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Sarbanes-Oxley and the reach of US corporate governance into EU companies

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Abstract

This paper explores the extent to which a key piece of US corporate governance law is impacting companies operating in the European Union. It assesses the extra regulations and costs that EU companies are likely to endure as a result of the rapid passage of the Sarbanes-Oxley Act in the months after the *Enron* bankruptcy back in 2002. The paper questions whether these burdens were intentional or just unforeseen consequences. And finally, it questions whether the extraterritorial impact of US legislation on EU companies is so bad after all. For answers, the paper examines key areas that are the focus of both US and EU corporate governance reform, and assesses whether the consequences are really dual regulations and a duplication of costs. Or is the result a virtuous harmonisation leading to single standards and lower costs. The study finds that there is a bit of both, although it is premature to make solid conclusions given that the Act is still in a state of evolution.

By “evolution”, it is meant that the Act is not yet fully effective, and new guidance and regulations are emerging from US authorities frequently. The paper reflects the law as it was at the end of 2004. While recognising that the Sarbanes-Oxley Act is of significant practical importance, the goal of this paper is to present an academic discussion of the issues indicated above, rather than to be a user guide to the law. The focus is on the Act’s consequences for the companies operating in the original 15 EU member states, using the Dutch and British corporate sectors as examples where appropriate.



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Table of Contents

SUMMARY.....	5
1. INTRODUCTION.....	6
1.1. MAJOR CORPORATE GOVERNANCE AND FINANCIAL REPORTING REFORMS AFFECTING EU COMPANIES.....	6
1.2. CORPORATE GOVERNANCE, ITS SCOPE AND APPLICATION IN THE EU, PRIOR TO SARBANES-OXLEY.....	7
1.3. THE ARRIVAL OF US SARBANES-OXLEY INTO THE EU.....	10
1.4. WHAT COMES NEXT.....	13
2. SARBANES-OXLEY: INITIAL INTENTION AND FINAL CONTENT OF THE ACT....	15
2.1. CORPORATE FAILURES PRIOR TO SARBANES-OXLEY.....	15
2.2. POLITICAL AND ECONOMIC CLIMATE THAT PROMOTED FAST PASSAGE OF SOX AND ITS INTENTIONS.....	16
2.3. QUICK ENACTMENT AND THE CONSEQUENTIAL NEED FOR CHANGES POST-ENACTMENT.....	17
2.4. THE CONTENTS OF SARBANES-OXLEY AND ITS LEGISLATIVE REQUIREMENTS.....	19
2.5. WHEN IS SARBANES-OXLEY EFFECTIVE.....	21
2.6. WHO NEEDS TO COMPLY WITH SARBANES-OXLEY.....	22
2.7. EXCEPTIONAL TREATMENT FOR FOREIGN COMPANIES.....	24
3. ACTUAL IMPACTS OF SARBANES-OXLEY ON EU COMPANIES AND OTHERS....	28
3.1. ACTUAL IMPACTS – “FORESEEABLE” OR “UNINTENTIONAL” OR BOTH.....	28
3.2. SECTION 404 (“MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS”).....	29
3.3. IMPACT ON COMPANY RATINGS.....	31
3.4. INCREMENTAL COSTS OF SARBANES-OXLEY IMPLEMENTATION.....	31
3.5. INCREASED DEMAND FOR THE ACCOUNTANCY/AUDIT PROFESSION.....	34
3.6. HIGHER COST AND LOWER QUALITY OF COMPANY EXTERNAL AUDITS.....	36
3.7. ESCAPING SARBANES-OXLEY REGULATION BY DELISTING OR REMAINING A PRIVATE COMPANY.....	40
3.8. THE “CASCADING” OF SARBANES-OXLEY LEADING TO HARMONISATION IN CORPORATE GOVERNANCE.....	44
3.9. PROLIFERATION OF SOX AND CORPORATE GOVERNANCE VIA MULTINATIONALS’ INTERNAL POLICIES.....	47
3.10. OTHER UNINTENDED CONSEQUENCES.....	49
4. AUDITING PROVISIONS: DOES SARBANES-OXLEY CHANGE EU PRACTICES? ...	50
4.1. DEFINITIONS AND DESCRIPTIONS OF THE VARIOUS AUDIT FUNCTIONS.....	50
4.2. AUDITING PRACTICES: SCOPE, TYPE AND OBJECTIVES.....	53
4.3. THE REGULATION OF AUDITING PRACTICES AND THE INFLUENCE OF CULTURE AND CRISES.....	57
4.4. AUDITING PRACTICES WITHIN THE US CONTEXT.....	61
4.5. AUDITING PRACTICES WITHIN THE EU CONTEXT.....	65
5. CONCLUSION.....	71
6. BIBLIOGRAPHY.....	73
7. GLOSSARY.....	86
8. LIST OF APPENDIXES.....	91
APPENDIX A: US SARBANES-OXLEY ACT OF 2002: MAIN TITLE HEADINGS.....	92
APPENDIX B: OVERVIEW OF INTERNATIONAL FINANCIAL REPORTING STANDARDS IN THE EU.....	93
APPENDIX C: THE WIDE VARIETY OF CORPORATE GOVERNANCE FRAMEWORKS IN THE EU.....	94
APPENDIX D: THE POLITICAL AND CORPORATE CLIMATE LEADING UP TO SARBANES-OXLEY.....	95
APPENDIX E: THE INCREASING COSTS AND EMPLOYMENT RELATED TO SARBANES-OXLEY.....	98
APPENDIX F: US SARBANES-OXLEY ACT: SELECTED EXTRACTS (RELATED TO AUDITING PRACTICES).....	99
APPENDIX G: THE POTENTIAL “CASCADING” AFFECT OF EU STATES WIDENING THE USE OF IFRS.....	101
APPENDIX H: THE COST-BENEFIT OF SARBANES-OXLEY COMPLIANCE ACCORDING TO NON-US ISSUERS.....	102
APPENDIX I: THE COSO FRAMEWORK WHICH UNDERLIES SECTION 404 INTERNAL CONTROLS.....	103
APPENDIX J: EU 2004 PROPOSAL TO EXPAND THE 8TH COMPANY LAW DIRECTIVE.....	104
APPENDIX K: THE COMPLEX WEB OF EU REGULATIONS, WITH THE UK AS EXAMPLE.....	106
APPENDIX L: AUDIT COMMITTEE COMPOSITION.....	107
APPENDIX M: EU MULTINATIONALS’ ANNUAL REPORTS: REFERENCES TO THE IMPACT OF SOX.....	108
APPENDIX N: COMPANIES REPORTING INTERNAL CONTROL WEAKNESSES, AS PER SOX SECTION 404.....	109
APPENDIX O: STATUTORY AUDITS: EU TEN PRIORITIES TO IMPROVE QUALITY AND PROTECT INVESTORS.....	110

SUMMARY

Problem

The multi-billion dollar bankruptcies of *Enron* and *WorldCom* in the US during the early 2000's resulted in new "investor protection" legislation called the US Sarbanes-Oxley Act of 2002 (SOX). The objective of this paper is to show that SOX legislates much more than investor protection; it delves into all aspects of corporate governance. And that the jurisdiction of SOX goes way beyond US borders, since its direct influence is imposed on EU companies, EU auditors and EU legislation. In net, the research goal of this paper is to demonstrate that US corporate governance, in the form of SOX, has direct effect on EU companies, despite the absence of EU law requiring such compliance.

The motivation for this research is two-fold. First, from a business perspective, there is much debate amongst practitioners as to what extent EU companies must comply with SOX, especially where it relates to Section 404 concerning internal controls in a company. Second, from a legal perspective, the EU has comparable pending legislation, and it will be interesting to observe any convergence.

Analysis

The method of research was to undertake an extensive review of professional, academic, corporate and regulatory literature. The study examined SOX application and scope from the perspective of all these sources. *De facto* observations are assigned higher weights than explicit SOX provisions that have yet to be tested. In other words, evidence that an EU company *is* preparing to voluntarily comply with SOX is more significant than an untested interpretation that SOX *should* apply to an EU company. Considering that SOX requirements are frequently changed, an important remark is that this research is primarily based on the law and all its related regulations as at the end of 2004.

Results

The study established that EU entities are very much impacted by the extraterritorial reach of SOX. This influence is manifested predominantly in three ways: EU entities adopting the corporate (SOX-compliant) policies of its parent company; voluntary compliance from EU entities wanting to adopt (SOX) 'best practices' and/or who had to comply at the insistence of 3rd party (e.g. customer, bank); "copy-cat" legislation from member states and the EU, especially in regards to auditing practices. The paper concluded that: the net affect of SOX harmonising corporate governance standards, because of its transparency, consistency and global reach is positive. The conclusion is based on the premise that: US extraterritoriality is beneficial, if the exported legislation achieves higher levels of EU adoption of good corporate governance than would have otherwise been achieved in its absence.

1. INTRODUCTION

1.1. Major corporate governance and financial reporting reforms affecting EU companies

The last decade has seen the introduction and extensive reform of company law and financial reporting requirements within the European Union (“EU”¹). The initial motivation of these reforms originated from goals of greater harmonisation, comparability and consistency. New impetus came as a result of American and European reactions to the corporate and investor scandals of the early 2000’s. The *Enron* bankruptcy² was but one of many US and EU corporate failures at that time.

The year 2005 has seen an exceptional barrage of major reforms that were designed and legislated many years ago, but are only now finally coming into effect for EU publicly-listed companies.³ Most observers will have read about the “new” Sarbanes-Oxley Act of 2002⁴ (“Sarbanes-Oxley” or “the Act” or “SOX”) corporate governance and International Financial Reporting Standards (“IFRS”) financial reporting requirements.⁵ These are indeed major noteworthy reforms, requiring important organisational, procedural and administrative changes in publicly-listed companies. However, with all the press coverage given to Sarbanes-Oxley and IFRS,⁶ it would be easy to think that companies need concern themselves only with these reforms.

In reality, EU companies face a host of other new company law and financial reporting requirements, in parallel to Sarbanes-Oxley and IFRS, and in addition to other new business-related legislation (e.g. regarding tax, employment, environment, international trade). For example, many companies listed on the London Stock Exchange at the beginning of 2005 would have needed to be prepared for new reporting and disclosure requirements stemming from IFRS, Sarbanes-Oxley,⁷

¹ The terms EU or EU15 are used in this paper since the focus is on the pre-2004 membership. *See*, Glossary for detail.

² The 2001 *Enron* bankruptcy costing shareholders \$68 billion was the largest one in the US before *WorldCom* in 2002.

³ There were 7,113 domestic listed companies in EU15 (excluding investment funds) of which 2,388 were from the UK, followed by 1,020 in France, 974 in Spain and 725 in Germany. No other EU15 country had more than 400. [Source: PricewaterhouseCoopers: International Accounting Standards in Europe – 2005 or now? (November 2000)]. In comparison, the US has nearly 15,000 public companies and 15 million private firms [Source: K. Waring and C. Pierce, *The Handbook of International Corporate Governance*, a definitive guide, Institute of Directors publication (2005) 179]

⁴ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). Hereinafter referred to in the footnotes as “Sarbanes-Oxley”. An outline summary of its main chapters and Sections can be found in the attached Appendix A.

⁵ We say “new”, because although Sarbanes-Oxley and IFRS have come to prominence within the EU this year, many of the actual underlying requirements have already been in effect with certain companies in certain countries under the guise of national corporate governance and company law frameworks (re: Sarbanes-Oxley) and other international accounting standards and Generally Accepted Accounting Principles (re: IFRS).

⁶ *See*, Appendix B for an overview of IFRS in the EU. This is included given the importance of financial reporting to Sarbanes-Oxley. And within the EU, IFRS and corporate governance reforms are captured within the same Action Plan.

⁷ Sarbanes-Oxley is estimated to impact “at least 200 groups operating in the UK”. [Source: Booth G., *Get into training for the new regime*, Accountancy (UK), January 2005, at 42]

Companies Act, the Financial Services Authority, London Stock Exchange listing rules, tax authorities, the revised Combined Code of corporate governance, revised takeover rules.⁸ This onslaught of new regulations was neatly summed up in an address from *Deloitte*⁹ to UK company directors:

[y]ou could be forgiven for thinking that too much is happening too quickly. As a [UK] quoted company director, the chances are that you're currently wrestling with the issues raised by the [UK] Combined Code, the upcoming [UK] Operating Financial Review regulations and possibly even Washington's [US] Sarbanes-Oxley legislation. And of course, there is also the imminent transition from UK GAAP to the new [EU-mandated] International Financial Reporting Standards, or IFRS.¹⁰

Most of these developments are captured under the banner of "corporate governance reforms", to the extent that some commentators even include IFRS and corporate social responsibility within this grouping. The next section goes on to clarify how, for the purposes of this paper, the study sees the boundaries of corporate governance, and, in particular, its role and application with the EU.

1.2. Corporate governance, its scope and application in the EU, prior to Sarbanes-Oxley

The scope and legal bases of corporate governance within the EU varies widely depending on each member state's own culture, company ownership structures, business practices, company law and national corporate governance framework. Even within one member state, there may be several formal corporate governance frameworks, each with their own definition of corporate governance.¹¹

The scope of these definitions is quite wide-ranging, from the very simple: "corporate governance is the system by which companies are directed and controlled" (UK¹²), to the more complex:

[Corporate governance is] the goals, according to which a company is managed, and the major principles and frameworks which regulate the interaction between the company's managerial bodies, the owners, as well as other parties who are directly influenced by the company's dispositions and

⁸ For a fuller discussion on all of these new reporting and disclosure requirements, see, e.g., Fisher L., *It's raining regulation*, Accountancy (January 2005), at 26

⁹ *Deloitte* is second of the "Big Four" accountancy firms. The biggest is PriceWaterhouseCoopers (fee income, no. employees: \$17.6 bn, 122,471), Deloitte (\$16.4 bn, 115,000), Ernst & Young (\$14.5 bn, 100,601) and KPMG International (\$13.4 bn, 93,983) [Source: Fisher L., *Sarbox boosts revenues across globe*, Accountancy (June 2005), 26]. Sometimes the "Big Four" are referred to as the "Final Four" big accounting firms [see, e.g. Burrowes A., Kastantin J. and Novicevic M., *The Sarbanes-Oxley Act as a Hologram of Post-Enron Disclosure: a Critical Realist Commentary*, 15 *Critical Perspectives on Accounting* 2004, at 807], because of the reduction in their number since the time of 'Big 8'.

¹⁰ Clawson T., *IFRS: Countdown to Transition*, PLC Director (December 2004 supplement: Preparing for IFRS: A director's guide), at 3

¹¹ Prior to an EU initiative pursuant to the *Winter Report*, the EU15 had over 35 corporate governance frameworks, with the UK alone having eleven. [Source: Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, *Comparative study of corporate governance codes relevant to the European Union and its member states* (2002), 2]. See Appendix C

¹² Cadbury Report (UK)

business (in this context jointly referred to as the company's stakeholders). Stakeholders include employees, creditors, suppliers, customers and the local community." (Denmark¹³)

With a Dutch definition falling somewhere in between: "The concept of corporate governance has been understood to mean a code of conduct for those associated with the company [...] consisting of a set of rules for sound management and proper supervision and for a division of duties and responsibilities and powers effecting the satisfactory balance of influence of all the stakeholders."¹⁴

Another way to understand the variations in these definitions is assess underlying factors such as:¹⁵

FACTORS AFFECTING CORPORATE GOVERNANCE SYSTEMS	
U.K.	NETHERLANDS
<ul style="list-style-type: none"> • market culture • market-oriented • short-term strategy • relatively more reliance on equity • stock exchange relatively large • relatively less influence of controlling shareholder(s) 	<ul style="list-style-type: none"> • consensus culture • network-oriented • long-term strategy • relatively more reliance on debt • stock exchange relatively small • relatively more influence of controlling shareholder(s)

In the late 1990's, the European Commission (EC) considered this wide and diverse set of codes which governed European companies. It was interested to know to what extent such diversity was hampering or facilitating its objectives of enhancing Europe's single market. In particular, the EC wanted to know what role corporate governance plays in European economies and capital markets. To this end, the EC commissioned a law firm to conduct an in-depth study to compare corporate governance codes across the EU15. The law firm issued its 806-page report in January 2002.¹⁶

The then EC Internal Market Commissioner highlighted his main conclusions of the lengthy report:

[f]irstly, the main differences between Member States are found in differing company law and regulation (for example, with respect to issues like one-tier / two-tier boards, workers' participation, or the principle of one share/one vote) as opposed to the corporate governance codes which show a remarkable degree of convergence.

