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IMPLEMENTING THE REGULATIONS AND INFORMATION TECHNOLOGY CONSIDERATIONS OF THE SARBANES - OXLEY ACT IN UKRAINE

The purpose of this paper is to raise the important implementation issues and information technology considerations that have been associated with the implementation of the Sarbanes - Oxley Act of 2002 in the USA. Among other provisions, the Act requires auditors to attest to the effectiveness of their client's system of internal control over financial reporting on every audit. Since the Act has helped to strengthen the reliability of companies' financial statements in the USA, that the Ukrainian business environment may benefit from implementing the Act's regulations. Thus, in this paper, we aim to assist companies from Ukraine and other parts of the world that seek to implement the Act.

Background

The Sarbanes — Oxley Act (SOX), passed by the USA Congress in 2002, has had a dramatic impact on the American business landscape. In addition, since its regulations also apply to foreign companies which enter the American capital markets, the Act has also had a worldwide impact. The Act regulates specific types of business activity for all issuers that have registered its bonds or equity securities with a regulatory body in the USA, such as the Securities and Exchange Commission (SEC). Given the Act's requirements, what are the imple-

mentation issues and information technology considerations that must be considered by Ukrainian companies seeking to enter the American capital markets?

In order to defend the public from unreliable financial information, the Act requires a company's management team to assess the effectiveness of their own system of internal control over financial reporting and then mandates that the company's auditor issue an opinion attesting to the effectiveness of the internal control system. Since one of the primary purposes of the Act's regulations is to

strengthen the transparency and reliability of companies' information and to increase the effectiveness of the auditing profession, we believe that the Ukrainian business environment would benefit from implementing the Act's regulations.

The purpose of the research

The purpose of this paper is to raise the important implementation issues and information technology considerations that have been associated with the Act's implementation in the USA. In so doing, we aim to assist companies from the Ukraine and other parts of the world that seek to implement the provisions of the Act.

Analysis of the contemporary sources and publications

An analysis of the literature (i.e., journal articles, book and chapters) reveals an absence of relevant publications in Ukraine which would help to elucidate the issues related to applying the regulations of the Sarbanes — Oxley Act. Further, to date, Ukrainian scientists have only given passing mention to the provisions and related implications of the Act. For instance, the Head of the Ukrainian Federation of Accountants and Auditors Sergiy Golov [1] states that the Act essentially requires the CEO and CFO of publicly traded companies in the USA to take personal responsibility for the reliability and authenticity of the financial statements. In addition, there is some information in Russian that is available from the public reports of the «Big Four» Auditing firms (e. g., a short overview of the Act by Ernst&Young)¹. However, in the USA, both auditors and scientists alike have comprehensively considered the implementation issues and information technology considerations of the Act from both a practical and theoretical viewpoint. For example, science papers, surveys and white papers are numerous, which show cost, behavioral and implementation issues that have arisen as a result of the Act's implementation.

Explanation of the basic material

The majority of Ukrainian companies, except those with bonds and equity securities already registered by the SEC, are not subject to the Act's requirements. However, we believe that it is very important for Ukrainian companies to consider tak-

ing measures that will demonstrate good corporate governance, including the issuance of reliable financial reports. Stated simply, the system of financial reporting and information disclosure in Ukraine must be improved.

There are three primary reasons. First, companies that plan to enter the American capital markets have no choice; they must meet the requirements of the Act. In addition, the present enforcement of the Act's requirements in the USA is indicative of an emerging trend throughout the world. It is likely that in the near future similar rules and enforcement will occur in the legislative acts of the EU², the financial markets of which are clearly an important source of capital for Ukrainian companies. At present, only five Ukrainian companies have executed an initial public offering (IPO) on an American Stock Exchange³. But, Ukrainian president Victor Yushchenko recently declared his strong intention to help at least 10 more Ukrainian companies list on the New York Stock Exchange (NYSE) at a meeting with the director of the NYSE on January 25, 2008 in Davos (Switzerland) during the World Economic Forum⁴.

