controls for financial reporting also need to be explained.

The company's auditor then needs to issue an opinion on this subject, using a specific auditing standard. Besides his opinion on the reliability of the financial reporting, the auditor also has to include his own opinion on the effectiveness of the internal controls over financial reporting at year-end, using the same frame of reference as the company.[7] It should be noted, however, that some smaller audited entities are exempt from the requirement to have an auditor issue an opinion on that aspect.[8]

Also relevant, lastly, is section 906, which provides for criminal sanctions for issuing in-control statements in cases involving misleading or fraudulent financial reporting by directors. Penalties vary, and range up to USD 5 million and 20 years' in prison.

3. ANALYSIS OF THE CRITICISM ON AND THE DRAWBACKS AND BENEFITS OF THE SOX IN-CONTROL REGIME

3.1. Criticism

According to Romano, corporate governance entrepreneurs[9] saw SOX as their opportunity to put pre-existing ideas on the political agenda.[10] In her opinion, it was rushed through in response to situations of abuse without helping to prevent those abuses. Rather, it only leads to higher costs and market distortion, while at the same time infringing on the freedom of entrepreneurs and the individual states to determine the optimum form and scope of internal and external controls through competition and innovation. The mandatory in-control statement to the financial report is one of the topics examined by Romano,[11] who argues that the introduction of this requirement was not supported by the findings of empirical accounting and finance studies. Bhattacharya et al. conclude that the mandatory in-control statement is not '*value relevant*': it does not create value and consequently leads to a higher valuation of the company to which it applies.[12] The stock markets also responded unfavourably to the introduction of SOX, as confirmed by Zhang,[13] who analysed the economic consequences of SOX by examining whether '*overall direct and indirect private costs of SOX on businesses outweigh its private benefits*'. His conclusion was that they do. The atypical cumulative returns on shares that occurred around the introduction of SOX were significantly negative, and this fostered a negative attitude towards SOX among investors at the time. However, this is limited to private costs and benefits; societal benefits, the improved functioning of the stock market and the trust in companies are left out of the equation.

Butler and Ribstein opt for a more theoretical and substantive approach.[14] They also emphasize that SOX was introduced on factually incorrect grounds and leads to high costs. The annual direct costs of compliance are estimated at USD 600 million.[15] Butler and Ribstein consider the differences between a world with and without SOX. In a properly functioning market, good conduct is enforced, and bad conduct is punished. Shareholders are able to

3 G. T. M. J. Raaijmakers & O. M. Buma, *In Control Statement*, in *Handboek Jaarrekeningenrecht'* 882 (J. B. S. Hijink, M. P. Nieuwe Weme, G. P. Oosterhoff & L. in 't Veld eds, Van der Heijden Instituut series no. 164, Deventer: Wolters Kluwer 2020), Ch. 38.
4 *Ibid.,* at 882.
5 The phrase '*the effectiveness of the organization's internal controls*' is a true in-control statement.
6 J. de Groot & S. Hijink, *Verslaggeving over 'in-control' door Nederlandse beursvennootschappen*, 94(11/12) Maandblad voor Accountancy en Bedrijfseconomie 482 (2020).
7 De Groot and Hijink, *Maandblad voor Accountancy en Bedrijfseconomie* 482–483 (2020).
8 C. Posner, *SEC's Carve-Out from SOX 404(b) for Low-Revenue Companies*, Harvard Law School Forum on Corporate Governance, 4 Apr. 2020. Can be viewed at, https://corpgov.law.harvard.edu/2020/04/04/secs-carve-out-from-sox-404b-for-low-revenue-companies.
9 A 'corporate governance entrepreneur' is a policy entrepreneur who focusses on the policies surrounding corporate governance. A 'policy entrepreneur' means a person who seizes opportunities to influence policy results to support his own interests.
10 R. Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L. J 1521–1611 (2005).
11 *Ibid.,* at 1521–1611.
12 U. Bhattacharya, P. Groznik & B. Haslem, *Is CEO Certification of Earnings Numbers Value-Relevant?*, 14(05) J. Empirical Finance 611 (2007).
13 Y.X. Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, 44(01–02) J. Accounting & Econ. 74–115 (2007).
14 H. N. Butler & L. E. Ribstein, '*The Sarbanes-Oxley Debacle: How to Fix it and What we Have Learned*', Washington: AEI 2 (2006).
15 The expectation was, however, that those costs also included initial costs (for the first compliance round) and would therefore drop in subsequent years.