¹³ Nørby Report (Denmark)

¹⁴ Peters Report (The Netherlands), which has now been superseded by the Dutch Corporate Governance Code which was published in December 2003 by the Tabaksblat Committee. The 40 recommendations of the first Dutch Corporate Governance Committee (Peters Committee), as contained in the 'Corporate Governance in the Netherlands; the Forty Recommendations' report (1997), formed the point of departure for the activities of the Tabaksblat Committee. Introduction of the new Code for the financial year 2004 was received with good marks from observers, for example: "Dutch regulators have imposed a tough new corporate governance code with the result that [corporate governance] ratings for the country [...] have risen by 50% in two years." [Source: Davis P., *Dutch governance laws kick in*, Financial Times, 7 March 2005 (Fund Management supplement), at 1]

¹⁵ Reprinted from: Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, Comparative study of corporate governance codes relevant to the [EU] and its member states (2002), at 30. (Original authors: Fraser, Henry & Wallage)

¹⁶ Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, Comparative study of corporate governance codes relevant to the European Union and its member states (2002)

The existence of many codes in the EU is not perceived as a difficulty by issuers and this for three reasons. First of all, issuers continue to operate primarily on their domestic market, which means that most of the time they are not faced with foreign codes. When they are, code provisions are pretty similar. And finally, if there are some differences, code provisions are not binding anyway. The study concludes that the EU should not devote time and effort to a European corporate governance code. So - should there be an initiative in the area of corporate governance at EU level?¹⁷

Mr. Bolkestein went on to conclude that this last question should be addressed by a special committee¹⁸ to be chaired by Professor Jaap Winter. The “Winter Report”,¹⁹ which evolved in November 2002,²⁰ became a cornerstone and reference point for EU cooperation in corporate governance and company law matters. It announced its key recommendations and priorities as:

- Enhanced corporate governance disclosure requirements
- Providing for a strong and effective role for independent non-executive or supervisory directors, particularly [...] where executive directors have conflicts of interests, i.e. nomination and remuneration of directors and supervision of the audit of the company’s accounts
- An appropriate regime for directors’ remuneration, requiring disclosure of the company’s remuneration policy and individual directors’ remuneration, as well as prior shareholder approval of share and share option schemes in which directors participate, and accounting for the costs of those schemes to the company
- Confirming as a matter of EU law the collective responsibility of directors for financial and key non-financial statements of the company
- An integrated legal framework to facilitate efficient shareholder information, communication and decision-making on a cross-border basis, using where possible modern technology, [...]
- Setting up a structure to co-ordinate the corporate governance efforts of Member States.²¹

These recommendations (together with the others in the 161-page Winter Report) went through an extensive consultation process. This involved academia, industry, financial operators, governments, trade unions, associated professions, many of whom broadly found favour with the substance.

Two underlying themes which were particularly well-received were those suggesting: (i) that there was no advantage in creating a common European governance code; and, (ii) to rely on voluntary compliance, disclosure and “comply or explain” rather than a strict legislative or rules-based approach.²² Both of these themes implicitly recognised the cultural and legal diversity that existed

¹⁷ Bolkestein F., *Corporate Governance in Europe* (speech to the Conference on Corporate Governance at *Clifford Chance* in Amsterdam, on 30 January 2003), at 3.

¹⁸ The High Level Group of Company Law Experts (7 experts from academia, law, industry and business groups)

¹⁹ Winter J. (Chair), “The Winter Report”: A modern regulatory framework for company law in Europe (2002)

²⁰ The Winter Group deliberations took place throughout 2002, and was therefore exposed to *Enron* and Sarbanes-Oxley issues.

²¹ Winter J. (Chair), “The Winter Report”: A modern regulatory framework for company law in Europe (2002) [and the related press release dated 4 November 2004]

²² The “principles versus rules” discussion is addressed later in chapter 4. At this stage, we provide just the key points: “The case here is similar for accounting: whereas in the UK there are *principles*, the US has accounting *regulations*. I realise this is a simplistic way of putting it, but where there are principles you can either adhere to them or not. With regulations you can find dodges and loop holes that might not contravene the *letter* of the regulations, but do not live up to the principles that might have been intended.” [Keenan J., *Corporate Governance in UK/USA Boardrooms*, 12 *Corporate Governance: An International Review* 2004, at 174]

within EU member states. As PricewaterhouseCoopers puts it: “Both ethical behaviour and good management cannot be legislated for.”²³ And “To have a single [corporate governance] code that has to be applied more or less the same way in every country just wouldn’t work.”²⁴

Many of the measures promoted by the Winter Report went on to be adopted within EU Action Plans²⁵ and individual member state initiatives, such as, the Dutch Tabaksblat Committee.²⁶

This section now concludes by summarising the common themes and scope of corporate governance frameworks that now function to varying degrees across the EU, as follows²⁷:

- Structure and independence of the Board
- Shareholder rights and protection
- Independence and integrity of the audit process
- Compensation systems for executive and non-executive directors
- Executive and non-executive stock ownership

To a large extent, the US Sarbanes-Oxley Act also captures these themes (plus a lot more) within its provisions. However, as shall be seen in the next section, the approach with which the Act is implemented has caused much distress within the EU.

1.3. The arrival of US Sarbanes-Oxley into the EU

Although the Sarbanes-Oxley Act was enacted in July 2002, the impact of its various provisions on EU companies came into effect over a number of years, so there is no one “effective date”.

Nevertheless, the cumulative and ultimate affect on a minimally-compliant EU company is such that it is subject to a number of the Act’s provisions, even though Sarbanes-Oxley has no explicit legal basis in EU or member states’ legislation. This was a major cause for concern within the EU.

²³ PricewaterhouseCoopers: 2004 Building the European Capital Market, at 13

²⁴ Wyman P., head of professional affairs at PricewaterhouseCoopers [Source: Baker N., *The European Reform Agenda; European Regulators Have Been Trying To Limit The Impact Of Sarbanes-Oxley So They Can Reach Their Own Solutions To Governance And Audit Failures*, Internal Auditor, April 2004, at 56]

²⁵ Company Law Action Plan (May 2003); Combined with the Financial Services Action Plan in September 2004.

²⁶ For a concise summary of Dutch corporate governance from an expert, see, e.g. Winter J., *Corporate Governance in the Netherlands*, in Winter J. (Chair), *European Corporate Governance in company law and codes 39* (18 October 2004)

²⁷ Based on an analysis of various corporate governance frameworks and studies, including The Winter Report (EU), the Tabaksblat Committee (NL), Combined Code (UK), Cromme Code (Germany), OECD Corporate Governance Principles [Source: FTSE/Institutional Shareholder Services, *Corporate Governance Index Series* (March 2005), at 8]

The then EC Commissioner for the EU's Internal Market, Mr. Frits Bolkestein, "wrote to the SEC complaining about Sarbanes-Oxley's 'unnecessary extraterritorial consequences' and the 'unnecessary difficulties' for European companies it would cause."²⁸ Mr. Bolkestein's assessment that aspects of SOX were "unnecessary" reflected the fact that the EU was already addressing many of the objectives of Sarbanes-Oxley, under his leadership, and had been doing so well before *Enron*.

After all, he had commissioned an in-depth study comparing corporate governance codes across the EU15 back in 2000, set up the Winter Group in 2001, and was simply awaiting their findings due late 2002 before proceeding to the next stages of formulating Action Plans and EU Directives. EC's frustration in 2002 was that *Enron* and Sarbanes-Oxley "hijacked the European reform process".²⁹

The EC was initially having some success in its efforts (and negotiations with the SEC) to limit the impact that Sarbanes-Oxley would have on European companies. In a 2003 speech, the EC said:

[...] we clearly wanted to avoid the undesirable extra-territorial effects of the Sarbanes-Oxley Act. We identified the issues at the source of the main conflicts of laws and tried to find common solutions. I made it clear to [the US] that we have seven broad areas of concern, namely:
the registration of audit firms with the new Public Company Accounting Oversight Board;
the direct US access to EU audit working papers;
the audit committee requirements;
the rules on auditor independence;
the issue of loans to Directors and Executive Officers (notably for banks);
the certification of financial reports;
and the certification of internal control.

And I think we have been quite successful [...] in convincing the SEC of many of our arguments.³⁰

However, during this 2002-2003 process, a number of European corporate failures evolved, such as France's *Vivendi*, the Netherlands' *Royal Ahold*, and most significantly, Italy's *Parmalat*. These events undermined the EC's negotiation efforts, since they indicated that the EU also had significant corporate failures, *Enron* was not unique to the US, and therefore the EU also needed to urgently enhance its investor protection and corporate governance frameworks. Mr. Bolkestein conceded last year that the *Parmalat* bankruptcy is of a "similar magnitude" or worse than *Enron*.³¹

²⁸ Sobel C., *The United States and Europe: Regulatory Cooperation and Conversion*, Remarks by the Ambassador of the U.S. to the Netherlands to the International Law and Practice Association of the New York State Bar Association, Amsterdam, 26 October 2003

²⁹ Baker N., *The European Reform Agenda; European Regulators Have Been Trying To Limit The Impact Of Sarbanes-Oxley So They Can Reach Their Own Solutions To Governance And Audit Failures*, Internal Auditor, April 2004, at 59

³⁰ Bolkestein F., *Corporate Governance in Europe* (speech to the Conference on Corporate Governance at *Clifford Chance* in Amsterdam, on 30 January 2003), at 5

³¹ Baker N., *The European Reform Agenda; European Regulators Have Been Trying To Limit The Impact Of Sarbanes-Oxley So They Can Reach Their Own Solutions To Governance And Audit Failures*, Internal Auditor, April 2004, at 55

Europe's resistance to SOX's imminent arrival further diminished as US companies started to implement it during 2003-2004. Two important elements emerged. Firstly, no matter what changes (i.e. exemptions) were agreed, there was already significant impact on European companies, merely because of their status as subsidiaries of US parents/multinationals.³² Secondly, "there is very little in Sarbanes-Oxley on a principle level that the EC hasn't already decided we should have in Europe. It's just down to the detailed application."³³ And here we come to the crux of the matter.

It would seem, given hindsight, that Europe's concerns with Sarbanes-Oxley were less about the substance and objectives – after all, much of what it legislates is already reflected in various corporate governance codes and company laws across the EU – but rather, to do with the approach and application of the Act. Importantly, the EU and its member states prefer an approach based on *principles* (that allow room for flexibility), rather than *rule-based* or statute-imposed compliance.³⁴ The US has argued that its "approaches to corporate governance must necessarily start from our distinct legal and regulatory traditions [...]"³⁵ The EC meanwhile, decided to stick with Europe's traditional principles-based approach, by promoting the "comply or explain" concept in its corporate governance reforms.

The US continues to question the efficacy and level of protection of such voluntary non-binding approaches in the current corporate climate. It cites as one example the home base of *Parmalat*, where Italy's non-binding corporate governance code indicates that listed companies should have an internal audit function. In explaining its non-compliance, a 2001 *Parmalat* document stated that:

[t]he group's existing structure is already sufficiently well-organised to manage so-called internal audit procedures [and that its existing procedures were] capable of guaranteeing healthy and efficient management, adequate to identify, prevent, and manage risks of a financial and operational nature and fraudulent behaviour that may damage the company.³⁶

[*Parmalat* went "bankrupt"³⁷ in 2003, and as of July 2005, it is still operating under administration.]

³² The question as to which European companies are impacted by Sarbanes-Oxley is addressed in subsequent chapters. However, at this stage we note that 94.4% of US consumer multinationals effect the certification processes required by SOX Sections 302 and 404 across their foreign locations. [Source: Deloitte & Touche, *What Consumer Business Companies Must Know to Succeed Under Sarbanes-Oxley: Readiness Survey* (2003)]

³³ Wyman P., head of professional affairs at PricewaterhouseCoopers [Source: Baker N., *The European Reform Agenda; European Regulators Have Been Trying To Limit The Impact Of Sarbanes-Oxley So They Can Reach Their Own Solutions To Governance And Audit Failures*, Internal Auditor, April 2004, at 57]

³⁴ This is not a new difference of view between the US and EU; it is prominent in many other areas, for example in the application of accounting standards and tax law.

³⁵ Sobel C., *The United States and Europe: Regulatory Cooperation and Conversion*, Remarks by the Ambassador of the U.S. to the Netherlands to the International Law and Practice Association of the New York State Bar Association, Amsterdam, 26 October 2003

³⁶ Baker N., *The European Reform Agenda; European Regulators Have Been Trying To Limit The Impact Of Sarbanes-Oxley So They Can Reach Their Own Solutions To Governance And Audit Failures*, Internal Auditor, April 2004, at 57

³⁷ It was declared insolvent and sought *Amministrazione straordinaria* (extraordinary administration) under Italian law.

Nonetheless, the EC-US dialogue did result in some exemptions for EU and other foreign companies, and the dialogue continues as the EC seeks exceptional treatment for as yet unimplemented or interim provisions. Meanwhile, both Sarbanes-Oxley Act and EU Action Plans promoting similar corporate governance themes in different ways are being progressed and implemented, with a key milestone just passed in July 2005 when the Act's Section 404 ("Management Assessment of Internal Controls") became effective for certain EU companies.

1.4. What comes next

July 2005 is the milestone when the most onerous of all SOX provisions³⁸ becomes effective for thousands of EU entities, including many which are subsidiaries of both US and non-US multinationals.³⁹ This milestone is three years since the July 2002 enactment of Sarbanes-Oxley.

How did we even start on this road back then? What were the expectations at that time, and was it indeed intentional that European companies would be subject to this American statute? This paper explores these questions and why it comes out believing that it was intentional in the next chapter. This is followed by chapter 3 where the actual impact of the Act on multinational companies is examined. Here the study confronts the issues as to whether these observed impacts – mostly in the form of extra regulation, disclosures and costs – are detrimental to the affected companies. And even if they are, were these changes in corporate governance inevitable; in a sense, just part of the evolving political and economic climate. The paper argues that many of these developments were more or less unavoidable. Chapter 4 illustrates this by comparing US and EU regulatory reforms for what is seen as a key area of SOX reforms and corporate governance: the independence and integrity of the audit process.⁴⁰ Key arguments and findings are then concluded in Chapter 5.

³⁸ That is, Section 404 on "Management Assessment of Internal Controls". We review this in subsequent chapters.

³⁹ "Of the 7000 or so companies with a stock listing on one of the European exchanges, the EC says 280 have a dual listing in the United States. [...] But Sarbanes-Oxley also applies to bond issuers and the countless European businesses that are subsidiaries of US parents, so the act's reach is far wider than those 280 companies." [Source: Baker N., *The European Reform Agenda; European Regulators Have Been Trying To Limit The Impact Of Sarbanes-Oxley So They Can Reach Their Own Solutions To Governance And Audit Failures*, Internal Auditor, April 2004, at 55-56]. At this stage it is impossible to quantify how many entities are affected, since each (US and foreign) multinational will make its determination as to how many subsidiaries need to comply with Section 404, and this will be reported from July 2005. To make this determination "[companies] will whittle the list [of all their locations and business units] down to the most critical of these sites. [The] objective is to separate the insignificant – those locations or businesses that could not create, either individually or in the aggregate, a material misstatement in the financial statements – from the significant." [Source: Deloitte, *Taking Control: A Guide to Compliance with Section 404 of the Sarbanes-Oxley Act of 2002* (2004)]

⁴⁰ Audit-related practices are seen by many commentators as the core element of SOX, given the "gatekeeping" role played by auditors. For example: Carmichael D., *The PCAOB and the Social Responsibility of the Independent Auditor*, 18 Accounting Horizons, June 2004, at 127: "The centrepiece of the Act was the creation of the PCAOB...", and, *see, also*, Ronen J. and Berman A., *Musings on Post-Enron Reforms*, 19 Journal of Accounting, Auditing & Finance, Summer 2004, 331: "A primary instrument for accomplishing [SOX] objectives is the establishment of the [PCAOB]."

This paper aims to present an academic discussion on the extent to which US corporate governance, in the form of Sarbanes-Oxley Act, affects EU15 companies. It does not purport to be a pragmatic guide on the implementation of the Act. Nor does it intend to simply duplicate provisions in SOX. Rather, it provides a critical analysis of the Act's scope and effect. Given the dynamic and current nature of the Act, readers seeking a practical guide would do better by seeking professional advice. In view of this paper's aims, as outlined above, it does not reflect up-to-the-minute developments in this arena. Literature and regulations are those which were in effect up until about the end of 2004.

To illustrate key points, the paper makes extensive use of third-party surveys and literature in the appendices.⁴¹ In most cases, the purpose underlying the use of such materials is merely to reinforce assertions already established in the main text, rather than to become entangled in specific percentages or dollar amounts. In any event, it is recognised that some of the results in these appended surveys have not undergone the rigour of sound statistical sampling methods. However, on balance, it is believed that they can still serve the abovementioned purpose, as well as providing supplemental clarity. Finally, one may note that this paper focuses on the impact of Sarbanes-Oxley on the original 15 members of the EU, rather than the current 25. Where appropriate, examples of such impacts are taken from The Netherlands and the UK for illustrative or comparative purposes.⁴²

See, also, quote from PCAOB CFO, T. Hohman: “[the auditing] profession on whose shoulders the [SOX] law has placed heavy new responsibilities is one of the uncertainties hanging over the [SOX] act's future effectiveness.” [Source: *Sarbanes-Oxley – A Price Worth Paying?* Economist, May 19 2005 (website August 2005)]. *See, also*, section 3.9 below for further discussion as to why auditing practices are so central to SOX effectiveness.

