SOX & Investor Confidence

The Sarbanes-Oxley Act at 15

TRANSCRIPT

KEN BERTSCH: When Enron hit it was quite a shock, really, and then when WorldCom hit it was like, oh, we can't trust anything.

PEGGY PETERSON: The economic environment was extremely difficult. America was recovering from the bursting of the tech bubble in the late '90s, and that was still going on in 2001. Then 9/11 happened, of course, and then less than three months after that was the Enron bankruptcy. It was a very frightening time, a lot of volatility in the market, and a lot of people were scared.

BOB HERZ: I remember just getting a load of calls at my house from reporters saying, "You're the incoming FASB Chair, what are you going to do to restore confidence in the American reporting system?"

PEGGY PETERSON: The Financial Services Committee was new, it had been formed around the old banking committee, and Mr. Oxley was a relatively new chairman. It was an enormous weight, and what the bill had to accomplish was that we had to restore faith in the US capital markets, both for domestic investors and international investors. That was the large purpose.

CINDY FORNELLI: We need to have investors be confident in our markets because that's where the majority of US citizens put their money ... Is either in the stock market or in their 401(k)s, in mutual funds. And if investors don't have confidence in the process or the system, they won't put their money in those key areas that are so important to our economy, to a thriving economy, and frankly that makes the United States economy the strongest in the world.

DAN GOELZER: I think there was really a tremendous amount of cynicism among investors and maybe even among preparers, and companies, about financial reporting. And I think SOX largely cured that. I don't think people have that attitude today.

KEN BERTSCH: We're an association of asset owners, and we've got asset manager associate members. So going from what I hear from them, people have more confidence in financial statements. And in particular, we work with some overseas asset managers, a couple of whom have made the point recently to me that, with regard to changes in 404 requirements, they see those requirements as part of the fabric and the market texture in the United States. They expect that as part of the reliability of financial statements, and they have a high degree of confidence.

MARK OLSON: What SOX did was really put the provisions in place to restore the confidence in financial reporting.

JEANETTE FRANZEL: I think we've seen a very good impact, a very positive impact from the Sarbanes-Oxley Act. We've seen investor confidence restored and we've really seen integrity returned to our capital markets. I think the real key is for us to learn from history. We do not ever want to end up in the type of financial reporting and auditing crisis that we were in in this country prior to the passage of the Sarbanes-Oxley Act.

SOX & Audit Committees

The Sarbanes-Oxley Act at 15

TRANSCRIPT

CINDY FORNELLI: As you look at the reforms that Sarbanes-Oxley put into place, of course there's a lot of focus on the financial statements, which are important. But another key provision of Sarbanes-Oxley was making sure that the audit committee was independent of management. And this was an important safeguard because it was thought that the audit committee should stand in the shoes of investors and have investors' perspectives at the top of their mind and at the forefront of their thinking.

DAN GOELZER: Sarbanes Oxley put the audit committee at the center of the relationship between a public company and the auditor. So, today, from the auditor's perspective, the client is the audit committee rather than the management that's preparing the financial reports that are being audited. I do think that's made a major difference.

PETER GLEASON: It's kind of the fortunate output of the scandals that happened back in 2000, in that era of Enron, WorldCom, we now have a greater focus on the duties of being a director, and what it takes to be on an audit committee, and have high valued and clearly stated financial reporting. It's just part of the evolution, and I think SOX was one of the triggers that helped us get there, but it's not the sole reason that we're here.

KEN BERTSCH: A lot of the importance of SOX ended up being in cultural changes that are not necessarily mechanical. You can say this happened exactly because of this, but there was I think a sea change in how audit committees related to the auditor and how investors viewed that whole relationship over time.

DAN GOELZER: It's a very serious and challenging job, not just a certain ornament on your resume the way that I think it was at a certain time in the past.

JEANETTE FRANZEL: I think they are feeling the pressure and have felt the pressure for sure, because a lot of these were very significant changes as we discussed, and they were overseeing all of it. There is some tension in the system, but I think healthy tension is necessary and audit committees do feel the brunt of that tension, if there's tension between the auditors and management, but that's what the audit committee is there to deal with. And to really find the right balance.

LEW FERGUSON: I think it's made corporations in picking audit committee members more sensitive to bringing people in who really do have a financial expertise and know about complicated financial reporting and auditing matters. I think that has been very useful. I've noticed an improvement in the quality of audit committees in the five years that I've been at the PCAOB.

BOB HERZ: When I was in the profession as an audit partner, as the head of the national office of PricewaterhouseCoopers, I got the opportunity to attend a number of audit committee meetings. They varied in quality by company, but clearly now they're much more robust, [there is] much more discussion. Everybody along the supply chain now takes financial reporting very seriously, as it should be, because good financial reporting is really key to the health and vitality of the capital markets into our economy.