make allowances for fraud and deception by diversifying, which enables them to spread the incidental associated costs,[16] and managers and entrepreneurs risk their reputations and human capital if it emerges that they are operating in a manipulative manner. As such, a properly functioning and efficient market solves the problem of fraud at relatively low cost. Those market forces made corporate governance robust and resilient. The introduction of SOX has therefore hindered the proper functioning of the forces at play. The markets and the companies operating in them are now restricted in their ability to optimally prevent and detect fraud. Consequently, companies have fewer incentives to substantiate their own credibility. In fact, companies can now get away with the standard checklist. Butler and Ribstein specifically mention the following four corrective mechanisms that keep companies in control in a world without SOX: [17]

1. *Market monitoring*[18]: empirical research shows that the stock market has many implicit methods of assessing fraud risks (e.g., shifting the emphasis from profit to cash flows) and enforcing the control of those risks. 'Cash is a fact, profit an opinion'.[19] The stock market was not functioning properly momentarily because of a boom on the stock market, which was temporary. While the stock market is unable to foresee every new instance of fraud, SOX similarly cannot prevent all instances.
2. *Reputation and signalling*[20]: damage to managers' reputations is a key mechanism for enforcing good conduct. In addition, companies themselves can signal that they are in control. The advantage of voluntarily demonstrating that everything is in order (i.e., signalling) compared with a mandatory one-size-fits-all regulation is that companies can (or could) better establish whether the returns on the 'in-control operations' exceed associated costs. Based on that reasoning, it is in fact the properly functioning companies that are adversely affected by SOX, given that it deprives them of part of their freedom to decide for themselves how to be in control.
3. Besides 'supervision' exercised by the stock market, companies' major shareholders can also put forward proposals for tightening controls.[21]
4. The introduction of SOX at the Federal level in the US meant that the individual states were forced to surrender some of their own influence. At the time, the involvement of individual states created an efficient, resilient and robust system that was suddenly replaced by a Federal system when SOX was introduced.[22]

The basic idea is that companies and their directors can build up a functioning monitoring system in their free competitive, innovative interaction with the market. The draconian SOX – *one size fits all* – with its rule – based design does not take into account the market's self-cleansing ability, where competition determines what method is best. The introduction of SOX implicitly assumes that the legislature is better informed about what is good for companies (or society overall) than the companies themselves. Consequently, some directors experience the draconian SOX as a constricting corset.

However, the question is not only whether company directors can do better, but more importantly whether they want to. What is good for a company is not always good for its director. This may result in 'misalignment' of interests,[23] where the company and its director are not on the same page. For example, directors might be incentivized in the short term to cover up poor results or failure, or to negotiate better specific contractual terms, for example their terms of employment. In doing so, directors do not (or at least not always) take into account the external effects of their conduct, e.g., undermining society's trust in companies.

3.2. Drawbacks

According to Butler and Ribstein and other critics of SOX, the costs of SOX are underestimated, and its benefits are overestimated.[24] They argue that SOX carries not only direct compliance costs,[25] including audit fees, but also implicit costs, since directors work more cautiously and have less time for strategic and operational activities (i.e., opportunity costs).[26] According to its critics, SOX leads to inertia and working across multiple tracks. It can lead to a culture where people do not trust each other, and therefore it opens the doors to all manner of legal disputes. Furthermore, the critics argue, SOX can undermine the competitive position of companies and weaken their innovative capabilities. SOX can also deter companies from the US stock market, causing them to delist, since SOX applies only to listed companies. Butler and Ribstein therefore argue that SOX brings with it considerable costs,[27] as discussed in more detail below:

16 So, although 8% of the 2,500 largest companies had shortcomings in their financial reporting, all companies invested millions in compliance.
17 As a fifth point, they noted the following: '*Finally, it is worth wondering whether private organizations might have picked up any regulatory slack that existed in the absence of SOX. Firms can supplement market discipline by subjecting themselves to regulation by non-governmental bodies*' (Butler & Ribstein, *supra* n. 14, at 33).
18 Butler & Ribstein, *supra* n. 14, at 26.
19 P. Epe & W. Koetzier, *Jaarverslaggeving* 238 (Noordhoff Uitgevers 2014).
20 Butler & Ribstein, *supra* n. 14, at 28.
21 *Ibid.,* at 30.
22 *Ibid.,* at 30.
23 Bouwens 2020. *See also* para. 3.6. The resulting conflicts are studied in the agency theory.
24 Butler & Ribstein, *supra* n. 14, at 22.
25 *Ibid.,* at 35.
26 *Ibid.,* at 45.
27 The focus here is on the costs of s. 404 SOX and related aspects of the introduction of SOX.

3.2.1. *Direct Compliance Costs*

The in-control statement and the auditor's report carry relatively high direct costs, especially for smaller listed companies.[28] The costs of segregating control duties (the division of responsibilities and the associated powers) can also be high for smaller listed companies. In small companies, requiring control duties to be segregated can hamper the specialization that is desirable for their operations.

3.2.2. *Managing in the Shadow of SOX: A Climate of Fear*[29]

A modern company with specialized functions is organized (at least in part) on the basis of trust. That trust can sometimes interfere with the controls that are imposed and might even break down as a result, and then the safe option of control will generally take precedence. It also stands in the way of changes, adjustments and improvements to the in-control statement. The in-control statement can feel like a suffocating 'one-size-fits-all' tailored suit. Major adjustments to the company's in-control statement are sometimes passed by, as doing nothing is the safest course of action: if the major adjustments were to become public, the company could run the risk of being penalized. Segregated control duties (the division of responsibilities and powers, which stimulates mutual independence) can also have an inhibiting effect on innovations and risk appetite.[30] The independence created by introducing segregated duties sometimes leads to a lack of understanding and animosity, and can consequently restrict the free flow of information within companies. This undermines critical opposing views and may lead to tunnel vision and silos. Particularly managers who have to sign the in-control statement will be apprehensive about the possibility of legal disputes (litigation).[31] Butler and Ribstein also argue that whistleblowers can then use every single detail to threaten the organization. This means that SOX creates new opportunities for potential whistleblowers to report wrongdoings, because they are better protected.[32]

3.2.3. *Opportunity Costs of SOX*

Managers have less time for operational and strategic activities. In some instances, managers withdraw from listed companies to seek refuge in companies financed by private equity that are not subject to the SOX rules.[33] The choice for draconic controls is based on the idea that they create enterprise value by reducing business risks and fraud. However, the stricter controls can have a wide array of negative side effects that cancel out the benefits of enterprise value creation. Also, companies are more likely to remain privately owned (e.g., in the form of private equity) rather than going public, since a stock exchange listing brings with it the stricter rules. This can discourage start-ups that might otherwise eventually go public, and makes it more difficult for high-risk or small companies to raise capital.

3.2.4. *Perverse Incentives and Undoing Efficient Risk-bearing*

Another argument that Butler and Ribstein put forward is that SOX might disrupt the functioning of the common practice of segregation of duties between a company's management and its ownership, known as separation of ownership and control.[34] Shareholders can reduce the financial risk of their investments (and the risk of fraud) by diversifying their share ownership among different companies. This results in lower required risk premiums on their investments and lower costs of capital for the companies. According to Butler and Ribstein, SOX can disrupt this traditional function of companies. SOX explicitly places the responsibility for business risk with the company's management, since management can monitor it better. This could, however, cause managers to become more risk averse, for example by applying more conservative accounting methods. The results that were often overstated in the pre-SOX era are now replaced by understated results in the post-SOX era. As a result of this risk-averse behaviour, therefore, SOX does not necessarily lead to more accurate figures.[35] As such, Butler and Ribstein argue that whereas pre-SOX separation of ownership and management could lead to management fraud (the agent in the agency theory), since the introduction of SOX it can lead to management taking excessive precautions to hedge against risks. Instead of agency costs being reduced by SOX, they increase as a result.[36]

3.2.5. *Criminalization of Corporate Agency Costs*

One specific aspect of SOX is that it provides not only for measures under civil law, but under criminal law too. This can cause the level of control to be amplified even further.[37] As long as non-compliance leads to criminal liability, excessive compliance with the rules will be the norm, given that SOX criminalizes not only any and all instances of fraud that are detected, but also any shortcomings in the internal controls.