⁴¹ Typically sourced from reputable and professional audit, legal or consultancy firms.

⁴² *See, e.g.*, Appendix M with extracts of UK and Dutch company reports, or Appendix K re: UK corporate governance.

2. SARBANES-OXLEY: INITIAL INTENTION AND FINAL CONTENT OF THE ACT

This chapter starts by providing an account of how the Act came into being. What were the driving forces that lead to such significant legislation, what was the role of the US government in forming it and what were the issues that they intended SOX to address. This is followed by a description of the Act itself. What it contains, who it impacts and when, with a particular emphasis in the last section explaining to what extent EU companies can escape SOX given the exemptions issued until 2004.

2.1. Corporate failures prior to Sarbanes-Oxley

Although corporate bankruptcies have occurred for centuries, it was the size and familiarity of the multinationals involved in the corporate failures of the early 2000's that caused such an outcry for legislative reform, eventually leading to Sarbanes-Oxley Act. One influential US senator captured the mood of the country during a 2002 Senate debate on the proposed Sarbanes-Oxley legislation:

[t]he last 18 months have shaken the foundation of the public's belief in the accuracy of the financial statements of our major U.S. corporations, beginning with the precipitous fall of Enron last year.[...] The plain truth is that the system of checks and balances in the marketplace designed to prevent, expose, and punish corporate misconduct is broken and needs to be repaired. Action is critically needed on a number of fronts to restore these checks and balances.[...] [Company] Lies about income and profits, hidden debt, improper insider trading, tax evasion, conflicts of interest--the list of recent corporate malfeasance is an alphabet of woe.⁴³

And Senator Levin, an enthusiastic supporter of the Sarbanes-Oxley legislation, went on to list over a dozen recent “corporate failures”,⁴⁴ including such well-know companies as: Dynegy, Enron, Global Crossing, Halliburton, IBM, ImClone, Kmart, Merrill Lynch, Qwest Communications, Rite Aid, Stanley Works, Tyco International, WorldCom and Xerox. [Appendix D provides brief extracts on the alleged and actual wrongdoings of these companies, according to Senator Levin].

With the Enron, Global Crossing and other scandals making front-page news in the first half of 2002, Senator Paul Sarbanes (Democrat) managed to get unanimous support in the US Senate for his initial draft of SOX. But the US Congress was less enthusiastic, and “the bill was expected to

⁴³ Levin C., *The Need To Enact Accounting And Corporate Reforms* (remarks by Senator Levin in the US Senate, July 10, 2002), Arnold & Porter Legislative History: Sarbanes-Oxley Act of 2002, at 1-4. See, Appendix D for abridged text.

⁴⁴ Senator Levin, included within his definition of “corporate failures”: bankruptcies, financial restatements, companies under SEC investigation for potential irregularities and companies using highly-aggressive tax-avoidance strategies.

die quietly in the House. But early last June [2002] the scandal involving WorldCom broke into the news and, as one Republican operative puts it, “Suddenly the Sarbanes legislation took on a life of its own”⁴⁵. Congress became supportive, and Congressman Michael Oxley (Republican) picked up the baton, made some minor changes to the bill and received overwhelming support from all parties.

2.2. Political and economic climate that promoted fast passage of SOX and its intentions

Such corporate failures had widespread impact on mainstream America. Employees lost jobs, pensioners and investors lost billions⁴⁶ and America lost prestige. Coupled with the economic malaise of 2002, the recent memories of the September 2001 terrorist attacks, the misery of imminent war in Iraq and the political reality of congressional elections in the fall 2002, US politicians needed to be seen to be doing something constructive for the electorate, and they gave widespread bipartisan support for the Sarbanes-Oxley bill. As one commentator put it: “[...] the WorldCom debacle made it politically imperative for the US government to appear to be seen as taking action.”⁴⁷ The bill glided through Congress, passing through the Senate by 99 to 0 votes and the House by 423 to 3 votes.⁴⁸ President Bush picked up on the theme during his signing of the bill:

During the past year the American economy has faced several sudden challenges, and proven its great resiliency. Terrorists attacked the center and symbol of our prosperity. A recession cost many American workers their jobs. And now corporate corruption has struck at investor confidence, offending the conscience of our nation. Yet, in the aftermath of September the 11th, we refuse to allow fear to undermine our economy. And we will not allow fraud to undermine it either.[...]

My administration pressed for greater corporate integrity. A united Congress has written it into law. And today I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt. This new law sends very clear messages that all concerned must heed. This law says to every dishonest corporate leader: you will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law.[...]

This law says to corporate accountants: the high standards of your profession will be enforced without exception; the auditors will be audited; the accountants will be held to account. This law says to shareholders that the financial information you receive from a company will be true and reliable, for those who deliberately sign their names to deception will be punished. This law says to workers: we will not tolerate reckless practices that artificially drive up stock prices and eventually destroy the companies, and pensions, and your jobs.[...] Corporate misdeeds will be found and [...] punished.⁴⁹

⁴⁵ Whalen C., *Revisiting Sarbanes-Oxley: Was the well-intentioned landmark legislation slapped together too quickly?*, International Economy, Fall 2003, at 40

⁴⁶ According to a study by *Glass Lewis*, “investors lost well over US\$ 900 billion in 30 big scams between 1997 and 2004”. [Source: *Accounting – The ones that get away*, Economist, 30 July 2005, at 59]. Nonaffiliated stockholders lost about US\$ 250 billion in market value from Enron and WorldCom together. [Source: Aronson N., *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 Stanford Journal of Law, Business and Finance (2003)]

⁴⁷ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 Information Systems Control Journal 2004, at 17

⁴⁸ Allen M., *Bush Signs Corporate Reforms Into Law*, Washington Post, 31 July 2002, at 4

⁴⁹ Bush G.W., *President Bush Signs Corporate Corruption Bill* (remarks by President Bush upon signing Sarbanes-Oxley into law, July 30, 2002), Arnold & Porter Legislative History: Sarbanes-Oxley Act of 2002, at 1-4

President Bush went on to make a statement⁵⁰ to summarise key expectations from Sarbanes-Oxley:

- to protect investors by improving the accuracy and reliability of corporate disclosures;
- to deter and punish corporate and accounting fraud and corruption;
- to ensure justice for wrongdoers, and protect the interests of workers and shareholders;
- to strengthen the existing corporate reporting system;
- to protect against company retaliation for lawful cooperation with investigations.

The initial and core intentions of Sarbanes-Oxley were to address the shortcomings that led to the *Enron* failure, and thereby, try to prevent a reoccurrence.⁵¹ The Act therefore comprised provisions drawn from various branches of law, including: company law, financial reporting, corporate governance, securities law, accounting standards and labour law.

2.3. Quick enactment and the consequential need for changes post-enactment

Although many commentators complained that the legislation was going through Congress too quickly, and the ramifications had not been properly deliberated, there were others who felt that a rapid response was going to be the only way to get legislation passed. One commentator concluded:

US corporate governance was in need of cleaning-up. Doing so by means of knee-jerk legislation is better than waiting five years. It was not until 1934 that legislation was enacted to deal with Wall Street banking regulation following the 1929 crash!⁵²

So it was no surprise that within the 2-3 years since SOX was enacted, there have been plenty of changes, clarifications, statements of guidance and implementing regulations, much of which has modified the original intentions or expectations of some.

[w]itness for example the SEC's backtracking of the requirement that lawyers resign and blow the whistle on securities law violations (influenced by the lawyers' lobby) and of the barring of tax shelter planning by auditors (effected by the accountants' lobby).⁵³

⁵⁰ Bush G.W., *Statement By The President Upon Signing Into Law* (statement by President Bush upon signing Sarbanes-Oxley into law, July 30, 2002), Arnold & Porter Legislative History: Sarbanes-Oxley Act of 2002, at 1

⁵¹ "One Bush Administration official belatedly frets that the explosion of WorldCom and other scandals last year [2002] made Sarbanes-Oxley more draconian than originally intended. He warns that it is unlikely that Congress will revisit the Sarbanes-Oxley legislation until after the next election – if at all." [Source: Whalen C., *Revisiting Sarbanes-Oxley: Was the well-intentioned landmark legislation slapped together too quickly?*, International Economy, Fall 2003, at 43]

⁵² Keenan J., *Corporate Governance in UK/USA Boardrooms*, 12 Corporate Governance: An International Review 2004, at 176

⁵³ Ronen J. and Berman A., *Musings on Post-Enron Reforms*, 19 Journal of Accounting, Auditing & Finance, Summer 2004, at 332

In addition to substantive changes, such as those (retractions of expected obligations) above, the scope (relating to who is subjected to certain provisions) and timetable for effect have also changed.

These developments (they are not amendments to the law) should be of no surprise for three main reasons. Firstly, extensive and meaningful consultation with all impacted practitioners (rather than the politicians) took place after SOX enactment, rather than during its fast passage through the legislature. Secondly, the SEC has plenty of leeway, insofar that it has the mandate of drafting implementing regulations. During this drafting process, it could accommodate the concerns of those interests that were not given proper hearing prior to SOX enactment. And, thirdly, some of the provisions were in conflict with other (domestic and foreign) laws, and therefore could not be implemented as envisaged unless other laws were amended or exemptions were given.

As a result of the rapid passage⁵⁴ and implementation mechanism of SOX (as outlined above), much of the input and commentary from interested parties came after SOX enactment rather than before. In a sense, the politicians spoke before enactment and the practitioners and subjects came after. Consequently, the intent and expectations of SOX (pre-enactment) mainly reflects the political dialogue in 2002, as captured in section 2.2 above. The practitioners and those subjected to SOX have expressed their expectations and commentaries subsequently. Some of their expressions came during the implementation phase but after enactment, and are therefore reflected in Chapter 3.

In view of the above dynamics, there have been and continues to be many developments and changes to the SOX that is now being implemented (in comparison to the enacted provisions). The following sections outline the enacted Sarbanes-Oxley provisions and those changes and developments to the law (especially in regards to EU companies) up until around the end of 2004.

⁵⁴ “The Sarbanes-Oxley legislation made it through conference with the Senate in three days and was signed into law on July 30, 2002.” [Source: Whalen C., *Revisiting Sarbanes-Oxley: Was the well-intentioned landmark legislation slapped together too quickly?*, International Economy, Fall 2003, at 40]

2.4. The contents of Sarbanes-Oxley and its legislative requirements

The scope, content and application of Sarbanes-Oxley legislation is derived from various sources. In addition to the primary legislation grouped into eleven chapters,⁵⁵ there are directly-related regulations / guidance issued by US regulators,⁵⁶ and referenced legislation,⁵⁷ which entities and persons need to comply with if they are to be in full compliance with Sarbanes-Oxley. The following paragraphs aim to provide a summary understanding of the what, when and who questions about Sarbanes-Oxley, before we address the specific treatment for foreign companies.

The eleven chapters of Sarbanes-Oxley breakout into around 70 sections covering various corporate governance and financial reporting provisions, the main ones can be broadly classified as follows.⁵⁸

Oversight and implementation

- Establishes the SEC and PCAOB as the two main bodies to oversee and enforce the Act.
- Setting up the Public Company Accounting Oversight Board (“PCAOB”) to oversee: audits of public companies, the standards applied therein, and the conduct of audit firms and staff.
- Increases the SEC’s disciplinary authority and resources to oversee securities regulations.
- Requires other bodies, in addition to SEC and PCAOB, to make and enforce certain rules. [i.e. the US stock exchanges (via listing their requirements) and the Department of Justice.]

Auditor and Audit Committee independence and activities

- Regulation of which non-audit services can be provided by an audit firm.
- Requires rotation of audit partner (every 5 years) and assesses merit of audit *firm* rotation.⁵⁹
- “Cooling-off” period required of auditors wanting to change employers and work for issuer.
- Auditors required to maintain all audit work papers for 5 years (otherwise criminal penalty).
- Establishes the “independence” requirements and roles/responsibilities of audit committees.
- Audit committees and/or Board of Directors should include a “financial expert”, and the company must disclose this compliance in their annual report, and name who is the “expert”.

⁵⁵ See, Appendix A for a list of the eleven chapters and a summary listing of the main provisions.

⁵⁶ Eg., the SEC – Securities Exchange Commission, and the PCAOB – Public Company Accounting Oversight Board

⁵⁷ Eg., the US Securities Act of 1933, and the Securities Exchange Act of 1934

⁵⁸ The classification is mainly based on summaries found in: Root K., *The impact of Sarbanes-Oxley on European corporates*, 130 Treasury Management International 8 (2004)

⁵⁹ Sarbanes-Oxley section 207 mandated the General Accounting Office (GAO) to investigate the merits of a mandatory rotation of a company’s audit *firm* (i.e. not just *partner*). In November 2003, the GAO concluded against such action. [Source: As reported in PricewaterhouseCoopers: 2004 Current Developments for Audit Committees, at 41]

Corporate responsibility

- CEO and CFO to certify financial reports and the internal controls on which they depend.⁶⁰ (The Act establishes criminal liability for failure of CEO/CFO to certify financial reports.⁶¹)
- CEO and CFO are responsible for the internal controls regarding material information concerning the issuer and consolidated subsidiaries.
- Annual reports to include an internal control report assessing the effectiveness of controls, requiring: “companies to identify financial reporting risks, ascertain related controls, assess their effectiveness, fix any control deficiencies, and then retest and re-document anew”.⁶²
- Sarbanes-Oxley requires companies to implement a “code of ethics”, and to disclose in its annual report whether this Code governs senior officers and directors, and if not, why not.

Financial reporting and disclosure

- Enhanced disclosure of off-balance sheet transactions and relationships.
- Personal loans to corporate officers prohibited (certain exceptions require disclosure).
- Faster disclosure of insider transactions (within 2 days; formerly 10 days after month-end).
- New disclosure requirements about: “code of ethics”; financial expert on audit committee.

Criminal provisions⁶³

- Destruction, alteration and falsification of records (penalties increased from five years imprisonment to twenty years);
- The destruction of audit workpapers;
- The obstruction of justice and impeding of investigations; and
- Securities fraud (increased penalties for violations of the Securities Exchange Act of 1934).

Other key provisions

- Restrictions on the conduct of securities analysts (aiming to minimise conflicts of interest).
- Whistleblower protection prohibiting issuers taking retaliatory action against employees.
- Standards of conduct for lawyers (who transact business in relation to issuer and/or SEC).

⁶⁰ Although both CEO and CFO have personal responsibility for certification, in practice only 3% of CEOs make it their primary operational responsibility, preferring to defer it to the CFO (67%), Controller (13%), General Counsel (8%) or Internal Audit (4%) and others (5%). [Source: Protiviti, *Insights On Today's Sarbanes-Oxley And Corporate Governance Challenges; Survey Of Chief Financial Officers With 300 Publicly Held U.S. Companies* (2003), at 7]

⁶¹ Sarbanes-Oxley Section 906: false certifications are subject to fines of not more than \$1 million and/or imprisonment of up to 10 years. Wilful false certifications are subject to fines up to \$5 million and/or imprisonment of up to 20 years.

⁶² Deloitte, *Under Control: Sustaining Compliance with Sarbanes-Oxley in Year Two and Beyond* (2005), at 1

⁶³ This paragraph is paraphrased from: Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance 297-298* (2003)

2.5. When is Sarbanes-Oxley effective

Some provisions became effective upon the enactment of Sarbanes-Oxley on 30 July 2002. These provisions mainly concerned situations where Sarbanes-Oxley merely increased penalties for existing non-compliance with existing (pre Sarbanes-Oxley) legislation, e.g. mail and wire fraud, obstruction of justice, securities fraud, although some new provisions (such as those related to whistleblower protection, destruction of audit workpapers, prohibition of loans to officers and directors) also had immediate effect.⁶⁴ Many provisions only became effective according to the timing indicated below. This intentional delay resulted from the requirements of Sarbanes-Oxley that certain bodies needed to be established and resourced (PCAOB and SEC) before they could draft the rules, regulations and guidance that would implement Sarbanes-Oxley legislation.

Mid-2002 to mid-2003

- Criminal provisions, CEO/CFO certification and most other provisions, except those below.

22 October 2003

- US public accounting firms must be registered with the PCAOB.

19 April 2004

- Non-US public accounting firms must be registered with the PCAOB.
[The 19 April 2004 deadline was extended to 19 July 2004 by the PCAOB Rule 2100.⁶⁵]

15 November 2004

- Section 404 (Management Assessment of Internal Controls) for “Accelerated filers”, i.e. for US companies with a market capitalisation in excess of \$ 75 million.