SOX & Audit Quality

The Sarbanes-Oxley Act at 15

TRANSCRIPT

PEGGY PETERSON: Politically, there was a great cry for this legislation. Not only was it supported on a bipartisan basis, but it was supported and called for by business leaders and also the investor class.

MARK OLSON: We went from self-regulating to an outside regulator. …now you have the external supervision of the accounting profession, and not only that, but what's remarkable is that has happened basically globally. All the mature economies of the world, and several of the emerging economies, have done the same thing. So it's changed not in the US but it's changed globally.

RANDY ELDER: I definitely think audit quality has improved. That's actually something we spend a lot of time on in my graduate course, trying to understand. Has it improved and is it going to stay at a higher level? I think it probably will. I think there's evidence from the markets that audit quality has improved.

JEANETTE FRANZEL: It really was a systemic approach to various problems and various root causes of the problems. [There are] accountability and responsibility reforms, both in financial reporting and auditing, as well as internal controls, and then, the audit committees' oversight of the whole process.

MARK OLSON: I will say to both Sarbanes and Oxley, both of whom I respect greatly, I think they did some very wise things.

DAN GOELZER: Really the key to that has been the PCAOB inspection program. The firms again after maybe a bit of a rocky start, I think the firms take extremely seriously what the PCAOB tells them in inspection reports, and I know that they devote major resources to addressing the quality control criticisms that the PCAOB identifies.

JEANETTE FRANZEL: I think the inspection function is obviously the most critical function. It's our largest function. Our early inspections really revealed some systemic, significant weaknesses and issues in auditing, and over the years the firms have put in place significant remediation efforts to try to address some of the root causes. They've put a lot of resources into updating methodologies, employing new tools, and looking at staff supervision and the people issues as well. And so, that has been critically important.

CINDY FORNELLI: Whether you're talking to regulators at the PCAOB or the SEC, whether you're talking to investors, whether you're talking to audit committee members, whether you're talking to auditors themselves – to a person—everyone feels as though audit quality has increased in the last 15 years.

LEW FERGUSON: We've seen very substantial improvements in audit quality, particularly of the largest firms that comprise the greatest portion of the market capitalization of the American capital markets. There's been that improvement. The other thing we've seen objectively are, for example, the number of restatements have gone down substantially. There are many fewer restatements than there were. We've also seen within the firms themselves a much greater focus on a process, improvement for example. Understanding where there are deficiencies, the root causes of those deficiencies. Looking more deeply at how you train people to be auditors, to be thoughtful, to be sensitive to risks, to be understanding of the importance of project management in audit. I think we've seen, really in this regard, a quite dramatic improvement.

SOX & Financial Reporting

The Sarbanes-Oxley Act at 15

TRANSCRIPT

PEGGY PETERSON: It was a targeted response. I think we tried to identify the exact problems that were happening within corporations, and address those problems.

BOB HERZ: Financial statements, financial information is a product or series of products and it's derived from a supply chain. You've got the standards by which the information needs to be prepared and disclosures need to be prepared. You've got the companies with their systems, their controls, their efforts to prepare the information. You then have the auditors looking at it, doing their audits, and you've got audit committees overseeing the whole process. If you think about Sarbanes-Oxley, I think [it] pretty forcefully touched each of those aspects of the supply chain.

BRIAN O'SHEA: I think when you look at internal controls, and the number of restatements that has dropped dramatically since Sarbanes-Oxley was passed. I think that by that measure alone you can see that the quality of reports has improved. I also think, just in discussions that we have with public companies, they have come to appreciate the importance of internal controls in their own practices, particularly over the last 15 years.

LEW FERGUSON: Financial reporting is much richer today. I think, not only in this country but I think around the world both regulators and companies themselves have begun to do much more open, robust disclosure than they did in the past. I think that's all to the good, for example. I think a number of things that Sarbanes-Oxley did with increasing the kinds of things that are disclosed has been very helpful to us.

CINDY FORNELLI: I think financial reporting and public company auditing is the strongest that it's been. Certainly, since the passage of Sarbanes-Oxley. However, we also have empirical data to show that as well. Whether it's the CAQ's Main Street Investor Survey, which we conduct every year. And this year confidence in our capital markets is the highest that it's been since we began doing that survey 10 years ago. It's also the auditors. Independent public company auditors are the entity that investors think have their interests at heart the most. I think those are two really important data points.

MARK OLSON: If you look at the financial crisis of 2007 and 2008, one of the things that went unchallenged was the voracity of financial reporting. There were a lot of other issues, but it wasn't the accounting profession and it wasn't the audit profession that was found to be at risk or lacking. So, the marketplace has determined that there's a new confidence there and a restored confidence, if you will, that has happened.