Second, there is an emerging body of scientific evidence which demonstrates that effective internal controls reduce the cost of bond and equity securities for a corporation [2]. It may be that effective internal controls are viewed by investors as an example of leading practice exhibited by the corporate management team; which increases demand for the corporation's securities and reduces the cost of bonds and equity. It could also be the auditor's independent attestation of internal control effectiveness reduces the riskiness of the corporation in the opinion of investors. As a result this reduction in risk, when the corporation seeks capital, investors are willing to accept a lower rate of return in exchange for their investment. In summary, the evidence suggests that an effective system of internal controls appears to provide a corporation's management team with an important advantage when investors make their final decision among investment alternatives.

Third, the Act mandated governmental regulation of the audit profession in the USA. The newly established Public Company Accounting Oversight Board (PCAOB) in the USA is now required to perform detailed inspections of the audit process

¹ [www.ey.com/global/download.nsf/Russia/Sarbanes_Oxley_Act/\\$file/EY_Sarbanes_9_12_02r.pdf](http://www.ey.com/global/download.nsf/Russia/Sarbanes_Oxley_Act/$file/EY_Sarbanes_9_12_02r.pdf)

² Consider the \$7.1 Billion recent loss sustained by the French Corporation Societe Generale, which is likely to spur type of action related to internal control.

³ Whereas Japan has 62; Russia has 27; and Germany has 19. Source: <http://www.sec.gov/rules/other/34-48063.htm>

⁴ <http://unian.net/ukr/news/news-232790.html>

employed by each audit firm. Prior to the Act, the audit profession in the USA relied solely on peer evaluation; thus, auditors were only subject to inspections by other auditors. Evidence from active USA practitioners suggests that the added regulatory oversight on the audit process performed by the PCAOB has had an immediate and positive impact on auditing quality.

International issues

Some have asserted that the demands of the Sarbanes — Oxley Act has helped to discourage corporations from seeking capital from USA markets (e.g., NYSE) and instead has led them to other world financial markets, like London; where it is generally believed that the extent of regulation is far less burdensome to corporations. However, it is interesting to note that recent research on companies that actually delisted from the capital markets in the USA do not support this proposition [3]. In fact, the results reveal that the number of delistings actually declined after the Act! So, the cost/benefit proposition is not entirely clear.

There is some evidence that suggests a clear benefit for companies from a home country with less corporate governance regulations, like Ukraine. According to Litvak [6], the Sarbanes — Oxley Act's effect on international companies that are currently listed in the US is dependent, in part, by the level of regulation of the company's home country. Companies from poorly regulated countries tended to benefit from higher credit ratings if they complied with the stringent regulations of a country like the USA.

Auditing Standards

According to International Standards on Auditing (ISA) [5], which must be used by Auditors in Ukraine since 2004 and in the EU since 2005, auditors must gain an understanding of the internal control systems, including an understanding of the business processes that are executed at a company, such as translation, registration, processing, and recording (ISAs 315, 610). Auditors need this type of detailed information to reach a conclusion of whether to rely on the internal control system as an important step towards reaching the final audit report. If after gaining an understanding, an auditor decides that the internal control system is weak, it is possible to avoid detailed testing of the internal control system. In this situation, an auditor

would have to conduct more substantive testing. A second reason may be when an auditor decides that it is more efficient to complete the audit of financial statement with substantive testing only, even if the internal control system might be strong.

Although ISAs are not required to be followed by USA auditors, the PCAOB standards⁵, which are designed to comply with the Act, demand more than the ISAs. They require the presence of two audit opinions in each annual report of a publicly traded company — 1) a report on the financial statements themselves; and 2) a report on the effectiveness of a company's internal control system over financial reporting. At present, the USA is the only country where it is obligatory for an auditor to issue a report on the internal control effectiveness⁶. So, when auditing a publicly traded company in the USA, an auditor must evaluate the effectiveness of the internal control system on each audit. As a result, internal control systems have never before faced so much scrutiny by so many professionals!

The ISAs do not require that auditors issue a report on the effectiveness of their client's internal control system over financial reporting. However, we believe that other countries should consider the possibility of requiring the audit of internal control systems. Indeed, the mechanisms can be spread around the world. For example, a country which adopts ISAs as the national standards or harmonizes national standards with ISAs has a choice to either establish its own law (like the Act) or recommend appropriate additions to the country's own auditing standards to add internal control auditing (ISAs allow any country or professional auditing society use the stronger regulations than ISAs do themselves)⁷.