15 July 2005⁶⁶ (fiscal year ending on or after)

- Section 404 (Management Assessment of Internal Controls) for “Non-accelerated filers”, i.e. for foreign companies and smaller US companies.

The legislative timetable is considerably more complex than the outline indicated above. Effective deadlines for implementation are a function of: which of the 70 SOX provisions are being considered; the status of the company and its external reporting timetable; the specific rule, regulation or guidance from the regulatory body that implements the provision (e.g. SEC, PCAOB).

⁶⁴ Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 294 and 298 and 301 (2003)

⁶⁵ Public Company Accounting Oversight Board, PCAOB release no. 2004-003: Registration Deadline For Non-U.S. Accounting Firms, March 11, 2004

⁶⁶ This 15 July 2005 deadline is under consideration for a further delay (for non-accelerated filers) until 15 July 2006.

2.6. Who needs to comply with Sarbanes-Oxley

Most of the Act applies to entities who have issued securities that are listed on US securities exchanges,⁶⁷ whether they are US or non-US incorporated. Although certain provisions are directed to persons such as CEOs, directors and advisors, irrespective as to whether they are issuers or not. In addition, foreign companies not captured within the above categories may be obliged to comply with certain Sarbanes-Oxley provisions by virtue of the fact that they are branches or subsidiaries of a Sarbanes-Oxley reporting entity, or, separately, they have a certain number of US-based shareholders. Those impacted by Sarbanes-Oxley obligations can be broadly classified as follows.

US public companies⁶⁸

- US operations
- Foreign subsidiaries⁶⁹ and branches

Non-US public companies⁷⁰

- US subsidiaries and operations (of a non-US company that has a US securities listing)
- Foreign subsidiaries and branches of a non-US company that has a US securities listing (e.g. a UK subsidiary of Dutch multinational AEGON must comply due to AEGON's US listing.)
- Companies with debt or equity listings on a US securities exchange. (There were some 1300 such "foreign private issuers" from 59 countries listed in 2002.⁷¹)
- Companies with a significant number of US-based investors. (Please refer to section 3.7)

Other legal persons

- Corporate officers, i.e. CEO, CFO, directors
- Public company audit firms, their partners and employees
- Lawyers, securities analysts and whistleblowers

⁶⁷ There is a precise classification of such entities/issuers within the provisions of Sarbanes-Oxley, by reference to whether such issuers have registration and reporting obligations under the 1933 Securities and 1934 Securities and Exchange Acts. This captures issuers of American Depositary Receipts Levels 2 and 3 (but not Level 1, which are unlisted and trade Over-The-Counter). [Source: Mayer, Brown, Rowe & Maw (prepared for the United States Chamber of Commerce), *The Sarbanes-Oxley Act of 2002 and its Impact on European Companies*, September 2002, at 3]

⁶⁸ For the purposes of Sarbanes-Oxley, "public" companies includes those companies which are "unlisted" (i.e. no publicly-traded shares), but which have public debt [Source: Robert Half International, *The Impact Of Sarbanes-Oxley On Private Business; Are The New Rules Giving Rise To A Universal Standard* (2003), at 7]

⁶⁹ Not each and every subsidiary of a SOX-reporting company needs to comply; it should be materially significant.

⁷⁰ Categorisations taken from: Booth G., *Get into training for the new regime*, Accountancy (UK), January 2005, at 42

⁷¹ Rouse R.W., *How will Sarbanes-Oxley affect foreign companies*, 14 *Journal of Corporate Accounting & Finance*, September 2003, at 55

Voluntarily compliant

“Senator Paul Sarbanes emphasized in remarks to the Senate that the new law applies only to public companies.”⁷² This may well have been the political intention, but the economic reality is that SOX is being imposed on many other companies. So although it may be correct to use the term “voluntary compliance” – because compliance is not required by the Act – other external pressures such as societal/peer pressure, best practice and or contractual arrangements, result in the following groups also being subject to Sarbanes-Oxley.

- “Mutual organisations, government agencies and even larger universities”⁷³
- “Companies may find that their lenders, institutional investors and/or insurers⁷⁴ may require compliance with some or all of the corporate governance provisions contained in the Act.”⁷⁵
- Companies preparing for mergers & acquisition activity (either as bidder or target) may perceive being SOX compliant as beneficial, thereby reducing any doubts over governance.
- Other private companies who “self-impose” compliance for their own (non-mandatory) reasons, for example⁷⁶: “in the expectation of a public offering someday”, “improvement in quality of financial reporting, which translates into higher comfort levels for lenders, investors and customers”, “we are a private company, but bigger than many public companies, so we want to be in step with governance best practices”.

From the above one can conclude that if a foreign company has no contact with the US (i.e. no trade, no transactions, no office, no securities registration, no significant US shareholdings/investors in that foreign company⁷⁷), and, importantly, if that foreign company does not have any contractual obligation to comply with SOX, then that company will generally not be subject to the Act.

⁷² Mautz Jr. R.D. and Kiel M., *How Will Sarbanes-Oxley Touch Non-public Companies*, 6 Journal Of Corporate Accounting & Finance, September/October 2004, at 7

⁷³ Booth G., *Get into training for the new regime*, Accountancy (UK), January 2005, at 42

⁷⁴ An example of insurers insisting on compliance: “Insurers have warned that companies failing to comply with new accounting and corporate governance laws may have their liability insurance withdrawn. Insurers state directors could be liable for multi million pound negligence claims if companies do not meet imminent deadlines for the International Financial Reporting Standards and Operating and Financial Reviews. They add companies must comply with the US Sarbanes-Oxley Act to retain liability cover.” [Source: Seib C., *Insurers threaten to recall cover for liability*, Times (UK), 18 October 2004, at 43]

⁷⁵ Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 296 (2003)

⁷⁶ Examples taken from US 2004 survey reported in: Hartman T.E. of Foley & Lardner LLP, *The Impact of Sarbanes-Oxley On Private Companies* (2004), at 3. That same survey indicated that 77% of private organisations felt that “the Sarbanes-Oxley Act or other corporate governance reform requirements have impacted their organisations”.

⁷⁷ SEC: “Foreign private issuers with total assets in excess of \$10,000,000 and a class of equity securities held of record by 500 or more persons, of which 300 or more reside in the United States, are subject to registration under Section 12(g) of the Securities Exchange Act of 1934 [...]” [Source: SEC website: <http://www.sec.gov/rules/other/34-39681.htm>]

2.7. Exceptional treatment for foreign companies

The original Sarbanes-Oxley legislation does not directly provide exceptional treatment (or exemptions) for non-United States companies. However exemptions are achieved indirectly by the Act referring to SEC rules, within which there is differential treatment for “foreign private issuers”.

[a] “foreign private issuer” is a company that is incorporated outside the United States and in which:

- (1) United States residents do not hold a majority of the shares; or
- (2) If United States residents do hold a majority of the shares, then:
 - (a) a majority of its directors and officers are not United States citizens or residents;
 - (b) its business is administered from outside the United States; and
 - (c) a majority of its assets are located outside the United States.⁷⁸

Financial reporting and disclosure

- Differences in the reporting of financial results by foreign private issuers (vs. US registrants) were already embedded in SEC regulations prior to Sarbanes-Oxley. The Act simply reinforces this differential treatment by reference to the SEC regulations. Some examples are listed below.
- “Quarterly reporting for foreign private issuers is not required unless the foreign country’s regulatory agency mandates interim reporting on a quarterly basis”.⁷⁹
- Financial reporting via the electronic EDGAR system is optional for foreign private issuers.
- Foreign private issuers can choose between one of three bases of accounting for the financial reporting⁸⁰: US GAAP, International Financial Reporting Standards (IFRS), local GAAP.⁸¹

⁷⁸ Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 295 (2003)

⁷⁹ Rouse R.W., *How will Sarbanes-Oxley affect foreign companies*, 14 *Journal of Corporate Accounting & Finance*, September 2003, at 56

⁸⁰ *See*, Glossary for explanation of these terms. Reconciliations to US GAAP are still required (*see* section 3.7)

⁸¹ For a description of the differences between US GAAP and IFRS, *see, e.g.*, PricewaterhouseCoopers: *Similarities and Differences – A comparison of IFRS and US GAAP* – October 2004. For an overview of how IFRS affects UK GAAP accounts, *see, e.g.*, Trapp R., *IFRS: What are the Main Changes to Accounts*, *Financial Times*, 28 September 2004

Auditor and Audit Committee independence and activities

- Audit partner rotation requirement⁸² would not apply to partners serving an issuer's foreign subsidiary that amounts to less than 20 percent of issuer's consolidated assets or revenues.⁸³
- The "cooling-off" period required of audit team members prior to working for an issuer is waived in countries where such employment restrictions are prohibited by local labour laws.
- "The [PCAOB] has authority to exempt any foreign public accounting firm from any provision of Sarbanes-Oxley or the rules of the [PCAOB] or the SEC issued under Sarbanes-Oxley."⁸⁴ Although the PCAOB has been somewhat reluctant to use this authority, especially after *Ahold* became "Europe's Enron"⁸⁵. They used examples of European corporate malfeasance – such as *Ahold* – to justify and "successfully negotiate the extension of [PCAOB] oversight to European accounting firms working in the US or working on foreign companies listed in the US."⁸⁶ However, as the next point illustrates, the PCAOB acknowledged the need for exceptional treatment for foreign public accounting firms.
- "The [PCAOB] rules raise special concerns in relation to non-US firms. In an effort to address such concerns, the [PCAOB] could implement [Sarbanes-Oxley's] provisions by relying [...] on a non-US system."⁸⁷ The exception envisaged by the PCAOB was to allow foreign public accounting firms to register with their own domestic registration entity (rather than directly with the PCAOB). The domestic registration entity would then submit to the US PCAOB.⁸⁸ To facilitate this 'change of rules', the PCAOB extended the registration deadline for foreign public accounting firms by 90 days to 19 July 2004.⁸⁹
- The "financial expert" of a foreign private issuer will satisfy the GAAP qualification requirement if he has an understanding of the foreign private issuer's local GAAP (rather

⁸² Sarbanes-Oxley Section 203

⁸³ Rouse R.W., *How will Sarbanes-Oxley affect foreign companies*, 14 *Journal of Corporate Accounting & Finance*, September 2003, at 57

⁸⁴ Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 311 (2003)

⁸⁵ *Ahold – Europe's Enron*, *Economist*, 27 February 2003 (*The Economist* website August 2005)

⁸⁶ Jong A. de, Jong D.V. de, Mertens G. & Roosenboom P., *Royal Ahold: A Failure Of Corporate Governance* (2005), 4

⁸⁷ Public Company Accounting Oversight Board, PCAOB release no. 2004-003: Registration Deadline For Non-U.S. Accounting Firms, March 11, 2004, at 2

⁸⁸ Public Company Accounting Oversight Board, PCAOB Release No. 2003-020: Briefing Paper; Oversight Of Non-U.S. Public Accounting Firms, October 28, 2003, at 4

⁸⁹ Public Company Accounting Oversight Board, PCAOB release no. 2004-003: Registration Deadline For Non-U.S. Accounting Firms, March 11, 2004, at 1

than US GAAP). Furthermore, the issuer will not need to disclose whether the “financial expert” is “independent” from management (as is the requirement of US registrants).⁹⁰

- SOX mandated US stock exchange listing standards require compliance regarding audit committees by 31 July 2005 (whereas for US registrants the deadline is 1 December 2003⁹¹).
- Where foreign private issuers have ‘boards of auditors’ or ‘statutory auditors’ (in accordance with their home country obligations), they may be exempt from the “independence” (SOX) requirements for audit committees, provided certain minimal conditions are satisfied.
- Similarly, where a foreign private issuer has a two-tier board (typically comprising a management board and a supervisory board – as in Germany, for example), no separate audit committee need be formed provided that the supervisory board is non-management and independent, and is designated as the audit committee for the purposes of the Act.

Other exemptions

- Sarbanes-Oxley requires CEO/CFO certifications on certain forms⁹² (e.g. financial reports such as 10-K and 10-Q) filed with the SEC. Since foreign private issuers typically use different forms (e.g. 6-K and 8-K), to which certifications do not apply, “foreign private issuers are exempt from providing these certifications”.⁹³ But this “exemption” is not so clear-cut. “The certification requirements apply to non-US companies’ annual reports filed on Form 20-F, but not current reports submitted on Form 6-K.”⁹⁴
- SOX mandated standards of conduct for lawyers do not apply to “non-appearing foreign attorneys” [i.e. who practice law outside the US and do not give advice regarding US law]⁹⁵ or if such “advice on SEC matters is only incidental to their practice outside the US”.⁹⁶

⁹⁰ Sarbanes-Oxley Section 407

⁹¹ Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 305 (2003)

⁹² Explanations of the main types of SEC forms mentioned in this paragraph can be found in the Glossary (SEC Forms).

⁹³ Rouse R.W., *How will Sarbanes-Oxley affect foreign companies*, 14 *Journal of Corporate Accounting & Finance*, September 2003, at 56. *But cf.* “In April 2003 the SEC exempted foreign companies from most of [SOX] requirements, although CEOs must still certify financial results and accept personal criminal liability if the statements are proven invalid.” [Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, *CPA Journal*, February 2004, 38]

⁹⁴ Freshfields Bruckhaus Deringer, *The Sarbanes-Oxley Act and US Regulatory Developments*, April 2004, at 2

⁹⁵ Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 316 (2003)

⁹⁶ Freshfields Bruckhaus Deringer, *The Sarbanes-Oxley Act and US Regulatory Developments*, April 2004, at 11

This chapter has briefly outlined the complexity of Sarbanes-Oxley in terms of how and when it applies. It indicated to what extent certain groups such as EU companies can now escape certain requirements, whilst other groups such as private companies can be captured within SOX reach. It traced this complex application and implementation to the original legislative passage which was too rapid to allow all interested parties to be heard, and too brief to allow its intent to be spelt out with any comprehensive clarity. The chapter put into context this imperfect legislative process, summarising the agitated political and corporate climate at the time of enactment. The law is explicit in its aim to wield jurisdiction over foreign companies, if they want to seek US capital. Nevertheless, the chapter confirmed certain regulatory flexibility by way of the exemptions and exceptional treatment available to foreign private issuers (as summarised in the last section). The next chapter explores how this emerging SOX is impacting its subjects, especially those in the EU.

3. ACTUAL IMPACTS OF SARBANES-OXLEY ON EU COMPANIES AND OTHERS

This chapter outlines selected impacts of SOX on EU companies, using observations from the US wherever EU experience is unavailable. It starts by assessing whether such impacts and their costs were foreseeable. A key focus is SOX Section 404 on internal controls – its scope, timing and costs. Knock-on effects of Section 404 are also reviewed, for example, the structural and cost changes in the audit professions, and we show how these secondary effects rebound to impact companies that are subject to SOX. Is there any escape? We look at the options of delisting or remaining a private company, but conclude that such is the widespread influence of SOX that these are not solutions.

3.1. Actual impacts – “foreseeable” or “unintentional” or both

The wide-ranging scope and staggered timetable of Sarbanes-Oxley have resulted in widespread uncertainty of the applicability of its provisions to foreign companies. A 2003 survey⁹⁷ concluded that four percent of affected EU firms did not even realise that Sarbanes-Oxley applied to them.

Nonetheless, a UK-based multinational with a securities (debt or equity) listing and business operations in the US will be subject to the Act provisions in a number of areas. This would have been foreseeable from the text of the Act. On the other hand, the high costs and wide reach of the Act has surprised many observers. Some go as far to say that these results were “unforeseeable”.

Probably the answer depends on how much thinking was done upfront. Sarbanes-Oxley passed through the US Congress in record time with near-unanimous support.⁹⁸ Some say this was a quick bad enactment brought about by pressures from a variety of constituencies, pushing US lawmakers to act before they were prepared. Lack of preparation for a new law and/or absence of sufficient deliberation and consultation can result in unintended consequences, one extreme being where the law is counterproductive and in fact has the complete opposite effect of its intention. An example of such extremity is illustrated by the following account when Congress rapidly enacted reform to decrease excessive executive remuneration, resulting in loopholes that actually increased pay:

⁹⁷ Research carried out by HandySoft and Marketing UK, as reported in: Dayasena M., *European companies listed in US faced with high costs of Sarbanes-Oxley compliance*, 342 International Accounting Bulletin, February 2004, at 4

⁹⁸ Passing through the Senate by 99 to 0 votes and the House by 423 to 3 votes.

