A UK SARBANES-OXLEY ACT? IT'S COMING…

A British version of SOx regulation now looks more likely that ever in the wake of the UK Government's whitepaper on restoring trust in audit and corporate governance.

By Oli Templeton, Director, SH Consulting at Sheffield Haworth

Rod Ellis has worked in finance and compliance for over 30 years. Having started his working life as an auditor at KPMG in the UK and Hong Kong, he then spent the lion's share of his career working for Invesco in Asia, the US, and Europe, where in the last decade he focused on transformation projects in finance and compliance.

I recently had a conversation with Rod to explore the regulatory landscape for UK asset management firms, and why they should start preparing now for a UK version of the US Sarbanes-Oxley Act. What costs are involved? What are the benefits? What are the pitfalls?
Here's Rod's take on what UK asset management firms can learn from the US experience.

Q: What do you see as the biggest regulatory challenges for UK-based asset management CFOs at the moment and why?

A: There are several regulatory priorities right now, from IFPR and value assessment to the ESG agenda – particularly the need to restore trust in corporate governance.

The Investment Firm Prudential Regime (IFPR) goes live next year, so all finance groups will have to be focused on that. This is the FCA looking to adapt the internal capital adequacy assessment process (ICAAP) to asset managers with its new 'K-factors' approach to calculating capital requirements and the new Internal Capital Adequacy and Risk Assessment (ICARA) process.

Finance groups should also be looking at the value assessments for their funds. In early July, the FCA published a paper on their observations on the first year of firms carrying out these assessments. This is consistent with the FCA's focus on product quality and governance. Where finance needs to get involved is in the areas around the concept of value, economies of scale, and looking at the profitability of the funds themselves.

The whole Environmental, Social and Governance (ESG) agenda is huge. Finance will need to keep abreast of these issues, an example being the recent FCA consultation paper on Climate Related Disclosures for legal entities and products.

Regarding Governance, in March 2021 the UK Government's Department for Business, Energy and Industrial Strategy published a white paper on 'Restoring trust in audit and corporate governance'. This could be a big deal. Certainly, it has led to many in the industry anticipating that the UK is likely to bring in what's being called 'UK SOx' – a British variation on the US Sarbanes-Oxley Act which was introduced over there in 2002.

Q: Why would the UK want a version of SOx? What would this mean for UK asset management firms?

A: I think the white paper is a response to a number of high-profile corporate failures in UK plc where there have been questions asked about management and boards' responsibilities and accountabilities and the role of the audit profession, particularly on the quality of audits. Many in the US – despite traditionally not liking regulation – have cited Sarbanes-Oxley as broadly positive.

Since SOx came in, there's a big difference between what you have in the US and in the UK, and it gives US boards a level of assurance they didn't have before. If and when this comes to the UK, I think boards should be and will be supportive when they realise that the level of assurance they're going to get is more robust than what they have today.

For US publicly-traded firms, every year the finance group has to ensure they have documented and tested procedures and key controls on all its material balance sheet items and all those material P&L items on revenue and expenses. This enables the CEO and CFO to sign off that the company has effective internal controls in place over financial reporting and disclosure controls in place. Independent testing of those controls is also performed to verify they're working effectively and have been designed appropriately.

This independent testing is normally performed by the internal audit group who would have a SOx testing programme providing additional assurance that what the finance department has put in place makes sense and is working effectively. The external auditors will perform further SOx work and will give an opinion on whether the internal controls over financial reporting are operating effectively.

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In the UK, what assurances do you have around the quality of financial statements? Your finance group will have controls and the procedures in place. Boards may get an internal audit report on some aspects of the finance procedures and key controls.

External auditors perform an annual audit on the numbers and you as a director are asked to sign off. Introducing a UK-style SOx would be a significant upgrade to the level of assurance boards would receive on their financial statements, and would be particularly pertinent for asset management firms regulated by the FCA under the SMCR regime.

Questions have been raised around the quality of external audit. This is where adopting something similar to SOx in the UK could be hugely beneficial, both for restoring public trust and for firms themselves. Obviously any UK rules would have a UK flavour, but I do think UK SOx is coming. Most influential bodies are seeing it as a positive step forward in governance.

Q: What can UK firms learn from the US experience of dealing with SOx?

A: The US have been doing this for a number of years now. Any international audit firm is going to be able to tap into that US experience. If you're a UK subsidiary of a US firm, you're probably already doing this. So again, the change is probably going to affect companies headquartered in the UK.

> ***"There is a tried and tested US framework, so firms won't have to reinvent the wheel."***

Scoping and planning this is going to be important for designing a framework around what SOx means in the UK. However, there is a tried and tested US framework, so firms won't have to reinvent the wheel here. They can adapt accordingly. Depending on what the legislation says, we'll likely see some good frameworks develop fairly quickly.

Q: What next steps do you recommend UK asset management boards take to prepare for this?

A: If you're a US-owned company this is not new, so you can wait and see what happens. For those firms for whom this would be new, all the big audit firms are already talking about this, so I think you'd need to discuss with your external auditors what might happen and when. I would certainly recommend that you start thinking about this and understanding the white paper and getting prepared, because I think it is inevitable that this will happen.

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Within the company you probably want to think about how this will impact other departments such as HR and IT. Create awareness within the company that there's going to be an increased emphasis on the robustness of the key controls that impact the financial statements of the firm.

Q: From your experience of dealing with SOx at Invesco in the US, what are the likely costs that firms should expect? What are the potential benefits?

