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Legal

NEW FRAMEWORK FOR SOX COMPLIANCE

The Sarbanes-Oxley Act (SOX), enacted in 2002 in response to notorious corporate accounting and accountability scandals of the immediately preceding years, has as its centerpiece Section 404 that mandates strict internal governance controls. Public companies must adopt an internal control framework and report on its effectiveness as part of their annual Exchange Act report. Last year, the private sector initiative that sets the standards for Section 404 compliance revised its "Internal Control—Integrated Framework" protocols for 2014. Knowing how to transition to the new framework is crucial for SOX compliance managers.

What Section 404 Requires

Under Section 404 of SOX, management is required to produce an internal control report that affirms "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting," and it must "contain an assessment, as of the end of the most recent fiscal year of the Company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting" (15 U.S.C. §7262 and 7262(a)).

The COSO Internal Control Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five not-for-profit professional organizations that was established in order to assist corporations in improving their corporate governance internal control, business ethics and enterprise risk management.

Since the requirements of Section 404 involve the most costly aspect of SOX compliance — as they entail extensive documenting and testing regimes — the COSO framework serves to standardize compliance in this area and at the same time help economize the process; therefore, it has been adopted by the majority of U.S. publicly traded companies. It should be noted that the original COSO Framework for Internal Control actually predated SOX by 10 years.

Why the Framework Was Updated

Since the last COSO Framework iteration, business structures and modes of operation have changed dramatically. Liability arising from shared services, as well as a significant rise in global market participation by U.S. companies, has added new complexity to the internal control schema and, correspondingly, the documentation and reporting undertakings related thereto. Added to these changes are the plethora of U.S. and foreign rules and regulations particularly affecting global financial transactions.

Principles of the New Framework

The updated COSO Framework delineates 17 principles that build on the concepts of the original framework. Within the new codification are fundamentals related to: demonstrating a commitment to integrity and ethical values, demonstration of board independence from management, establishment of reporting lines, individual accountability for internal control, identification of risks to the achievement of objectives and other tenets relating to information, communication and monitoring. Corporate governance professionals are encouraged to review the new framework principles in great detail.

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