[...] in the early 1990s, Congress set out to encourage companies to link salaries to performance by eliminating the deductibility of executive payments over \$1 million that were not tied to performance. Expanded use of stock options linked to stock performance was an obvious solution to the new constraints. In many instances, inflated nine-figure option-fueled compensation awards resulted from legislation originally intended to flatten compensation.⁹⁹

The author of this account then goes on to suggest that this enhanced use of performance-related pay led to a corporate mentality of achieving targeted earnings “at all costs”, eventually cumulating in fraudulent “profit-inflating” schemes such as those that brought down *Enron* and leading to the passage of another ill-thought through piece of legislation, namely Sarbanes-Oxley Act of 2002.

Other commentators, such as Alan Greenspan (Chairman of the US Federal Reserve) expected unintended consequences (from the Act), but were “surprised that a law which had been passed [through Congress] so rapidly had worked as well as it has...”¹⁰⁰ Our own view is neither as optimistic as Mr. Greenspan nor as pessimistic as our first commentator on executive pay above. The examples of “foreseeable” and “unintended” consequences and impacts that follow suggest that it is premature to conclude one way or the other, and that these are developments in the making that have yet to reach conclusion. It is premature because, despite enactment in 2002, many key Sarbanes-Oxley provisions only have effect in 2005,¹⁰¹ or the results of 2004 compliance are only reported in 2005.¹⁰² This chapter therefore analyses the impacts in the following sections without concluding definitively to what extent they could have been foreseen and/or intended.

3.2. Section 404 (“Management Assessment of Internal Controls”)

Section 404 has caused the greatest burden and cost to companies. “Most observers would agree that Section 404 of the Act, on the attestation of financial reporting controls, is its most momentous provision, at least at present.”¹⁰³ “Accelerated filers” (i.e. large US companies) with international operations have faced the most significant compliance challenges. According to a recent study,¹⁰⁴ the key challenges relate to: the existence of appropriate audit committees; ineffective financial closing and reporting processes; ability to evaluate controls over service organisations; existence of effective internal audit function; complex multiple-location environments; US GAAP expertise

⁹⁹ Howe H. and Gifford R.H., *Regulation and Unintended Consequences: Thoughts On Sarbanes-Oxley*, CPA Journal, June 2004, at 6, 8

¹⁰⁰ *Sarbanes-Oxley – A Price Worth Paying?* Economist, 19 May 2005 (website August 2005)

¹⁰¹ Importantly, foreign companies only need to report on the critical Section 404 (internal controls) from 15 July 2005.

¹⁰² “More than 4000 large and medium-sized US public companies began complying with Section 404 last year [2004], and have been outlining the state of their internal controls in recent annual reports.” [Source: Parker A., ‘Use your judgment on Sarbanes 404’, Financial Times, 17 May 2005, at 20]

¹⁰³ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 Information Systems Control Journal 2004, at 17

¹⁰⁴ Deloitte Touche Tohmatsu, *Sarbanes-Oxley Section 404: Compliance Challenges For Foreign Private Issuers* (2005)

deficiencies; management's experience to assess internal control over financial reporting; other challenges (language, computer controls, fraud prevention, etc.). "Indeed, so challenging was section 404 implementation that the Securities and Exchange Commission thrice delayed compliance deadlines, once in 2003 and twice in 2004."¹⁰⁵

The SEC effectively acknowledged that if these are challenges for "accelerated filers", then similar or greater issues would be faced by "non-accelerated filers" (e.g. non-US and small US companies):

[t]he benefits of 404 reports are too important not to do it right. An appropriate delay for these issuers might be desirable if, by waiting for [...] foreign private issuers to work through conversion to IFRS, it achieves more effective implementation of the internal control reporting requirements.¹⁰⁶

The SEC did eventually allow a delay for Section 404 implementation for non-US companies. However, postponement does not address the underlying concerns of many EU companies and opponents (to the Act). Part of this resistance from Europe stems from the different approach to matters such as auditing, financial reporting and corporate governance. Whereas the regulatory frameworks governing these activities in Europe traditionally focus on the necessary *principles* that need to be followed, US frameworks focus on specific regulations and *rules*, often referred to as a "check-the-box" approach.¹⁰⁷ Critics of the Act, such as Boston College (USA) law professor Lawrence Cunningham, argue that one consequence of this "rule-based" approach "is that [SOX] controls are written to be auditable rather than to address the underlying problem that they were originally intended to address."¹⁰⁸ It would seem that the SEC has been listening to these concerns:

A one-size-fits-all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve controls and financial reporting than a reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.¹⁰⁹

And the SEC's Assistant Chief Accountant recently confirmed that "the top-down approach in a risk-based assessment is something everyone will probably hear a lot of as we go through the second year [of compliance with Section 404]."¹¹⁰ These clarifications and supplementary guidance, which came as a result of the initial Section 404 submissions by US companies in early 2005, will be beneficial to foreign companies who can now adopt a risk-based approach from their Year 1.

¹⁰⁵ Deloitte, *Under Control: Sustaining Compliance with Sarbanes-Oxley in Year Two and Beyond* (2005), at 1

¹⁰⁶ Donaldson W., SEC Chairman, *Relief for Foreign Private Issuers*, SEC press release of 7 February 2005

¹⁰⁷ The paper explores the differences of "*principles-based* versus *rules-based*" approaches later in the section 4.3.

¹⁰⁸ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 *Information Systems Control Journal* 2004, at 19

¹⁰⁹ SEC staff as reported in: Parker A., *'Use your judgment on Sarbanes 404'*, *Financial Times*, 17 May 2005, at 20

¹¹⁰ As reported in: Doyle S., *Grappling with Section 404*, *Internal Auditor*, August 2005, at 59

3.3. Impact on company ratings

The major ratings agencies have stated that Section 404 control weaknesses will influence their assessment of company ratings. In an October 2004 special report from Moody's Investor Services (*Section 404 Reports on Internal Control: Impact on Ratings Will Depend on Nature of Material Weaknesses Reported*¹¹¹), Moody's stated that material weaknesses in company-level controls (such as the financial reporting process), "may result in us bringing a company to rating committee to determine whether a rating action is necessary [given that such] weaknesses call into question not only management's ability to prepare accurate financial reports but also its ability to control the business."¹¹² Fitch Ratings issued a similar report in January 2005.¹¹³ However, Moody's recently indicated that the number reported material (control) weaknesses are much less than expected:

[t]his year, for the first time, companies have been filing the reports required by section 404. Fewer large companies are reporting problems with their internal controls than had been expected. Moody's, a rating agency, says that about 5% of the companies that it rates had reported material weaknesses up to April 1st [2005], compared with the 10-20% that the market had been expecting. That figure might rise as smaller companies, which have been given extension to their reporting deadline, start to file.¹¹⁴

3.4. Incremental costs of Sarbanes-Oxley implementation

Observed extra costs

Various cost-benefit analyses have been conducted to assess the merits of Sarbanes-Oxley implementation. Most of the costs result from additional audit firm fees to meet compliance with Sarbanes-Oxley.¹¹⁵ The cost estimates vary wildly, with one survey¹¹⁶ suggesting that US-listed EU companies will incur additional audit fees of an aggregated Euro 370 million annually. Another indication of the high costs involved is a recent report estimating that US businesses have run up US\$ 1.4 billion.¹¹⁷ And yet another study¹¹⁸ suggested the cost of Sarbanes-Oxley Section 404 (internal controls) compliance was a staggering US\$ 7 (seven) billion in the first year alone.

¹¹¹ See, Appendix N for an extract from this report, indicating the type of internal control weaknesses that are reported.

¹¹² Deloitte Touche Tohmatsu, *Sarbanes-Oxley Section 404: Compliance Challenges For Foreign Private Issuers*, at 1

¹¹³ "Sarbanes-Oxley 404 – Fitch's Approach to Evaluating Management and Auditor Assessments of Internal Controls"

¹¹⁴ *Sarbanes-Oxley – A Price Worth Paying?* Economist, May 19 2005. *But cf.*: "As of May 15, 2005, 2,963 accelerated filers have disclosed their Section 404 opinions. Of these, 12.25%, or 363, received failing grades (material weakness opinions)." [Source: AuditAnalytics, *Section 404 Material Weakness Disclosures Will Exceed 14%*, 18 May 2005]

¹¹⁵ Key sources of Sarbanes-Oxley-related incremental costs to business stem from: "rising director and officer insurance; higher fees for external audits; increased costs related to internal audit expansion; and possible compensation increases for senior executives and board members." [Robert Half International, *The Impact Of Sarbanes-Oxley On Private Business; Are The New Rules Giving Rise To A Universal Standard* (2003), at 12]

¹¹⁶ Research carried out by HandySoft and Marketing UK, as reported in: Dayasena M., *European companies listed in US faced with high costs of Sarbanes-Oxley compliance*, 342 *International Accounting Bulletin*, February 2004, at 4

¹¹⁷ Wall E., *Sarbanes-Oxley Act: the level of scrutiny has never been greater: So far, putting the legislation into practice has cost businesses in the United States USD 1.400 billion*, *Times* (UK), 21 June 2005, at 6

The wide variations stem from the variety of measurement techniques, time and scope covered, and whether one includes internal costs (such as an allocation of expensive management time) or only out-of-pocket costs. Another key source of variation is whether the cost estimates include projects that were planned in any case, but are now captured under the Sarbanes-Oxley banner, e.g. a new internal audit department, EU/IFRS-related financial reporting improvements, establishment of ethical code, SAP/ERP enhancements. Given that most companies do not monitor internal costs of compliance, and if they do, they might not track Sarbanes-Oxley compliance costs separately from other compliance programs,¹¹⁹ any aggregate cost estimates would appear to mere speculation, or, at best, only indicative. What is clear is that the costs are high, and Sarbanes-Oxley implementation takes more than the SEC original assumption of “only a few extra hours of work”.¹²⁰

Potential benefits

The benefits – as usual - are less tangible and even more difficult to quantify, although the first survey cited above goes on to suggest that:

[o]ver half (57.8 percent) of the companies surveyed expected to implement automation by 2005 to significantly reduce compliance costs. [...] The survey found that some companies, mainly in Germany and the Netherlands, had appointed Sarbanes-Oxley specialists to target compliance and to explore business benefits that can be drawn from the project. The benefits included “improved real-time reporting for management information and strategy development, more powerful investor relations statements, better information for corporate finance strategy analysis, business unit performance analysis and cost streamlining.”¹²¹

A more in-depth survey/analysis that focussed on the benefits of SOX 404 compliance, still never *quantified* any tangible benefits, although it did clearly spelt out the qualitative benefits, as follows:

1. [a] more engaged control environment – with active participation by the board, the audit committee, [...].
2. [...] analysis of monitoring controls along with recognition that monitoring is an integral part of the control process.
3. More structure to the year-end closing process and recording of journal entries, [...].
4. Implementation of anti-fraud activities with defined processes in place, [...].
5. Better understanding of the risks associated with general computer controls, and the need to improve both control and audit procedures to gain assurances that the risks associated with computer systems are mitigated.
6. Improved documentation of controls and control processes that can serve as a basis for training, [...].
7. Improved definition of controls, and the relationship of controls and risk, across the organisation.
8. Control concepts becoming embedded into the organisation with broader understanding by operating personnel [...]

¹¹⁸ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 Information Systems Control Journal 2004, at 18

¹¹⁹ PricewaterhouseCoopers survey of US-based multinational companies: “62 percent report Sarbanes-Oxley is integrated with their other corporate regulatory compliance processes, [...] 56 percent, said their company does not track and report internally on the costs of Sarbanes-Oxley and other compliance programs.” [Source: PricewaterhouseCoopers, *Most Large Companies See Sarbanes-Oxley Compliance As Part Of Broader Corporate Governance Initiative*, Management Barometer, July 2004]

¹²⁰ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 Information Systems Control Journal 2004, at 18

¹²¹ Research carried out by HandySoft and Marketing UK, as reported in: Dayasena M., *European companies listed in US faced with high costs of Sarbanes-Oxley compliance*, 342 International Accounting Bulletin, February 2004, at 4

9. Improvements in the adequacy of the audit trail as a basis to support operations as well as to support audit assessment of control adequacy and financial reporting.
10. Re-implementation of basic controls, e.g., segregation of duties, periodic reconciliations of accounts, and authorisation processes that had been eroded as organisations downsized or consolidated operations.¹²²

Expectations for the future

Although such benefits can be expected to continue year-after-year,¹²³ the cost of compliance should come down given the Year 1 investment in systems, procedures and expertise should not need to be repeated in Year 2 and beyond. However, given SOX requirements for certifications of the *current* effectiveness of internal controls, commentators do not expect annual compliance costs to come down dramatically, given the need for auditors to re-validate (and CEO/CFO to re-certify) internal controls within the 90-day period prior to each annual report.¹²⁴ “Estimates predict that the ongoing annual cost of compliance will equal up to 75% of the first year investment.”¹²⁵ The source of SOX-related cost increases for the EU is likely to be similar to those of their US counterparts.¹²⁶

The American Institute of Certified Public Accountants (AICPA) has identified these as follows:

[t]hese expenses will likely be spent on increased technology, consulting, legal and audit fees, as well as higher premiums for directors and officers' liability insurance. The AICPA estimates that companies expect to spend an average of 32% more on internal audit and 16% on information systems while the FEI survey respondents estimate the average dollars in consulting costs related to Sarbanes-Oxley compliance at \$480,000.¹²⁷

This US\$ 480,000 is an average. Large multinationals are indicating costs in the tens of millions,¹²⁸ mainly due to higher audit fees, which some interpret as being linked to higher-quality audits:

What is new is that SOX has done [...] great service in demanding that auditors go back to basics and stop cutting corners [...] But apparently this reversion to basics [...] has a huge cost – and General Electric and BP, to quote two recent outcries, complain that ‘governance compliance’ in all its forms, but mainly SOX, will now cost them annually some \$30 [million] and \$125 [million] respectively.¹²⁹

¹²² The “Top 10” list of control improvements/benefits as extracted from: Rittenberg L. and Miller P., *Sarbanes-Oxley Section 404 Work: Looking at the Benefits*, Institute of Internal Auditors Research Foundation website, January 2005,¹²

¹²³ *But cf.*: “[...] roughly one half of over 200 public companies responding to a recent email questionnaire indicated that they will spend at least \$500,000 on Sarbanes-Oxley compliance. When asked “Has going through the Sarbanes-Oxley compliance process yielded any internal benefits for your company”, 52% of the respondents answered “No”. Indeed, 70% believe that the benefits of compliance do not outweigh the costs.” [Sources: Nyberg A., *Sticker Shock*, CFO Magazine, 1 September 2003, at 7; Baker & McKenzie North America, *The Sarbanes-Oxley / Outsourcing Intersection: An Introduction*, US Outsourcing Client Alert, September 2004, at 1]. *See, also*, Appendix H re: benefits.

¹²⁴ The 90-day period limitation, as required by SOX Section 302(a)(4)(C).

¹²⁵ Booth G., *Get into training for the new regime*, Accountancy (UK), January 2005, at 43. *But cf.* “Contrary to some predictions, the overall costs increases associated with corporate governance reforms in FY 2002 were not a one-time event. Costs continued to increase in FY 2003...” [Source: Hartman T.E. of Foley & Lardner LLP, *The Cost Of Being Public In The Era Of Sarbanes-Oxley* (2004), at 2]

¹²⁶ *See*, Appendix E(i) for perspective on how Section 404 costs vary by size of company

¹²⁷ American Institute Certified Public Accountants, *A Reasoned Approach to Reform - White Paper* (October 2003) at 4

¹²⁸ “The average estimated cost of first-year implementation for large companies is upward of US\$ 35 million.”

[Source: Mintz S., *Corporate Governance in an International Context: legal systems, financing patterns and cultural variables*, 13 *Corporate Governance: An International Review* 2005, at 582]

¹²⁹ Woolf E., *Sarbanes-Oxley and the Law of Unintended Consequences*, Accountancy (UK), September 2004, at 101

3.5. Increased demand for the accountancy/audit profession

The fall of *Enron* and the subsequent enactment of Sarbanes-Oxley affected the auditing profession in both positive and negative ways, but, overall, it enhanced the role¹³⁰ and demand for qualified auditors. Following is a brief examination of the factors that lead to this development.

The greater transparency of reporting requirements of Sarbanes-Oxley (alongside IFRS in the EU) has resulted in a considerable increase in demand for qualified professionals.¹³¹ Some of this demand has gone to the (external) accountancy firms, with the rest being absorbed internally by companies. Internal requirements stem from, for example, Sarbanes-Oxley induced pressures for an internal audit function and enhanced financial reporting and transparency. External audit firms benefit from, for example, the increased scope of an audit engagement to include certification of management's assessment of internal controls (SOX Section 404), as well as the "assistance" that they give companies to become Sarbanes-Oxley compliant.

