The Sarbanes-Oxley legislation in the United States was introduced in 2002, partly in response to the earlier failure of the American energy company, Enron. It was decided by United States legislators that compliance should be enforceable under law rather than under listing rules. At the time it was being debated, some said that the legal enforceability of Sarbanes-Oxley would be unfair to smaller companies without the infrastructure needed to generate internal control data and to report on it. One example of this was the debate over s.404 of Sarbanes-Oxley, which mandated external reporting on the adequacy of internal controls. Before a size criterion was later introduced, this applied equally to all companies but now smaller companies are partly exempted from this requirement.

In its advice on this requirement, the United States Securities and Exchange Commission (SEC) published the following comments:

The rules we adopted in June 2003 to implement s.404 of the Sarbanes-Oxley Act of 2002 ('Sarbanes-Oxley') require management to annually evaluate whether internal control over financial reporting (ICFR) is effective at providing reasonable assurance and to disclose its assessment to investors. Management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment. This evidence will also allow a third party, such as the company's external auditor, to consider the work performed by management.

Required:

(a) Distinguish between rules and principles-based approaches to the regulation of corporate governance, and explain the disadvantages of a rules-based system such as Sarbanes-Oxley in the United States. (7 marks)

(b) Define 'agency' in the context of corporate governance and discuss the benefits to shareholders of 'maintaining a system of internal control over financial reporting' in a rules-based jurisdiction. (10 marks)