The criticisms described above were raised during the first years after SOX's introduction. During the period that followed, when the SOX smoke cleared, it became possible to qualify the criticisms and costs and recognize the benefits of SOX (both societal and private).

28 Butler & Ribstein, *supra* n. 14, at 37, note the following: '*a one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance*'.

29 Butler & Ribstein, *supra* n. 14, at 39.

30 For example, in the case of an acquisition.

31 Butler & Ribstein, *supra* n. 14, at 44, state the following on this topic: '*the most profitable corporations subject to SOX will be the ones whose executives are well-trained to anticipate litigation difficulties, rather than business issues*'.

32 Conversely, whistleblowers are shown to be an important source in detecting fraud, *see* para. 3.6.

33 Butler and Ribstein say the following on this topic: '*the allocation of executive talent should depend on market opportunities, not federal regulation*'.

34 Butler & Ribstein, *supra* n. 14, at 52. Shareholders specialize in bearing risk, directors do not.

35 This is precisely why tax accounting and financial accounting are two separate fields and not – according to the German *massgeblichkeits* principle – one and the same.

36 Butler & Ribstein, *supra* n. 14, at 53 say the following on this topic: '*In other words, the same separation of ownership and control that leads to agent fraud also leads to excessive precautions against it. Instead of reducing agency costs, SOX may actually increase them*'.

37 Butler & Ribstein, *supra* n. 14, at 53.

3.3. Benefits to Society

In addition to the drawbacks described above, several researchers have also identified some societal benefits of SOX's introduction.

3.3.1. *Better Quality of Reporting*

One of SOX's objectives was to improve the quality of reporting, and studies show that the quality has in fact improved as a result of SOX. This was examined on the basis of the number of restatements made following the discovery of material weaknesses in internal controls. Bouwens examined this using data from Auditanalytics.[38,39,40] After an initial increase – which can be explained as clearing a backlog of misstatements – the number of restatements has decreased significantly since SOX was introduced. This is an indication that the reporting quality has gradually improved.[41]

3.3.2. *Fraud Prevention*

Other objectives of SOX are to combat fraud and to restore investor confidence. The Association of International Fraud Examiners ('**ACFE**') annually publishes its *Report to the Nations*, in which it describes the importance of the various fraud detection methods.[42] Studies show that the damage as a result of financial statement fraud is relatively high. This indicates a need for measures to detect and reduce such fraud. The table below shows the detection methods used to identify fraud at companies.[43]

Table 1 Fraud Detection Methods – how Is Fraud Detected?[44]

Tip	*43%*	*Account Reconciliation*	*4%*
Internal audit	15%	Document examination	3%
Management review	12%	Surveillance/monitoring	3%
Other	6%	Notified by law enforcement	2%
By accident	5%	IT controls	2%
External audit	4%	Confession	1%

The table shows that in 15% of the cases fraud is detected by internal audits. On the one hand, this score is not high: SOX does not seem to be a panacea. On the other, it is important to bear in mind that error prevention (even unintentional errors) is another of SOX's aims. However, this table also shows the importance of a proper whistleblower policy in addition to SOX, given that 43% of the instances of fraud are discovered based on tips.

3.4. Private Benefits

In addition to the benefits to society that have been outlined, it turns out that companies themselves also benefit from SOX. First and foremost, studies show that strong internal control can create value for companies and their stakeholders. Chalmers et al. conducted research into the determinants of the internal control quality and its economic consequences for the various stakeholders of a company.[45] The findings from their study confirm that an in-control statement by the CEO and CFO of the company is an important determinant of the quality of the internal control of the company. The quality of the internal control has a favourable effect on the financial health of the company, which is beneficial for its stakeholders.