The destruction of the accountancy firm, *Arthur Andersen*, following the indictment by the US Department of Justice in 2002, was positive for the demand and profitability of surviving individual competitor accountancy firms, but broadly neutral for the overall demand. Essentially, *Arthur Andersen*'s clients and staff were "reallocated" to the remaining "Big Four" accountancy firms.¹³²

As a result of companies shifting consulting work away from their auditors, non-audit fees dropped significantly after the introduction of Sarbanes-Oxley, with some estimates indicating a 20% decrease.¹³³ Unlike the *Arthur Andersen* "reallocation" of clients which essentially kept fee income within the big accountancy firms, Sarbanes-Oxley resulted in lucrative non-audit consulting services going "outside" the profession. Some of this business was simply assumed by the consultancy firms that were affiliated with (or spun-off from) the Big Four accountancy firms (e.g. Deloitte Consulting, KPMG Legal, Capgemini). Legal services, some tax planning, information technology consultancy, management consultancy, M&A and all the non-audit services (or

¹³⁰ "The accounting firms say that the fall of Enron and Arthur Andersen has done their recruitment no harm: instead, they claim, it has made students realise that accounting is not mere number-crunching, but also involves moral judgments. The "Big Four" accounting firms are all among this year's top 15 ideal employers." [Source: *Undergraduate Recruitment - In Search Of The Ideal Employer*, Economist, 18 August 2005] . See, Appendix E(ii) for full table.

¹³¹ For example: "Companies across Europe are scrambling to recruit experts in International Financial Reporting Standards, which are being introduced in the European Union this year [...]" [Source: Jopson B., *Rush to find IFRS experts*, Financial Times, 21 February 2005, at 19]

¹³² "The Big Four" accountancy firms: Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers. An example of this "reallocation" was that the operations of Arthur Andersen in The Netherlands was essentially absorbed within Deloitte.

¹³³ Hartman T.E. of Foley & Lardner LLP, *The Cost Of Being Public In The Era Of Sarbanes-Oxley* (2004), at 2

“prohibited activities” as described by Sarbanes-Oxley in Section 201¹³⁴) trickled back to the traditional specialised service providers. There is little evidence that companies decided to award non-audit service contracts to an accountancy firm other than their auditor;¹³⁵ hence the overall reduction in the fee income from non-audit services of the Big Four. Such was the decline in fee income, that there was some speculation in the UK that some audit firms may venture back into consulting;¹³⁶ after all Deloitte has managed to keep its consulting business.

The combined effect of scarce accounting manpower and restrictions on the provisions of non-audit services led the Big Four firms to reassess their client lists for pure audit work. Smaller unprofitable clients and “high-risk” clients were “dropped”, often by a suggestion of sharply-increased audit fees ‘for next year’. Larger clients with lucrative non-audit projects/services were being advised by their principal audit partner that perhaps an alternative Big Four or medium-sized firm could do next year’s audit ‘just as well’, and, ‘in any event, I’ll have to be “rotated” off your company soon in any case’ (SOX Section 203 on audit partner rotation). The objective behind the Big Four reassessment of long-time clients would be to target the optimal profitable mix of audit and non-audit clients.

In net, the combination of all these factors have resulted in greater demand and recognition for the accountancy profession, despite the original expectations as contrasted in the following extract:

[o]riginally, the [Sarbanes-Oxley] Act was seen as imposing additional regulation on the accounting profession as punishment for its ethical lapses; now, it is derided as a full employment Act for those same accountants, as firms complain about burden that section 404 of the Act imposes upon them.¹³⁷

Even the PCAOB is complaining that they cannot find enough available qualified accountants:

[t]his underlines a notable unintended consequence of the legislation: it has provided a bonanza for accountants [...] The demand for accountants has surged to such an extent that the PCAOB has had to curb its own growth plans. In January, Thomas Hohman, the agency's CFO, told Accounting Today, “We would like more [experienced auditors], but we recognise this is a very tight employment market.” This shortage of personnel in a profession on whose shoulders the law has placed heavy new responsibilities is one of the uncertainties hanging over the act's future effectiveness.¹³⁸

¹³⁴ See, Appendix F for the list of Sarbanes-Oxley Section 201 prohibited non-audit services. Certain tax work is acceptable, providing that it is first approved by the Audit Committee. This relaxation came after “SEC’s backtracking [...] of the barring of tax shelter planning by auditors (effected by the accountants’ lobby).” [Source: Ronen J. and Berman A., *Musings on Post-Enron Reforms*, 19 Journal of Accounting, Auditing & Finance, Summer 2004, at 332]

¹³⁵ The picture is not so clear cut for two reasons, since there are some indications that accounting firms have kept some consulting business, but just not “classified” it as such. [Source: Reed K., *Consultancy - Firms' Ardent Denials Seem Shortlived*, Accountancy Age (website), 19 July 2004]

¹³⁶ Reed K., *Consultancy - Firms' Ardent Denials Seem Shortlived*, Accountancy Age (website), 19 July 2004: “[...] it begs the question of whether another Big Four firm could re-establish a consulting arm. One or more of them must be tempted, especially when their fee income performance over the last 12 months hasn't exactly set the world alight.”

¹³⁷ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 Information Systems Control Journal 2004, at 17

¹³⁸ *Sarbanes-Oxley – A Price Worth Paying?* Economist, May 19 2005 (website August 2005)

3.6. Higher cost and lower quality of company external audits

Section 201 (restricting the non-audit services by an auditor) and section 203 (audit partner rotation) aims to address potential ‘conflict-of-interest’ issues.¹³⁹ But these provisions may well have the secondary effects of both increasing audit costs, and, more debatable, reducing audit quality.

Increased audit fees

“Audit fees reported by the Big Four are up by 25% to 33%. [...] Audit fees are expected to rise an additional 35% by mid-2004.”¹⁴⁰ Although there are many factors behind these developments,¹⁴¹ there are three key drivers:

- The increased demand for a limited pool of qualified auditors driving up costs of recruitment and employment (please refer to the previous section discussing this).¹⁴²
- Inability of audit firms to offset the high real costs of auditing by taking income from the higher-margin consulting work, result in audits being charged out at full cost recovery rates, rather than the lower rates (that could be cross-subsidised from non-audit services).
- Auditors must now do extra work in order to gain the requisite knowledge needed to do a proper audit.¹⁴³ Previously auditors had access to this knowledge base (of company-specific information, strategy, operations, business processes and internal controls, etc.) through their involvement in the provision of non-audit services and/or a long relationship of performing audits with that company. Both of these sources are now restricted by Sarbanes-Oxley (provisions on “non-audit services” and “auditor rotation”).

¹³⁹ See, Appendix F for the list of Sarbanes-Oxley Section 201 prohibited non-audit services.

¹⁴⁰ Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, at 37

¹⁴¹ “A March 25, 2004, article on CFO.com cited an average 23% audit fee hike in a sample of North and South Carolina firms, with one Charlotte-based manufacturer incurring a 127% increase.” [Source: Howe H. and Gifford R.H., *Regulation and Unintended Consequences: Thoughts On Sarbanes-Oxley*, CPA Journal, June 2004, at 8]

¹⁴² The tight supply of qualified auditors is likely to be felt internationally, given the global scope of the activities that are absorbing them (e.g. international corporate governance, financial reporting and risk management). Rob Bosman, the technical director of NIVRA, a Dutch professional accountancy body said: “We do expect a shortage of auditors in the next few years.” [Source: *The Netherlands: A War of Independence*, The Accountant, July 2005, at 18]

¹⁴³ “The new [SOX Section 404] requirement of the external auditors’ attestation report on internal controls will not only increase hiring in the public accounting profession to do this additional work, but it will also provide additional revenue resources to public accounting firms that were restricted by other provisions of [SOX], particularly in providing “consulting” and “internal control outsourcing” services.” [Source: Geiger M. and Taylor III P., *CEO and CFO Certifications of Financial Information*, 17 Accounting Horizons, December 2003, at 366]

In addition to these three key factors, there are other influences which all point to higher audit fees:

- Higher risk of successful litigation against audit firms,¹⁴⁴ now that they have mandated audit standards to respect.¹⁴⁵ This results in correspondingly higher liability insurance¹⁴⁶ and/or self-insurance provisions, all of which will be passed on as higher audit fees.
- The Big Four will not fiercely compete to get a new audit client,¹⁴⁷ so fees will not be overly competitive, and will therefore probably reflect a fully-costed plus mark-up basis.
- And finally, there will be less competition, since:

[...] one likely result of Sarbanes-Oxley will be a reduction in the number of firms that offer audit services to public companies. Without the ability to use audit services as a “loss leader” to initiate a client relationship that holds the prospect of higher-margin consulting business, many firms will find it desirable to concentrate on consulting and exit the audit field altogether.¹⁴⁸

To some extent, this reduction in the number of audit firms is already on record. Before Sarbanes-Oxley, there were over 850 accounting firms auditing US public companies, and an additional 250 had the credentials to do so. Only 598 firms registered with the PCAOB by the October 2003 deadline. “Small firms must not only weigh the PCAOB registration costs but also consider the accompanying operating costs, such as increased liability insurance costs, staff training costs, and increased liability risk.”¹⁴⁹

The only potential protection against higher audit fees arising from all these factors is the wrath of the PCAOB, or further legislation, giving it the powers to regulate the audit fees charged by firms.

¹⁴⁴ Although some academics have argued that the litigation risk may shift to the client company as a result of the CEO/CFO certifications now required by SOX. See, e.g., Burrowes A., Kastantin J. and Novicevic M., *The Sarbanes-Oxley Act as a Hologram of Post-Enron Disclosure: a Critical Realist Commentary*, 15 *Critical Perspectives on Accounting* 2004, at 807: “Reducing reliance on the external auditor’s opinion seems also to potentially shift liability away from the audit firm” [to the client company whose officers certified the accounts].

¹⁴⁵ Wiesen J., *Congress Enacts Sarbanes-Oxley Act of 2002: A Two-Ton Gorilla Awakes and Speaks*, 18 *Journal of Accounting, Auditing & Finance*, Summer 2003, at 429: “The setting of auditing standards can be taken away from the profession by the Public Company Accounting Oversight Board.” (Sarbanes-Oxley Section 103)

¹⁴⁶ Partner liability insurance for LLP directors closely track Director & Officer insurance developments, whereby rates and availability have moved against those seeking coverage: “The market for directors and officers (D&O) insurance has hardened considerable over the last year, with effective limits on coverage (e.g., “entity coverage” caps) that in some cases are well below the level of possible damages.” [Source: Howe H. and Gifford R.H., *Regulation and Unintended Consequences: Thoughts On Sarbanes-Oxley*, CPA Journal, June 2004, at 10]. See, also, Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, at 38: “Rates for D&O insurance, if obtainable, have ballooned by 100% to 400%, depending on the size of the company.” { “[owing to] a combination of rising claims numbers, a doubling of average settlement cost per claim, and increased shareholder activism [...]” [Source: AON Corporation, *Directors and Officers Liability Insurance* (AON website August 2005)] }

¹⁴⁷ “[...] the General Accounting Office (GAO) found that the Big Four audit around 78% of US public companies.” [Source: Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, 37]

¹⁴⁸ Howe H. and Gifford R.H., *Regulation and Unintended Consequences: Thoughts On Sarbanes-Oxley*, CPA Journal, June 2004, at 9

¹⁴⁹ Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, at 37

Lower quality of audit

There are several conflicting influences on whether audit quality will improve or deteriorate as a result of Sarbanes-Oxley implementation, with our view coming down on the side of an eventual deterioration. At the end, we see that this is not necessarily detrimental for clients' internal controls.

Motivating improvement in quality of audit performed by the public accounting firms will be two legal factors: the enhanced litigation risk; the prescribed audit standards as mandated by PCAOB. Further supporting this quality enhancement is the change in external audit processes resulting from Sarbanes-Oxley Section 404 implementation. For example, pre Sarbanes-Oxley auditors would focus tests on preventative controls rather than detective controls. Under Sarbanes-Oxley, both types of controls need to be tested in order to attain a high level of assurance. The nature and extent of other types of audit tests also change.¹⁵⁰

On the other hand, adversely affecting the quality of audit will be two issues related to knowledge and skills. As discussed previously, Sarbanes-Oxley reduces the auditor's knowledge base, since he will no longer have first-hand exposure to the company's broader business and its audit history. And regarding the deterioration in skills available to conduct public audits, our prognosis is that the most skilled and capable people in public auditing will, in an ever-increasing fashion, be tempted away from Big Four (audit) firms before they reach senior manager or partner level as a result of:

- Lower profits in (pure) public company auditing will remove a key attraction for capable individuals staying on until partner level. Their colleagues in the consultancy arm or in the other accounting firms who audit private firms (and can therefore keep lucrative consulting business) will be more of an attraction for managers with an initial 3-7 years experience.
- Corporate governance is here to stay with the result being that the corporate sector will have expanding, permanent opportunities for the finance/risk professional that has been initially trained within a Big Four firm. Sarbanes-Oxley has fuelled the expansion of internal audit departments, and this together with other new risk-management functions,¹⁵¹ will attract Big Four audit/accounting managers.

¹⁵⁰ Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, at 39

¹⁵¹ "Companies may also have to consider creating new jobs, such as internal control specialists, and even establishing entirely new groups or divisions to assume responsibility for internal control." [Source: Deloitte, *Under Control: Sustaining Compliance with Sarbanes-Oxley in Year Two and Beyond* (2005), at 7]. See, also, "[...] the time may come for corporate America to place the chief risk officer (CRO) on a permanent rung on the organizational ladder." [Source:

Our assessment that the combined affects of these factors will result in lower quality public audits is a debatable one,¹⁵² which may never reach conclusion since corrective actions may intervene long before. However, we were persuaded of the likely downwards direction in audit quality, given the fact that such interventions by the appropriate watchdog – the PCAOB - would remain difficult (or at best, untimely), given their inability to even recruit suitable staff to perform oversight roles.¹⁵³

And if and when the PCAOB is adequately staffed to properly review the quality of public company auditing, given the “consolidation in the audit market,¹⁵⁴ [there is] some question whether regulators would be able to administer severe sanctions when disciplining the Big Four. A severe sanction, such as a firm-wide one year ban on auditing SEC clients, could put an accounting firm out of business and severely stress the remaining firms to cover the resulting needs of the audit market.”¹⁵⁵

The SEC and the US Department of Justice can therefore no longer afford to pursue one of the big accounting firms to destruction, as was the case with *Arthur Andersen*.¹⁵⁶ One can expect more financially-punitive and pragmatic sanctions similar to the six-month prohibition from accepting new public-company clients that the SEC handed down to *Ernst & Young* in 2004,¹⁵⁷ or the US\$50 million penalty paid by *Deloitte* in April 2005 to settle SEC allegations that its audits should have detected fraud at the company Adelphia Communications Corp.¹⁵⁸ Further government-induced reduction in competition in public company accounting services would not be considered prudent.

It is important to note that despite the above reasons suggesting an eventual deterioration in (external) audit quality, this does not necessarily imply a corresponding deterioration of a client company’s internal controls and financial reporting. The lower (external) audit quality, in this scenario, is countered by the enhanced internal audit function (of the client company), combined with all the other SOX-mandated internal control measures. This suggests that the source of investors’ confidence will in future shift, to some extent, from being derived from the (lower quality) external audit, to the higher quality internal assurances (now with enhanced independence).

Geiger M. and Taylor III P., *CEO and CFO Certifications of Financial Information*, 17 Accounting Horizons, December 2003, at 366]

¹⁵² For a contrarian view, *see, e.g.* the citation at the end of section 3.4 above.

¹⁵³ *Sarbanes-Oxley – A Price Worth Paying?* Economist, May 19 2005 (website August 2005). *See, also*, section 3.5.

¹⁵⁴ For a discussion on this “consolidation in the audit market”, please refer to the earlier paragraphs within this section, *i.e.*, footnote/reference 148 above.

¹⁵⁵ Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, at 38

¹⁵⁶ The handling of Arthur Andersen and resulting reduction in competition is further discussed at the end of section 4.4.

¹⁵⁷ Grant P., *Six-month client ban hits E&Y*, Accountancy Age, 19 April 2004

¹⁵⁸ Weiss M., *Deloitte's Audit of Navistar Is Target of U.S. Probe*, Bloomberg, 8 July 2005

3.7. Escaping Sarbanes-Oxley regulation by delisting or remaining a private company

As with most corporate decisions, the benefits should be seen to outweigh the costs. We have seen in the previous sections that the costs of being listed on a US stock exchange have increased significantly post Sarbanes-Oxley implementation. This cost increase (of being listed on a US stock exchange) manifests itself both in direct costs and extra management time and use of internal resources. Conversely, there is no obvious increase in benefits. The traditional benefits of being listed in the US remain unchanged, but not enhanced. Consequently, it is not surprising to see reports that foreign companies are reassessing their options:

[s]ome non-American companies have threatened not to list in New York because of the cost of the legislation; others that have recently delisted from an American stock exchange are said to have done so partly because of Sarbanes-Oxley; and some 20% of public companies in a study by Foley & Lardner, a law firm, said that they were considering going private to avoid the costs of the act. It would be regrettable if a law intended to improve the quantity and quality of financial information available to investors led many companies to seek relatively unregulated forms or jurisdictions—but that does seem to be happening.¹⁵⁹

There is no indication that of the 1319 or so foreign private issuers with securities registered on US exchanges, a large number are going to rush for the exit. More difficult to assess is whether a large proportion of those companies who wanted to register their securities in the US have been put off by Sarbanes-Oxley. Both groups – whether existing or prospective registrants – will need to consider several supportive and non-supportive factors before deciding on how to proceed.

