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What are the main governance aspects of the Sarbanes-Oxley Act?

The Sarbanes-Oxley Act was enacted in July 2002 after a prolonged period of corporate scandals in the United States from 2000 to 2002. It was enacted to restore investors’ confidence in the financial markets and close loopholes that allowed public companies to defraud investors. Not only is it a basic change of law but it is also a departure in the regulation mode where it introduces a vast array of corporate governance initiatives into federal securities law. The act has a profound effect on corporate governance in the U.S. It requires public companies to strengthen audit committees, perform internal control tests and strengthen disclosure etc.

One of the main governance aspect of the Sarbanes-Oxley Act is that it changes managements responsibility for financial reporting significantly. The act requires that the top managers personally certify the accuracy of the financial reports. The Act also places requirement on board to increase transparency in corporate governance practices, this incudes implementing procedures for ensuring accurate accounting. If a top manager knowingly or wilfully makes a false, certification he can face 10-20 years in prison. If the company is forced to make a required accounting restatement due to managements misconduct top managers can be required to give up their bonuses or profits made from selling the company’s stock.

It also strengthens the public companies audit committee. The audit committee receives wide leverage in overseeing the top managements accounting decisions. The audit committee members must be independent of management and gain new responsibilities such as approving numerous audit and non-audit services, selecting and overseeing external auditors and handling complaints regarding the managements accounting practices.

The Act requires that a firm in charge of auditing the corporation refrain from serving as independent consultants to that same firm. This includes refraining from bookkeeping, system designs and implementation, appraisals and valuations, actuarial services and investment banking services for the audited company. Furthermore, the corporation must change auditing firms at least every 5 years.

The Sarbanes-Oxley Act significantly strengthens the disclosure requirement. Public companies are required to disclose any material off balance sheet arrangement such as operating leases and special purposes entities. The company is also required to disclose any pro forma statements and how they would look under the Generally Accepted Accounting Principles(GAAP). Insiders must report their stock transactions to the Securities and Exchange Commission(SEC) within two business days.

The Act requires public companies to perform extensive internal control tests and include an internal control report with their annual audits. Testing and documenting manual and automated control in financial reporting requires enormous effort and involvement of not only external accountants but also experienced IT personnel. The compliance cost is especially burdensome for companies that heavily rely on manual costs. The Act has encouraged companies to make their financial reporting more efficient, centralized and automated

Much of the regulatory process prescribed by the Sarbanes-Oxley Act is carried out by Securities and Exchange Commission(SEC). The Act includes provisions that strengthens the ability of the SEC to oversee corporate governance matters and enforce violations. Sarbanes-Oxley Act established a criminal charge for conspiring to commit security fraud. SOX provides additional protections against discriminations for those reporting conduct that violates the securities laws (whistle-blower protection).

The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board, which promulgates standards for public accountants, limits their conflict of interest and requires lead audit partner rotation every five years for the same public company.