A: There are going to be some significant costs involved, but also some significant potential benefits. Looking at the costs, the finance group will have to spend time on documenting, assessing, and testing key controls. Firms will have to define what they see as material, scope out what they're going to do to check that, and then document the various procedures and key controls in those areas.

All of that will take time and resources. Also don't forget this impacts the whole group so you will have to consider international operations as well. Those that are deemed material from a financial statement line item basis will need to go through the SOx process.

It's likely that more resources will be dedicated to the SOx programme in the internal audit department on SOx work. Also, if external audit firms have to opine on the effectiveness of the internal controls over financial reporting, expect more external audit time in this area which is likely to lead to increased fees.

> ***"A more robust control environment across the business will be one of the likely benefits of doing this."***

Looking at benefits, you'll get a more robust internal control environment beyond finance. That's because you'll need to work with your IT department for example to look at your various IT systems that feed data into the finance systems and assess and test the internal controls they have in place. This does mean you'll need to develop auditable procedures and controls up to the standard that external audit will have to test and sign off on as part of their SOx opinion.

Once you have the internal controls over financial reporting in place. it's very likely that you will want to standardise these across the group to take advantage of system functionality and making it easier to test, audit and control changes. If you have this in place then you can begin to take advantage of concepts around shared service centres and centres of excellence, performing certain finance tasks in one place for the whole group, creating efficiencies and becoming more effective in the execution of these finance tasks.

One aspect to bear in mind is the impact on the annual reporting cycle if companies and auditors will be asked to opine in their annual financial statements on the effectiveness of internal controls over financial reporting. Ideally, you want to finish your prior year audit in Q1, scope out and start your SOx work in Q2, and then finish it in Q3.

You want the work completed and to have remediated any issues identified before the final quarter of your financial year. That way, you have a clean Q4 and year end, so when the external auditors come, you know everything is in order and any changes to controls that have occurred during the year have been operating effectively for some time.

You don't want to make any changes to your key controls just before year end as these will need to be re-tested. If you get any issues, this will cause additional work to get boards, auditors, and other stakeholders comfortable that all the controls are still working effectively. Where this may bite is in IT systems that fall under the scope of SOx. Firms may want to have a moratorium on any IT changes in the last quarter of their financial year because that would avoid a risk of a key control test failure.

Q: What other potential pitfalls would firms need to avoid?

A: If you under-resource this, you may get into trouble. Certainly, in year one you want to make sure you've got appropriate resource in place. You shouldn't have a problem getting most of the resources you need to implement SOx properly in year one as most boards and management should be supportive.

You're going to have to get your best people to work on this, including your financial controller and the heads of the relevant departments – AP, Revenue, all those areas. Having someone like a project manager or coordinator who has some independence and can make sure your efforts sync up properly will be important too.

Within the finance function a SOx coordinator dedicated to this is not uncommon in the US. I think that's the right way to go. They can be more independent and challenge the key controls in place which is what you need. They can also give advice to the various departments having to look at their SOx requirements.

> ***"Most of the requirements should theoretically already be in place in the UK. Your historical internal audits may well have some valuable observations that would be useful, for example."***

It's best not to go too far in preparing for this until we see the detailed requirements, so for right now I'd recommend raising awareness, documenting your existing processes and controls, and expecting that you'll need to put some resource into this once it becomes clear what those requirements will be.

In theory, most of the requirements should already be in place today, but I would expect that when people go and kick the tyres, they're likely to find some areas that could be made more robust. Your historical internal audits may well have some valuable observations that will be useful to look at as well.

Q: What skills, talent or training are UK asset management firms likely to need to help tackle SOx?

A: Within most finance functions there will be people with an audit background. That's obviously a good skillset here because you've got to think about documenting the processes and procedures, walking through those, checking the key controls are designed appropriately and work and so on.

The types of controls you have in place such as preventative controls and detective controls are important to think about too, so those skills will have to be developed if they're not inhouse already. Again, having a SOx coordinator who can be more dedicated to this area is likely to be useful.

I think accountants are pretty good at controls, procedures and processes. Firms will have most of what they need in place already. It's really just a matter of fine tuning and taking that to the next level. It is likely that firms may need to hire people with these skillsets, once we see what the requirements are likely to be.

> ***"From my experience in the US, if UK firms focus on the benefits, that will help them execute on it much more effectively."***

In year one you would need to consider bringing in more resources to ensure you're able to complete the work. This is mainly going to affect what you'd call the controller group or financial statements group along with finance operations. When they do start to work on SOx, they'd have to fit it into their existing monthly operating rhythm without disrupting business as usual.

When I went to the US, Sarbanes-Oxley had already come in so it's hard to say how things changed when it was first introduced. But what I know is we had all our groups doing SOx on a regular basis, we had a SOx coordinator, and everyone had built SOx into their monthly routines.

The main thing for firms to remember is to be positive about regulatory changes. If you treat it as a tick box exercise, you won't get the most out of it; it will be painful and laborious. If instead you can see that it's actually very helpful all round for the finance group, management, the board of directors, and for the company more broadly – if you can focus on the benefits, that will help you execute on it much more effectively.

About Rod Ellis

Rod is a globally experienced finance and compliance executive with a proven track record of change management and process improvement. He has worked for a large listed global asset management firm in executive positions across Asia, Europe, and the United States, giving him a truly global perspective on the market. Amongst his many successful past projects, he has led change management programmes in finance and compliance functions, managed successful function integrations following mergers and acquisitions, and implemented and coordinated complex regulatory change projects.

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