Delisting or remaining private may not be an escape from Sarbanes-Oxley

As we saw in section 2.6 regarding who needs to comply with Sarbanes-Oxley, if a foreign company delists but is still left with a “significant”¹⁶⁰ number of US-based investors, it is still subject to certain Sarbanes-Oxley provisions. Furthermore, even if it does “fully” delist and escapes this formal “post-delisting continual compliance” measure, it may still be subject to Sarbanes-Oxley “voluntary compliance”, as is the current and growing case for so many private companies as we saw in earlier in section 2.6.

¹⁵⁹ *Sarbanes-Oxley – A Price Worth Paying?* Economist, May 19 2005 (website August 2005)

¹⁶⁰ “[...] companies with 300 or more shareholders in the US are also bound by the requirements of Sarbanes-Oxley [...]” [Source: Howarth F., *Anti Sarbanes-Oxley Mood Rises in Europe*, Register, 11 January 2005]. See, also, “Currently, any non-US company delisting from the US markets that has more than 300 shareholders (the rule of 300) is required to continue its filings and registration with the SEC.” [Knight R., *Don't be Afraid of the Sarbanes-Oxley Act*, Financial Times, 25 April 2005]

The merits of a US listing for a foreign company are not as important as they used to be

To address this point, it is first worth noting where the foreign registrants come from. Out of the 1319 foreign private issuers with SEC registered securities,¹⁶¹ 498 or 38% are from Canada, 364 (28%) are European, with other large groups being Asia-Pacific and Latin America each with about 10%, according to SEC statistics.¹⁶² To some extent, the Canadian companies have had some of the onerous listing requirements mitigated by the so-called “Multi-Jurisdictional Disclosure System”,¹⁶³ and there are other particularities about the US-Canada arrangements that facilitate easier listing for registrants from Canada.¹⁶⁴

However, for the other large group of foreign registrants, those 300+ headquartered in Europe, the benefits of a US listing (e.g. access to US capital, deep liquid markets, being close to their biggest market) are no longer so obvious to new prospective registrants, for reasons to be reviewed in the next paragraph.

Why the pendulum has swung back to keeping EU companies listed in Europe

Sarbanes-Oxley-compliance is the latest in a series of other recent major influences that support the case not to register securities in the US. The other key influences relate to developments in financial reporting and capital markets. Concerning financial reporting, the 2005 requirement of using IFRS for EU-listed companies means that most EU public companies now need familiarity with two sets of accounting standards, IFRS and local GAAP. Listing in the US requires a third – US GAAP – since the SEC continues to insist on IFRS reconciliations to US GAAP for foreign registrants.¹⁶⁵ The merit of these SEC-mandated reconciliations is questionable, as illustrated by the following:

¹⁶¹ Out of this 1319, PricewaterhouseCoopers estimates that there are “470 non-US companies listed on the New York Stock Exchange, with a combined market capitalisation of \$3.8 trillion – or 30 per cent of the total value of capitalisation of companies quoted on the exchange.” [Source: Howarth F., *Anti Sarbanes-Oxley Mood Rises in Europe*, Register, 11 January 2005]. The other 900-odd listings are on NASDAQ, American Stock Exchange, other exchanges.

¹⁶² Ford P. of Simpson Thacher & Bartlett, *Sarbanes-Oxley and the Global Capital Market* (2003)

¹⁶³ “Currently, if the issuer elects IAS GAAP or domiciled GAAP, there must be a reconciliation of the reporting to US GAAP. Canadian companies may use Canadian GAAP and are exempted from such reconciliations via the Multi-Jurisdictional Disclosure System.” [Rouse R.W., *How will Sarbanes-Oxley affect foreign companies*, 14 Journal of Corporate Accounting & Finance, September 2003, at 56]

¹⁶⁴ For a fuller discussion of this, see, e.g. Steil B., *Trading Foreign Stocks in America: Whose Oxley's Being Gored?*, Council on Foreign Relations (August 2005 website)

¹⁶⁵ For a discussion of the US GAAP reporting and reconciliation requirements for foreign issuers, please see, e.g. Richter D., *Sarbanes-Oxley Act of 2002 and the non-United States Issuer*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* (2003), at 311-312. See, also: Wiesen J., *Congress Enacts Sarbanes-Oxley Act of 2002: A Two-Ton Gorilla Awakes and Speaks*, 18 Journal of Accounting, Auditing & Finance, Summer 2003, at 439: “pro forma financial information included in any...report..., or in any public disclosure or press or other release, shall be presented in a manner that...reconciles it with [US GAAP].” [reference to Sarbanes-Oxley Section 401(b)]

The question of whether the reconciliation requirement enhances or diminishes the investor protection and market-quality objectives of the SEC has been widely debated. Some believe that requiring foreign firms to reconcile certain financial information to US GAAP upholds the investor protection objective by requiring full and fair disclosure by foreign firms [...]. Others believe that the mandatory SEC requirements may deter foreign firms from listing on US exchanges, [...].¹⁶⁶

In net, the US is not (yet) showing the flexibility of competing stock exchanges – e.g., in The Netherlands, “Foreign companies listed on the Amsterdam Stock Exchange prepare their financial statements applying the accounting standards of the country of incorporation”¹⁶⁷ – and so this relative inflexibility of the US is likely to diminish its appeal relative to an alternative EU listing.

Another reason companies registered in the US was to access American financial capital.¹⁶⁸ US markets were “deep” (i.e. liquid) and funds were plentiful. Now EU companies have two key alternatives to achieve comparable benefits. A secondary listing on a major EU stock exchange (e.g., London, Paris or Frankfurt, for a public company) and access to private equity capital¹⁶⁹ (for either a public or private company). Either choice can still give access to US investors (in addition to EU investors), since US investors are now increasingly directly¹⁷⁰ active on EU bourses¹⁷¹ and in private equity investments¹⁷² within the EU. “As rules governing shareholding by US individuals and firms have been loosened recently, firms no longer need to have a presence on the US stock exchanges to generate a significant US shareholder base.”¹⁷³ Furthermore, the harmonisation of financial reporting (IFRS) and currency (Euro) will continue to play an important role in bringing US capital over to Europe, diminishing the need for EU companies to seek US listings.

¹⁶⁶ Hora J., Tondkar R. and McEwen R., *Effect of Foreign GAAP Earnings and Form 20-F Reconciliations on Revisions of Analysts' Forecasts*, 38 *The International Journal of Accounting* 2003, at 72

¹⁶⁷ Offeren D.H. van, *The Netherlands*, in Pacific Investment Research (Ed.), *Fundamental Solutions for Global Investing*, Section 10.1 of Volume 4 (August 2005 website)

¹⁶⁸ See, e.g., Weissenberger B., Stahl A. and Vorstius S., *Changing from German GAAP to IFRS or US GAAP: A Survey of German Companies*, 1 *Accounting in Europe* 2004, at 175, 186: “[...] a company might not only want to diversify its investor base in its home country but also abroad. One reason may be the fact that its domestic capital market is too limited for current or future capital needs. Another aim is the reduction of stock price volatility by scattering investors geographically.[...] To our mind, our results indicate that the change to an international GAAP regime was motivated primarily by the expectation of attaining improved standing on the capital markets, i.e. financial motives.”

¹⁶⁹ “Private equity looks like providing an escape for overburdened listed companies.” [Source: Robinson K., *Private Equity Provides an Escape From Regulatory Woes*, *Banker*, 4 April 2005, at 38]

¹⁷⁰ As opposed to “indirectly”, e.g. investing in EU companies by buying their ADRs which are listed on US exchanges.

¹⁷¹ For example, “Of the capital of 32 companies in the CAC 40, 42.6% belongs to non-resident investors, with an increasing proportion of British and Americans: In June this figure was 24.1%, as opposed to 20.3% one year earlier. On average in Europe, the non-resident investors hold 44.4% of the capital of major quoted businesses, a proportion which remains stable, but which, as in France, hides the increasing weight of the Anglo-Saxons.” [Source: Georgeson Shareholder., *Foreign Investors Control More than 40% of the CAC 40*, *Le Monde*, 22 June 2002]

¹⁷² For example: “The European private equity market surged to a record €33.5 bn (\$40.6 bn) in the second quarter [2005] with large buyouts, such as the €4.3 bn acquisition of Amadeus, [...] The sector is now firmly on course for another record year after the €81 bn worth of deals recorded [in 2004].” [Source: Smith P., *European private equity reaches record €33.5 bn*, *Financial Times*, 1 August 2005, at 14]

¹⁷³ Source: Howarth F., *Anti Sarbanes-Oxley Mood Rises in Europe*, *Register*, 11 January 2005

In net, EU companies can now find viable alternatives to a US listing right here in Europe. These opportunities are likely to increase as supporting factors such as harmonised financial reporting (IFRS) and access to US capital from within Europe, consolidate their already important role. To sum up the mood and considerations of EU companies in regards to listing in the US, we consider:

[f]or example, German chemicals producer BASF estimates that the extra costs of Sarbanes-Oxley compliance are somewhere between \$30m -\$40m per year. International companies used to list their shares on US stock exchanges to show how strong an international player they were, to get access to a wider pool of investors and to gain easier access to potential acquisitions; many feel that these are now not worth the cost. Other household names that have been quoted in the press recently as saying that they were at least considering de-listing include the Rank Entertainment Group and British Telecom from the UK.¹⁷⁴ [Note: e.g., Electrolux¹⁷⁵ and BAT¹⁷⁶ recently delisted from US exchanges.]

Finally, in addition to all the business considerations indicated above, some CEOs and CFOs may see the personal (criminal) liability to which they would be exposed under Sarbanes-Oxley¹⁷⁷ as being just one step too far. For them, escaping Sarbanes-Oxley may well be escaping prison in the literal sense of the word.¹⁷⁸

¹⁷⁴ Source: Howarth F., *Anti Sarbanes-Oxley Mood Rises in Europe*, Register, 11 January 2005

¹⁷⁵ During the discussions prior to Electrolux' delisting from NASDAQ, there was concern that such an action would give the impression that the company was trying to "escape" good corporate governance. Consider the following remarks from Åsa Stenqvist, head of investor relations at Electrolux: "We have a large US shareholder base but they basically buy shares in Europe and own us through their European [investment] subsidiaries." Stenqvist concedes that complying with the Sarbanes-Oxley Act will add costs, "but we haven't decided about the Nasdaq listing. You have to consider if there is a loss of prestige, and if we were to delist we don't want people thinking we didn't want to comply with the rules; that there might be something fishy." [Source: McAuley T., *The Coming Storm*, CFO Europe, July 2004]

¹⁷⁶ BAT 2004 annual report, page 23: "[BAT] has unlisted trading privileges [...] for its [...] ADRs [...] As a result, the Company is subject to neither [...] Stock Exchange listing standards nor the corporate governance rules under [SOX]."

¹⁷⁷ SOX Section 906(c) in regards to criminal penalties related to non-compliance with Section 302 (financial reporting)

¹⁷⁸ "Harsh penalties are in place for the CEO and CFO who choose to ignore the new requirements. We have recently seen a willingness by the UK to surrender, to the US judiciary, individuals* who are alleged to have transgressed US financial regulations from within the UK." (*The individuals referred to in this article, are UK bankers who authorised loans to *Enron*.) [Source: Booth G., *Get into training for the new regime*, Accountancy (UK), January 2005, at 43]

3.8. The “cascading” of Sarbanes-Oxley leading to harmonisation in corporate governance

It is not unusual that standards which are mandated for a select distinct group are eventually adopted by a wider group. International accounting regimes such as US GAAP or IFRS are a good example.¹⁷⁹ Although IFRS is mandatory for only approximately 7000 publicly-listed companies within the EU,¹⁸⁰ “most national [accounting] standard setters seem to agree that national systems of accounting should converge on IFRS in the medium term and it would be too problematic to have very different systems within a country for listed and unlisted companies”.¹⁸¹ There may be both voluntary reasons (following best-practice) and non-statutory obligatory reasons (bank lender’s requirement) to comply, resulting in a wider adoption of such standards by this “cascading” effect.

Within corporate governance, the “cascading” effect has always played a role in spreading ‘best practices’. The traditional non-mandatory nature of corporate governance best practices (at least within Europe) provide individual companies a chance “to show off” (via their annual report) that they are doing ‘more than required’ of them. This can easily enhance an investor’s perception of the company and improve his confidence and ultimately his valuation via a higher price/earnings rating.

The “cascade” effect for Sarbanes-Oxley is even stronger than for other corporate governance frameworks. The result of this strength is that the corporate world will most likely eventually end up with one ‘core’ framework based on Sarbanes-Oxley, as opposed to the highly fragmented¹⁸² and varied corporate governance frameworks that currently exist. The “cascading” that is driving this harmonisation evolution has manifested itself in several ways during the past couple of years, e.g.:

- Private company self-imposition
- US states’ legislation
- International practice
- EU legislation

The first two points are reviewed in the next paragraphs; the last two are covered in next sections.

¹⁷⁹ See, e.g., Weissenberger B., Stahl A. and Vorstius S., *Changing from German GAAP to IFRS or US GAAP: A Survey of German Companies*, 1 Accounting in Europe 2004, for assessment of the German adoption of US GAAP and IFRS.

¹⁸⁰ Of the 7000 companies, 2500 are estimated to be in the UK [See, <http://www.accaglobal.com/ifrs/practicaltools/faqs>]

¹⁸¹ Adams R. of the Association of Chartered Certified Accountants, *Preparing For 2005 - The Impact of IFRS On Unlisted Companies* (ACCA website, August 2005)

¹⁸² Prior to an EU initiative pursuant to the *Winter Report*, the EU15 had over 35 corporate governance frameworks, with the UK alone having eleven. [Source: Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, *Comparative study of corporate governance codes relevant to the European Union and its member states* (2002) at 2]. See Appendix C and Appendix K

Private company self-imposition

We briefly explored this in section 2.6 above when discussing those firms who voluntarily comply with the Act. This group can be further defined by assessing motivations for their compliance as:

- Pressure from various stakeholders, e.g. industry regulators (e.g. FDIC on banks¹⁸³), lenders, insurers, investors, customers (e.g. government procurement policy to defence contractors).
- Anticipation of corporate activity, e.g. friendly takeover, IPO, bid needing public financing.
- Public responsibility: “private non-profit organisations”¹⁸⁴, such as universities, charities, hospitals, labour unions, with the expectation of being held to the higher standards. The US Internal Revenue Service has since required additional governance and financial disclosures from organisations exempt from tax. In conceding the need to comply with the IRS request and adopt certain Sarbanes-Oxley governance practices, the Chairman of Drexel University in Philadelphia noted: “We are not a public corporation, but we do the public’s business”¹⁸⁵.

In a survey conducted soon after Sarbanes-Oxley enactment, 58% of 1400 CFOs of privately held businesses said their companies were “voluntarily” responding to Sarbanes-Oxley by changing practices related to: accounting procedures (44%), internal audit function (36%) and non-audit services (23%).¹⁸⁶ Although the word “voluntarily” is used, the following situation illustrates the underlying pressures and quasi-obligatory nature of SOX compliance by private companies:

[p]rivate companies who continue to contract with their independent auditors for consulting services should expect increased scrutiny from investors, lenders, and regulators. Weighing these costs against the benefits associated with single-source solutions is a management responsibility.¹⁸⁷

In net, although private companies are not obliged by law to comply with the Act, the incentives for voluntary compliance are widespread, significant and arguably economically beneficial.

¹⁸³ Regarding the FDIC influence, “[...] banks and thrift holding firms are already subject to controls very similar to Section 404 under the 1991 US Federal Deposit Insurance Corporation Improvement Act.” [Source: Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 Information Systems Control Journal 2004, at 18]

¹⁸⁴ The International Federation of Accountants refer to “private non-profit organisations” as “public interest entities”.