Metricstream's report finds that SOX has helped to shift the focus from internal controls and compliance to risk management and alignment with business objectives and processes. The report argues that SOX offers valuable support for companies in creating enterprise value. An effective SOX compliance process is a stepping stone to a more holistic practice of good governance and use of technology, which in turn can yield competitive advantages.[46]

The report[47] lists the following concrete advantages of SOX[48]:

3.4.1. *Prioritizing Risks*

By embedding a uniform and comprehensive risk management framework in the organizational culture, companies benefit from company-wide visibility and transparency in processes. This also increases anti-fraud and performance monitoring activities.

38 J. Bouwens *The Relation Between Auditors and Auditees: How Does the Regulator Affect That Relation Under SOX?,* UVA working paper 1–22 (2020). Auditanalytics distinguishes between reissuance restatements and revision statements: '*when looking at restatements, we categorize them by two levels: reissuance restatements and revision restatements. Reissuance restatements, sometimes referred to as "Big R" restatements, address a material error that calls for the reissuance of a past financial statement. Alternatively, revision restatements, or "Little r" restatements, deal with immaterial misstatements, or adjustments made in the normal course of business. Because revision restatements are less severe, they are generally not looked at as a sign of poor reporting. However, some would argue that the disclosure of revision restatements shows a level of transparency and honesty by the filer*', *see* https://blog.auditanalytics.com/2019-financial-restatements-review/, most recently (accessed 1 Sep. 2021).

39 Public data from Auditanalytics for 2015 and 2019 (which are shown in percentages in some instances and in absolute numbers in others) were used for this purpose, *see* https://blog.auditanalytics.com/2019-financial-restatements-review/ and, https://blog.auditanalytics.com/the-impact-of-sox-on-financial-restatements/, most recently (accessed 1 Mar. 2020).

40 Bouwens 2020 confirms the assertion by the Public Company Accounting Oversight Board ('**PCAOB**') '*that when there is a material weakness in internal controls, there is more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected*'.

41 The most common restatement is for revenue, due to an incorrect application of the realization principle The realization principle is one of the accounting principles that is used for compiling financial statements. According to that principle, revenue can only be recognized during the period when the products or services were delivered.

42 Association of International Fraud Examiners 2020.

43 *Ibid.*

44 Association of International Fraud Examiners 2020 – Report to the Nations 2020, at 19.

45 K. Chalmers, S. D. Hay & H. Khlif, *Internal Control in Accounting Research: A Review*', 42 J. Accounting Literature 80–103 (2019).

46 https://www.metricstream.com/insights/benefits-of-sox-compliance.htm (accessed 1 Mar. 2020).

47 https://www.metricstream.com/insights/benefits-of-sox-compliance.htm (accessed 1 Mar. 2020).

48 For other short overviews, *see* https://reciprocitylabs.com/6-sox-compliance-benefits/, https://visionlaunch.com/sarbanes-oxley-act-pros-and-cons. and, https://clutejournals.com/index.php/JBER/article/view/2479.

3.4.2. *Strengthening the Control Structure*

Standard control frameworks such as COSO enable organizations to strengthen their control structure and improve the link between control and risk. This also helps to streamline the efforts to document controls and to evaluate control processes. Strengthening internal control yields commercial benefits, such as more effective processes and more reliable financial reporting.

3.4.3. *Improving Audit Performance*

The introduction of SOX led to the Public Company Accounting Oversight Board (PCAOB) being founded, to assess the personal liability of auditors, executives and board members and to oversee managerial accounting decisions. This streamlined the efforts and narrowed the gap between the purpose of an audit and conducting it. Furthermore, it encouraged a well-functioning of the audited entity's risk management, governance and internal control processes.

3.4.4. *Centralized and Automated Financial Reporting*

SOX encourages companies to improve the efficiency and the quality of their financial reporting process, centralizing and automating it. It further helps to increase accountability for journal entries and public disclosures.

