SOX: The Landmark Legislation That Strengthened Financial Reporting and Audit Quality

Financial reporting and audit quality are strong due in part to the current regulatory structure established by the landmark Sarbanes-Oxley Act of 2002 (SOX), which protects investors in the capital markets, while allowing competition and innovation in the US audit market.

1

Early 2000s

The world faced the dotcom bubble burst; high-profile corporate bankruptcies; and fraud and accounting scandals at Enron and WorldCom. These events shook financial markets and investor confidence in them, dropping the NASDAQ Composite Index 78 percent in a few months.

2

2002

The policy response to these financial reporting scandals was intense, which drove the reform of corporate governance standards and the passage of SOX. SOX was designed to restore investor confidence in the capital markets by enhancing accountability and controls. Greater transparency in financial reporting and increased accountability were the underlying principles of the law, which include the following:

Establishment of a new independent regulator—the Public Company Accounting Oversight Board—with authority over audit firms to

+ set standards for audits of public companies;
+ enhance auditor ethics and independence (in tandem with the SEC);
+ set standards for an audit firm's system of quality control;
+ inspect firms' system of quality controls and audit engagements; and + enforce laws, regulations, and standards.

Stronger audit committees and corporate governance by requiring

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

Greater transparency, executive accountability, and investor protection by requiring

+ audit firms to report certain information about their operations, including names of public company audit clients, fees, and quality control procedures;
+ public company CEOs and CFOs to certify financial reports; and
+ 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)).

Enhanced auditor independence with new rules that prohibit audit firms from providing

+ specified non-audit services to audited companies; and
+ any other non-audit service to audit clients that may impair the firm's independence in fact or appearance.

3

Today

Building on the foundation laid by SOX, the financial reporting ecosystem is strong and effective. There is strong independent oversight of the auditing profession by regulators and audit committees. The auditing profession is focused on continuous improvement to audit quality that benefits investors in the US capital markets. The audit profession has quickly adapted to meet the needs of this moment, contributing to the sustained, orderly operation of our capital markets—an essential component of our national response to, and recovery from, catastrophic events such as the 2007 financial crisis and COVID-19.