IT issues. Since the business processes of most companies are dependent upon a high functioning, safe and secure information technology infrastructure (IT), an understanding of the software and technical components of the company's information systems is very important. And, any system of internal controls that relies on automated application controls or automated accounting calculations must be designed and system operating effectively in accordance with the Sarbanes — Oxley Act of 2002. At present, there is little, if any work published in the scientific and practical publications of Ukraine about the role of IT in the compliance

⁵ <http://www.pcaobus.org/Standards/index.aspx>, PCAOB standards №№5, 2.

⁶ Moreover, before 2007 an auditor by the PCAOB standard №2 had to express the 'third' opinion — on the management self-evaluation of the internal control system.

⁷ Importantly, the 8th Directive of the EU forbids any member country to modify the ISAs with one exception, if the country has its own sovereign law on the topic.

with the Act's requirements. In fact, about the only documentation available is the information that is used by software developers to advertise their software products to companies seeking to comply with the Act⁸. It is possible that such an investment in IT could reduce the time needed (and cost) to adopt the Act's regulations. Indeed, evidence from a recent the study [4] suggest that companies can improve overall financial reporting and significantly reduce the number of accounting errors by investing in IT. Of course, a significant hurdle for Ukraine is the lack of technological expertise of Ukrainian auditors, as a whole.

Conclusions and perspectives of the further researches

Conclusions. As a result of several significant frauds (e. g., Enron, WorldCom), the USA adopted the Sarbanes — Oxley Act of 2002, which led to a number of stringent regulatory requirements. Do the potential benefits of this set of regulatory requirements outweigh the costs? The answer to this question depends on one's perspective and time horizon. The two primary objectives of the Congress in the USA are to protect investors and maintain the integrity of the securities markets. In this light, it is our belief that the Act has imposed necessary regulatory mechanisms in the USA that have enhanced audit quality and improved the accuracy and reliability of financial statements. To date, there are no other countries in the world (including Ukraine) that have adopted internal control audit requirement, similar to the Act. Given that companies in the USA are now in their 4th year of implementation, much has been learned by practitioners and regulators in the USA. So it would be useful to learn from this experience in Ukraine.

Indeed, one of our research consequences is to help in the formation of detailed suggestions to be addressed to the Auditing Chamber of Ukraine, Ministry of Finance of Ukraine and Profile Committee of Verhovna Rada (Parliament). It is our hope that the generalization of experience from the USA would be helpful. In fact, we believe that the regulations of the Sarbanes — Oxley Act would be very important for Ukraine in several ways:

- introduction of a new approach toward state and public regulation of business;
- introduction of a new approaches toward developing effective corporate internal control systems over financial reporting;
- improvement of the corporate information technology infrastructures.

We also believe that successful establishment of the regulations of the Sarbanes — Oxley Act would have essential practical value for Ukrainian businesses.

Perspectives of the future research. There are a number of areas that are in need of research. We explore several below:

- the issues associated with the possibility of implementing the normative requirements of the Sarbanes — Oxley Act into the international and Ukrainian business community;
- to work out the best practice of developing and implementing software applications that are designed to work in a well controlled technological environment, which will reduce compliance costs and result in more automation and efficiency of business process execution for corporations;
- Can application of more recent technological financial reporting innovations, such as a XBRL (eXtended Business Reporting Language) help all companies better meet the goals of the Act?

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⁸ Consider the following examples about the local branch of SAP AG (www.sap.com) and the Russian company Terra-Link (www.terralink.ru).

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ВПРОВАДЖЕННЯ ЗАГАЛЬНИХ НОРМАТИВІВ І ПОЛОЖЕНЬ ЩОДО ІТ ЗАКОНУ САРБЕЙНСА - ОКСЛІ В УКРАЇНІ

Мета цієї статті - підняти важливі питання впровадження як загальних нормативів, так і аспектів, пов'язаних з інформаційними технологіями закону Сарбейнса - Окслі (США, 2002 р.). Серед інших вимог закон вимагає від аудиторів перевіряти ефективність систем внутрішнього контролю за складанням фінансової звітності своїх клієнтів під час кожного аудиту. Оскільки закон допоміг поліпшити надійність фінансової звітності у США, бізнес-середовище в Україні також може виграти від запровадження окремих його положень. У цій статті ми ставимо за мету допомогти українським та міжнародним компаніям, які розглядають можливість впровадження таких положень.