Wagner and Dittmar, who mapped out the unexpected benefits of SOX,[49] explain that when SOX was introduced the spotlight was mainly on the associated initial costs and efforts. At the same time, however, another development was taking place. Some companies had started to realize that, driven by organic growth, mergers and acquisitions and technological developments, they had lost their overview of and grip on the business processes. As a result, discrepancies between the 'real' and reported financial figures occurred at various companies. Reducing those discrepancies required greater control over and accountability for the actual underlying processes.[50]

Wagner and Dittmar identify the following broad areas in which SOX compliance '*has benefited firms governance, management, and investors*',[51] albeit on the basis of anecdotal evidence[52]:

3.4.4.1. Stronger Control Environment

Streamlining procedures, methods and routines contributes to the transparency of organizations and leads to efficient set-ups. This streamlining also strengthens the ethical awareness and consequently reinforces conduct and expectations within organizations, allowing them to operate in a more unified manner.

3.4.4.2. Improved Documentation

SOX has led to manuals, procedures and job descriptions being reviewed, making it easier to induct new employees and to share knowledge. It also highlights the importance of the SOX controls. Confusing procedures, or lack of procedures, can draw attention and motivation away from what actually needs to be done. Improved documentation creates clarity about who is responsible for what. SOX has also caused companies to review, rethink and design their actual processes. In addition, improving documentation also makes it possible to use data analysis to carry out the controls.

3.4.4.3. Closer Involvement of the Audit Committee

Under SOX, audit committees have been given an independent position: members of an audit committee may not have financial or personal ties to the company. In addition, at least one of the members of the audit committee must be a financial expert. As a result, audit committees now take their duties more seriously.

3.4.4.4. Capitalizing on Opportunities for Synergy

According to Wagner and Dittmar, companies take two different approaches to SOX.[53] One group of companies complies with the legal obligations, but spends as little as possible doing so, while the other group utilizes the expenditure and resources spent on SOX compliance to their benefit. These latter companies view the review of their processes as an opportunity to further streamline those processes, for example by eliminating duplication if they identify similarities in different legal regimes that require their compliance and then merging the various activities arising from this process. This helps those companies to leverage synergies.

3.4.4.5. Standardized Processes

Working methods evolve and change organically. Sometimes this leads to a company's branches or participations using different procedures. The standardization of the organization's controls that results from SOX can then yield great benefits. Wagner and Dittmar mention as an example the situation where separate branches apply different payment deadlines and charge different interest rates. Consolidating these activities led to a debtor portfolio that was difficult to monitor centrally, and made it difficult to establish what provision to form for doubtful debts. The standardization of processes under influence from SOX has helped to eliminate complexity and inconsistencies.

49 S. Wagner & L. Dittmar, *The Unexpected Benefits of Sarbanes-Oxley,* 84(4) Harvard Bus. Rev. 133–140 (2006).

50 SOX and the in-control statement can also be seen as an extension of the accounting obligation. Companies should not only keep records, but also guarantee their reliability. In the Netherlands, internal and external reporting are more or less separate worlds, and there is a great deal of freedom in how they are organized. In France, internal reporting is also strictly regulated, with strict schedules, for example.

51 Wagner & Dittmar, *supra* n. 49.

52 Anecdotal evidence is evidence based on one or a few real-life instances.

53 Wagner & Dittmar, *supra* n. 49.

3.4.4.6. Reducing Complexity

As an extension of the previous point, SOX has helped some companies reduce their complexity. SOX caused procedures to be reviewed and become better aligned. SOX made it necessary for companies to centralize, integrate and streamline their processes, which eliminated complexity and improved the general overview.

3.4.4.7. Reinforcing Weak Links

With SOX demanding a further analysis of business processes, this sometimes revealed weak or critical elements, including at important partners. In some instances, this caused companies to reallocate operations that had previously been outsourced.

3.4.4.8. Minimizing Human Error

Manual controls are prone to human error, as human judgment has its limitations. SOX has led to more automated controls, which can prevent such errors.

3.5. Table Summarizing Criticisms and the Drawbacks and Benefits

The criticisms and drawbacks of SOX described in professional literature are summarized in the table below.