DAN GOELZER: Today I think the culture is just totally different in terms of financial reporting.

KEN BERTSCH: I think that Sarbanes-Oxley did have the advantage [that] it was bipartisan legislation, genuinely bipartisan legislation. There wasn't the same sort of polarization in that way. And I think it's basically in the interest of good controls. It was pursued in the interest of good controls.

PEGGY PETERSON: Its principles have spread throughout the world. They've been adopted by other countries throughout the globe, and also by non-profits. A lot of non-profits now voluntarily comply with

Sarbanes-Oxley principles, and that's been very gratifying to those of us who worked on the bill. Again, the bipartisan nature of it, I think that it advanced and improved corporate governance and the operations of boards of directors and, in general, the gatekeeping that surrounds the functions of public companies. I think those improvements have been recognized and replicated.

SOX & Classroom Teaching

The Sarbanes-Oxley Act at 15

TRANSCRIPT

AUDREY GRAMLING: SOX has had a profound effect on what I do in the classroom. Although the PCAOB doesn't describe their website as containing teaching materials, I use a lot of their materials for classroom discussion.

ZOE-VONNA PALMROSE: SOX has provided wonderful opportunities for enriching the classroom experience. It's an opportunity to really cover the regulatory structure that will be affecting our students when they go out into the profession.

RANDY ELDER: I think it's important for graduate students to have an understanding of audit markets, and how regulations affect the practice of auditing, making certain that students understand the regulations, the profession, both at the national and the state level.

RICK HATFIELD: We've got the auditors, we've got the client. Now we need to consider the PCAOB inspection process and how that's going to influence these other players and their decisions and their judgments.

ZOE-VONNA PALMROSE: I have a PCAOB simulated roundtable. Our students form teams and the teams represent an investor perspective, an audit firm perspective, an audit committee perspective, and preparer perspective. We had a very engaging discussion and the students really embraced the project.

AUDREY GRAMLING: SOX has really encouraged, or probably required me, to do a lot more with internal controls. We tee up the idea of controls as being really important for generating quality information.

JEAN BEDARD: I assign a group project where I give the groups a company that has had a material weakness, and they have to research the company's business, the nature of this problem . . .Was there a flaw in revenue controls? We might look at that revenue number and say, "We're not quite so sure about that," or "uncertain about that."

RANDY ELDER: What I found is, talking to people from the large accounting firms, they'll teach the students how to do the audit, but they may not necessarily give them the broader perspective of the how and why things are done. We focus more on the why.

SOX & the Future

The Sarbanes-Oxley Act at 15

TRANSCRIPT

CINDY FORNELLI: As you look at Sarbanes-Oxley at its 15 year anniversary mark . . .It's a relatively new act that went into effect in 2002, but what I think we are going to continue to see is that the principles behind Sarbanes-Oxley and the work that the audit firms and the audit committees do will continue in effect for years and years to come. So we will be reaping the benefits of Sarbanes-Oxley many years from now because auditing and financial reporting is never done.

BRIAN O-SHEA: I think it's also important to understand that no law, and certainly no regulator or agency, is ever perfect. The 15-year anniversary provides us an opportunity to look back and see how exactly Sarbanes-Oxley is working in practice.

PETER GLEASON: I look to our members, and I watch what they're doing, and they're not worried about the threshold standards that some of these things have been put in place over the years, they're looking at, "How can we be the best company out there, and how can we be the most strategic asset we can possibly be to the companies that we serve?"

DAN GOELZER: I think the statute has been a success. I think there's more work to be done, more challenges, but it really put financial reporting and trust in financial reporting on a much better footing than we had at the beginning of 2002 before the Act was passed.

BRIAN O'SHEA: The SEC has been looking at the overall disclosure regime, both in terms of legal, but also financial reporting in ways that kind of modernize that regime and putting it into the 21st century. I think it's a good opportunity for us to look and see what can be improved upon with Sarbanes-Oxley and some of the resulting impact that it's had, but also within the context of the SEC's overall review of disclosures, I think this is an opportunity to see what's working and what's not working.

JEANETTE FRANZEL: It's very important to communicate across the system so that we don't have fragmentation because I do think that there is danger in that, when each party is defending their own rights and the system becomes fragmented. So, I think that we need to be vigilant across the system. I'm very encouraged by the amount of academic research that is now happening in the auditing space. Both behavioral as well as archival, so I think that will help inform us going forward. We'll need to be vigilant and be open to changes that might be needed going forward.

CINDY FORNELLI: You can never stop improving. You don't reach a certain level and then you can declare victory, but rather it's a process. It's something that the firms, the individual auditors, the audit committees, I would say our regulators, our academics, investors, all of us that are involved in financial reporting are constantly striving to improve audit quality and financial reporting in the future. And that will never stop.