SOX: CRITICISM AND DRAWBACKS	
CRITICISM OF SOX	
Investors rate SOX negatively (stock market research)	Bhattacharya et al., 2007; Romano, 2004; Zhang, 2007.
The existing system of market supervision, reputation, signalling and active shareholders worked well.	Butler and Ribstein, 2006
Previously, governance was regulated by the individual states, producing a functioning and competitive corporate governance system.	Butler and Ribstein, 2006
DRAWBACKS OF SOX	
SOX involves high costs for compliance and segregation of duties.	Butler and Ribstein, 2006
SOX is an extremely onerous tool for incidental fraud.	Butler and Ribstein, 2006
Working on trust is replaced by controls, which creates a culture of fear.	Butler and Ribstein, 2006
SOX may inhibit innovation and the risk appetite.	Butler and Ribstein, 2006
SOX creates high opportunity costs: managers have less time for operational and strategic activities.	Butler and Ribstein, 2006
SOX can upset the balance between control and trust, creating a risk that information will be withheld that would otherwise have been shared.	Butler and Ribstein, 2006
SOX can lead to perverse incentives and risk-averse behaviour. SOX can lead to an exaggerated level of precaution by management to hedge against higher risks.	Butler and Ribstein, 2006
Because SOX uses criminal-law measures, management will overcomply with the rules, leading to high agency costs.	Butler and Ribstein, 2006
The risk-averse conduct of managers resulting from SOX does not lead to accurate figures, but instead to overly cautious figures.	Butler and Ribstein, 2006
Fraud is reportedly detected mostly by whistleblowers.	ACFE, 2020
SOX can prompt managers to withdraw from listed companies.	Butler and Ribstein, 2006
SOX could lead to fewer stock exchange listings, since it does not extend to unlisted companies.	Butler and Ribstein, 2006

SOX: BENEFITS	
BENEFITS TO SOCIETY	
SOX leads to a better functioning of the stock market.	Zhang, 2007
SOX can improve confidence in companies.	Bhattacharya et al., 2007
SOX provides for a clear-cut one-size-fits-all rule.	Butler and Ribstein, 2006
The higher external audit costs resulting from SOX are limited and show hardly any change at all for large companies.	Auditanalytics, 2018
SOX leads to better external reporting.	Bouwens, 2020 and Metricstream, 2020
SOX prevents fraud.	Butler and Ribstein, 2006 and Metricstream, 2020
BENEFITS FOR COMPANIES AND THEIR STAKEHOLDERS	
SOX leads to better internal control.	Ge et al., 2017 Chalmers et al., 2019

SOX has helped to shift the focus from internal controls and compliance to risk management and alignment with business objectives and processes, which enhances enterprise value.	Metricstream, 2020
SOX increases awareness of the importance of risk assessment: business risks are given greater priority.	Metricstream, 2020
SOX leads to a better control structure and improves the link between control and risk.	Metricstream, 2020
SOX has led to better performance of audits, and has further closed the gap between the purpose of audits and how they are carried out	Metricstream, 2020
SOX has further centralized and automated financial reporting, making it better and more efficient.	Metricstream, 2020
Through SOX, the control environment has been strengthened, leading to more streamlined procedures and methods. This in turn provides greater transparency and an efficient set-up.	Wagner and Dittmar, 2006
SOX leads to better documentation, which makes it easier to share knowledge and understand responsibilities.	Wagner and Dittmar, 2006
SOX has led to more professionalism on audit committees, which now demonstrate greater commitment.	Wagner and Dittmar, 2006
Some companies use SOX to utilize convergence opportunities.	Wagner and Dittmar, 2006
The standardization of processes resulting from SOX has reduced complexity and inconsistencies. This improves the overview in the company.	Wagner and Dittmar, 2006
SOX pinpoints the weak links in and around the organization. These can be strengthened by rearranging activities.	Wagner and Dittmar, 2006
SOX leads to fewer human errors in controls, because less of the work is done manually and more of it is automated.	Wagner and Dittmar, 2006

3.6. Some Additional Remarks

Srinivasan et al. conducted a multidisciplinary study of the societal benefits and burdens of SOX.[54] They find that, despite the sometimes fierce criticism, SOX has proved to be fairly robust. Besides other countries have adopted similar systems. Familiarity with the underlying model (e.g., COSO) and international exchange have helped this model's diffusion and led to spillovers. The cautious general conclusion put forward by Srinivasan et al. is that the quality of financial reporting has improved as a result of SOX. In their view, the problem is that although the direct costs of SOX are clearly observable the same cannot be said of the indirect revenues and costs, and certainly not the external effects. They argue that SOX has made an important contribution in exposing significant or material shortcomings in internal control.[55]

The study conducted by Ge, Koester and McVay yielded findings that are similar to this conclusion. They studied the revenues and costs of companies that are exempt from mandatory audit according to SOX (SOX exemption 404(b)), and demonstrated that, despite saving hundreds of millions of dollars in audit fees (USD 388 million in total), in total these companies lost almost twice that amount in terms of lower operating income (USD 719 million) due to ineffective internal controls that went undetected and therefore unremedied at some of those companies (9.3% of the population studied). Moreover, those ineffective internal controls led to a significant overall decline in the market value of the companies concerned (USD 935 million).[56] Bédard et al. also demonstrate a correlation between the quality of internal controls and more efficient investment decisions, lower operating risks and better inventory management.[57]

With regard to the findings of those studies, Bouwens notes that they should be sufficient reason to prompt managers to improve the quality of their internal controls voluntarily. This raises the following rhetorical question: If good internal control can create value, why do directors not do that? Why does supporting internal control has to be mandatory? The reason might

54 *See* S. Srinivasan & J. C. Coates, *SOX After Ten Years: A Multidisciplinary Review,* 28(03) Accounting Horizons 627–671 (2014).

55 Studies of companies' disclosure of shortcomings in their internal control and how they manage those shortcomings reveal different outcomes. For example, *see ibid.,* at 627–671, and S. Rice, D. P. Weber & B. Wu, *'Does SOX 404 Have Teeth?', Consequences of the Failure to Report Existing Internal Control Weaknesses,* 90(03) Accounting Rev. 1169–1200 (2015).

56 W. Ge, A. Koester & S. McVay, *Benefits and costs of Sarbanes-Oxley Section 404(b) Exemption: Evidence from Small Firms' Internal Control Disclosures*, 63 J. Accounting & Econ. 378 (2017).

57 *See* J. Bédard, N. Glaudemans, M. Jans, M. van Peteghem, A. Renders, C. Schelleman & L. Zou, *FAR Literature Review - Internal Controls* 4 (2019), which refers to a number of studies on this subject. This can be accessed at, https://foundationforauditingresearch.org/files/far-project-2017b03-bedard—literature-review-1591969574.pdf.

lie in the assumption that directors' interests are aligned with the company's interests.[58] However, according to Bouwens, this is not necessarily true: directors can manipulate profit figures for their own benefit. He therefore emphasizes the importance of compensatory mechanisms separate from directors, to ensure that the company maintains effective internal controls to prevent such manipulations. According to Bouwens, the external auditor and the audit committee play an important role in achieving this.[59] As explained above, proper arrangements for whistleblowers can also make an important difference here.

4. CONCLUSION

The conclusion is that, although studies show that there are many positive aspects to SOX, the emphasis is often still on the negative aspects. In addition, the costs of SOX can be quantified with a reasonable degree of accuracy, while the benefits, for both companies and society overall, are more difficult to establish. However, SOX has undeniably led to an upturn in the quality of annual reporting.[60] Instances of profit manipulation are less frequent in entities with better internal controls and the financial statements of those entities are more informative.[61] Better internal controls often go hand in hand with higher reporting quality.[62] Having quick access to relevant and reliable information is essential for proper accountability and control by directors. Properly functioning internal risk management and controls are therefore crucial to good corporate governance. Although SOX has restricted the freedom of action of companies that already had in-control measures of their own, and market forces also help, overall SOX has helped to improve those internal risk management systems and controls. Our conclusion, therefore, is that the experiences with the SOX in-control regime can provide EU Member States with useful insights and food for thought.

58 Bouwens, *supra* n. 38, at 5–6.
59 *Ibid.,* at 6.
60 *See* Bédard et al., *supra* n. 57, at 4, which refers to a number of studies on this subject. *See also* Bouwens, *supra* n. 38, at 4–5.
61 *See* Bédard et al., *supra* n. 57, at 4, which refers to a number of studies on this subject.
62 *See ibid.,* at 4. *See also* Bouwens, *supra* n. 38, at 4–5.