¹⁸⁵ Robert Half International, *The Impact Of Sarbanes-Oxley On Private Business; Are The New Rules Giving Rise To A Universal Standard* (2003), at 10

¹⁸⁶ Robert Half International, *The Impact Of Sarbanes-Oxley On Private Business; Are The New Rules Giving Rise To A Universal Standard* (2003), at 11

¹⁸⁷ Mautz Jr. R.D. and Kiel M., *How Will Sarbanes-Oxley Touch Non-public Companies*, 6 Journal Of Corporate Accounting & Finance, September/October 2004, at 10

US states' legislation

Within one year of Sarbanes-Oxley being enacted, more than a dozen US states enacted parallel legislation¹⁸⁸ with a broader scope of eligible companies than those captured under the Sarbanes-Oxley federal jurisdiction. "For example, California has passed several laws that address issues as retention of audit paper and prohibitions on auditors joining client companies."¹⁸⁹ Although the nature of these laws is similar to Sarbanes-Oxley Sections 103 and 206, respectively, unlike Sarbanes-Oxley they apply to certain non-public companies. This might be compared to the situation where IFRS is mandatory by EU Regulation for the 7000 listed companies within the EU;¹⁹⁰ with individual member states then having the option of imposing IFRS requirements on unlisted companies if they see fit. This can snowball into a harmonising effect if and when enough states adopt the standards over and beyond the mandatory minimum.¹⁹¹ However, before the benefits of harmonisation will be enjoyed, state legislatures will have to overcome concerns such as those expressed by the American Institute of Certified Public Accountants (AICPA):

At the state level, several state legislators, regulators and other elected or appointed officials are seeking to duplicate and or extend provisions of the Sarbanes-Oxley Act to private companies and their auditors at the state level. While some measures may have merit and could possibly be supported, some of what is being discussed is overreaching and simply should not apply to CPAs and CPA firms that do not provide audits to publicly traded companies.¹⁹²

Despite such objections, state legislatures will continue to play a critical role in the cascading and proliferation of Sarbanes-Oxley, especially given their influence over local government investments and expenditure. Examples¹⁹³ of how states exert such influence include: Massachusetts laws requiring State Retirement Investment Boards not to invest in companies that have failed to implement Sarbanes-Oxley-related practices such as restrictions on non-audit services (supplied by company auditor); Montana proposed law to prohibit that state from signing contracts with non-Sarbanes-Oxley compliant corporations.

¹⁸⁸ The AICPA indicated that nearly 20 pieces of parallel legislation had been enacted in over a dozen US states (2003). This is not entirely surprising given that: "[...] all [US] corporations (including all privately held corporations) have their governance and liability provisions, outside of the securities law, governed by state law, and despite the "federalization" of corporate governance procedures by Sarbanes-Oxley, we are already seeing the good faith and fiduciary duty requirements of state law expand as a result of the environment created by Sarbanes-Oxley." [Source: Newlin W., Sarbanes-Oxley: It's Not Just for Public Companies (September 2003) TEQ Magazine, Pittsburgh Technology Council]

¹⁸⁹ Robert Half International, *The Impact Of Sarbanes-Oxley On Private Business* (2003), at 5

¹⁹⁰ Deloitte IAS Plus website, *June 2002: Europe Adopts Regulation Requiring IAS by 2005*, International Financial Reporting Standards in Europe: Events of 2002 (August 2005): "The [EU] has adopted an 'IAS Regulation' requiring listed companies [...] to prepare their consolidated accounts in accordance with IAS from 2005 [...] The Regulation has the force of law without requiring transposition into national legislation. [...] Member States have the option of extending the requirements of the Regulation to unlisted companies and to the production of individual accounts."

¹⁹¹ For a review of how EU member states have used their options to impose IFRS on unlisted firms, see Appendix G

¹⁹² American Institute of Certified Public Accountants (AICPA), *The State Cascade — An Overview of the State Issues Related to the Sarbanes-Oxley Act* (AICPA website August 2005)

¹⁹³ These examples are taken from: Mautz Jr. R.D. and Kiel M., *How Will Sarbanes-Oxley Touch Non-public Companies*, 6 *Journal Of Corporate Accounting & Finance*, September/October 2004, at 8

3.9. Proliferation of SOX and corporate governance via multinationals' internal policies

In the previous section, it was mentioned that 'international practice' and 'EU legislation' also have a role in spreading SOX across the corporate world, in addition to 'private company self-imposition' and 'US states' legislation' (as discussed above).

'International practice' is most vividly manifested in the way that large multinational companies conduct themselves. The importance and influence of the way in which the many international subsidiaries of major multinationals carry out their local business in different countries cannot be understated. This will probably be the most significant "effective carrier" of good governance across the globe. To see this in practice, take a glance at the annual report of any major US or EU multinational today. Unquestionably one will see pages about how they are applying best practice corporate governance; most likely, you will begin to see references to Sarbanes-Oxley. A selection of such references is captured in Appendix M (attached)¹⁹⁴ to give the reader a flavour of the future.

Some may argue, well this is no different from the past. Previously, major multinationals wrote about 'group policies & procedures', and now they have a new label, 'SOX corporate governance'. Well a reconciliation of the two would probably require a new thesis, so we will not explore that question now. Suffice to say, that there are two major differences with SOX, compared with past attempts at spreading corporate governance practices via simple dissemination of written policies. Those two new elements that were not widespread in pre-SOX days are: the law and, enforcement.

By "law", I do not refer strictly to the SOX statute and SEC/PCAOB guidance and regulations that followed. Included within the "law", is the "voluntary obligation" that all responsible multinationals will begin to feel, to either "comply or explain".¹⁹⁵ Consider the *BAT* multinational, where the Board felt obliged to clarify why this major¹⁹⁶ UK company is not adopting SOX: after explaining that *BAT* does not need to follow SOX, because they are no longer listed in the US, it went on say:

[n]evertheless, the Board has chosen, in the interest of good governance, to make a voluntary statement explaining the principal differences and common areas between the Company's corporate governance practices [...] and those that would be required if the Company were subject to [SOX].¹⁹⁷

¹⁹⁴ Appendix M contains SOX-related extracts from the recent annual reports of seven EU multinational companies.

¹⁹⁵ Here we are referring to "soft law", which has been cited by many (European) commentators as the most effective approach to installing corporate governance practices. See, e.g., Bolkestein F., *Corporate Governance in Europe* (speech to the Conference on Corporate Governance at *Clifford Chance* in Amsterdam, on 30 January 2003): "I think that a "soft-law approach", a self-regulatory market approach combined with disclosure and transparency obligations should be the guiding principle for any initiative in corporate governance."

¹⁹⁶ Ranked 140th largest company by market capitalisation [Source: FT Global 500, 11 June 2005 Special Issue, at 30]

¹⁹⁷ *BAT* 2004 Annual Report, at 23 (the paragraph on: "American Depository Receipts")

This leads us to the other major difference. One is no longer putting trust solely in words. Companies must now encounter enforcement. Again, “enforcement” is not limited to what SOX says the SEC can do. In fact, this may be relatively constrained.¹⁹⁸ Probably more effective “enforcement” will come in the form of ‘armies’ or internal auditors spreading across the multinationals’ networks of international subsidiaries with mandates from the parent companies’ Audit Committees. This kind of “enforcement” – physical site inspection and observation of actual practices – is key. “A necessary condition for effective implementation is willingness to enforce the regulations.”¹⁹⁹ And now it will become effective with the force of law, because SOX “encourages” such multinationals to have such internal audit functions, and SOX mandates both the Audit Committee and senior officers (CEO and CFO), to ensure that such assurance over internal controls is properly verified. The “encouragement” by SOX to use internal audit functions is not manifested explicitly (“the Act does not specifically address the role of internal auditors”²⁰⁰), but it is done, e.g.

- By SEC and PCAOB guidance outlining the role of the internal audit function under SOX;²⁰¹
- NY Stock Exchange listing requirements that companies maintain an internal audit function.²⁰²

So central are these activities of the internal audit function and the Audit Committee to the spread of SOX and good corporate governance,²⁰³ that we explore this in more depth in the next chapter 4, within which we assess the role of EU legislation and the extent to which it coincides with SOX.

The above paragraphs and the preceding section both indicate the powerful potential of Sarbanes-Oxley to bring about convergence in certain areas of corporate governance. The “cascading” of Sarbanes-Oxley – be it by private company voluntary compliance or via the internal policies of publicly-listed companies – will lead to greater harmonisation of corporate governance as a result of widespread application of some core standards.²⁰⁴ This is neatly summed up as follows:

[S]arbanes-Oxley is now the corporate world’s template for effective accounting and governance practices. “It sets the standard for what a disclosure should be like, what internal controls should be in place and what kind of independence should be followed – all those pieces are going to become the standard whether you’re private or public,” [Lawrence Lake, a managing director of Protiviti Inc.]²⁰⁵

¹⁹⁸ “Some 600 companies have had to admit their controls are “not effective” [relative to SOX Section 404 requirement]. At this point in the Sarbanes-Oxley process the SEC cannot take action against them all.” [Bruce R., *A tale of two different ways of thinking*, Financial Times, 19 May 2005]

¹⁹⁹ Ronen J. and Berman A., *Musings on Post-Enron Reforms*, 19 Journal of Accounting, Auditing & Finance, Summer 2004, at 332

²⁰⁰ IIA, *Internal Auditing’s Role in Sections 302 and 404 of the U.S. Sarbanes-Oxley Act of 2002*, 26 May 2004, at 6

²⁰¹ <http://www.sec.gov/rules/pcaob/34-49544.htm>, and various other communications, including webcasts (e.g. 25/5/05)

²⁰² <http://www.aicpa.org/pubs/jofa/sep2004/harring.htm>, <http://www.sec.gov/rules/sro/34-48745.htm>

²⁰³ As to why auditing practices are “so central” to SOX effectiveness, see, e.g., *supra* note 40

²⁰⁴ The survey of foreign private issuers in Appendix H indicates that companies see the value of global standards.

²⁰⁵ Robert Half International, *The Impact Of Sarbanes-Oxley On Private Business; Are The New Rules Giving Rise To A Universal Standard* (2003), at 6

3.10. Other unintended consequences

With its emphasis on greater transparency and better corporate governance, Sarbanes-Oxley was bound to have a wide-range of impacts and secondary effects. Some commentators have tried to compartmentalise these impacts. For example, one recent analysis²⁰⁶ categorised these impacts as “legislated”, “intended consequence” and “unforeseen consequence”²⁰⁷, with the outcome that out of the twenty-eight identified impacts, only four had been “legislated” with twelve in each of the other categories. This is not necessarily a bad thing, so long as the “unlegislated consequences” contribute to the overall objectives and mission of the legislation, while adhering to the principles of that framework. However, as we have seen from the analysis above, this is not the case in several areas.²⁰⁸ We go on to examine in more depth one of these particular areas in the next chapter.

This chapter has highlighted the uncertainties and costs awaiting EU companies, as they prepare for SOX compliance, especially in regards to Section 404. It has demonstrated that both direct and indirect costs are difficult to assess. But that failure to properly plan, budget and implement SOX can result in different costs in all forms, e.g., downgrades from ratings agencies or severe penalties for the CFO. It went on to argue that EU companies are indirectly impacted in many other ways too, especially in relation to auditing. Some companies are faced with setting up new functions (i.e. internal audit), whilst many others will simply face higher (audit) fees and lower quality audits. Then could an EU company escape SOX jurisdiction? The chapter looked at the options of delisting from a US exchange or staying a private company, and recognised that there may be merit in this. However, the subsequent section established that given the widespread and growing influence of SOX, “escaping” SOX jurisdiction in the formal sense does not mean that an EU company avoids some form of “voluntary compliance”. And to the extent that “no escaping” results in a global standard (or greater harmonisation) for some core practices of corporate governance, then this can be a positive consequence of SOX. The next chapter assesses how this spread of SOX affects, if at all, one central aspect of corporate governance within the EU, i.e. the role and practice of auditing.

²⁰⁶ Koehn J.L. and Del Vecchio C., *Ripple Effects Of The Sarbanes-Oxley Act*, CPA Journal, February 2004, at 39

²⁰⁷ For example: Negative influence on corporate mergers and acquisitions, increased cost of D&O insurance, changes in attorneys legal conduct, concerns about executive compensation, concerns about preferential trading at mutual funds.

²⁰⁸ An extreme example of an unintended consequence is where the result is counterproductive. Consider, for example, an intent of SOX being to ensure corporate officers acted in accordance with the law, and therefore used legal experts: “Several CEOs interviewed by [The International Economy publication] say the [SOX] legislation [now] forces corporate officers to exclude [legal] counsel from internal debates and limit information provided to lawyers.” [Source: Whalen C., *Revisiting Sarbanes-Oxley: Was the well-intentioned landmark legislation slapped together too quickly?*, International Economy, Fall 2003, at 41]

4. AUDITING PROVISIONS: DOES SARBANES-OXLEY CHANGE EU PRACTICES?

This chapter looks at the reach of Sarbanes-Oxley into the area of EU auditing practices, and asks whether EU firms need to adjust or are they already adopting SOX style auditing. It starts by aligning definitions of auditing activities, and then goes on to compare the scope of related regulation in both the US and EU. It also considers the merits of the EU “principles-based” approach versus the US “rules-based” approach, and then concludes with light optimism on the chances for US-EU convergence.

4.1. Definitions and descriptions of the various audit functions

There is often confusion regarding the different activities and entities involved within the various audit functions, especially within the context of international comparisons. To address this issue, this chapter starts by setting out the widely-accepted descriptions of key audit-related functions.

Internal controls

These are the internal management, administrative, financial and system controls that companies (and organisations, in general) adopt in order to ensure that the stewards²⁰⁹ of the organisation can effectively govern operations in accordance with various internal and external expectations and regulations. An example would be the blocking of a payment to a supplier unless the request has been approved by a certain level of management (pre-defined level according to amount payable). Internal controls are typically designed and implemented by the relevant operating management. However, they are checked and reviewed for their effectiveness and efficiency by Internal Audit.

Internal Audit

The official definition of *internal auditing* from the related worldwide professional organisation is:

[i]nternal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.²¹⁰

²⁰⁹ In the context of a public corporation, the “steward” is the Board of Directors.

²¹⁰ Source: The Institute of Internal Auditors (IIA) UK and Ireland Online [<http://www.iaa.org.uk/about/internalaudit/>]

Because the primary role of the internal auditor is to objectively review the effectiveness of the people, procedures and systems that combine to constitute internal controls, it is important that s/he has sufficient independence from the management that designed and implemented the control. Therefore, internal auditors would typically have a direct reporting line²¹¹ to the Audit Committee or the Board of Directors.²¹² Internal auditors are typically qualified members of one of the national professional accounting/auditing associations,²¹³ and they may also be professionally accredited by the *Institute of Internal Auditors* (IIA²¹⁴).

Although the key function of internal auditors is to provide operational (or internal) audits of their employer, they are also requested to perform many other activities, as revealed by a recent survey²¹⁵ in which 71% of those internal auditors surveyed also performed EDP or IT (computer system) audits, financial audits (also 71%), risk management (65%), consulting (64%), management support (52%), health, safety and environmental (HSE) audits (20%), quality audits (11%) and other (15%).

External audit²¹⁶

The activities of the external auditor are very often confused with those of the internal auditor, although their role, responsibilities and related (professional) liabilities are quite distinct. The first key difference is that *internal* auditors are employees of the company that they audit, whereas *external* auditors are not. External auditors are employees of one of the many audit (accounting) firms worldwide, the biggest and most familiar ones being known as a “Big Four” firm. A firm may provide both (external) audit and non-audit services²¹⁷. The mandate of an external audit²¹⁸ is to “examine and publicly issue an opinion on the reliability of corporate financial reports.... Although

²¹¹ “direct reporting line”, via their department head, e.g., Chief Audit Executive (CAE) or Director Internal Audit.

²¹² A 2003 survey among 1650 CAE’s with 379 responses revealed that the Internal Audit function (i.e. the CAE) reported directly to the Audit Committee in 55% of cases, to the CEO or President (22%), CFO (17%), Other (6%). [Source: 2003 IIA Inc. survey reported in: Paape L., Scheffe J. and Snoep, *The Relationship Between the Internal Audit Function and Corporate Governance in the EU – a Survey*, 7 International Journal of Auditing 2003, at 259]. Since this survey was skewed towards a heavy US IIA membership, the authors did a separate study of European practice. They concluded, similarly, that “about half of the respondents report to the [Audit Committee]. [...] The Netherlands, however, is a striking exception: almost 90% of CAE’s there report to the CFO.” [Source: *id.*, at 254]

²¹³ E.g., in the Netherlands, there are four major organisations (NIVRA, NOvAA, VRO, NOREA), with the two key ones being NIVRA (13,763 members) and NOvAA (6,441). [Sources: *The Netherlands: A War of Independence*, The Accountant, July 2005, at 19 and http://www.ijia.nl/publicaties/IIA_Brochure%20IAN_ENG_web.pdf]. The biggest EU professional accountancy body is the Institute of Chartered Accountants in England and Wales with 125,000 members.

²¹⁴ The IIA, although US-based, is recognised as the worldwide governing body for Certified Internal Auditors (CIA).

²¹⁵ Paape L., Scheffe J. and Snoep, *The Relationship Between the Internal Audit Function and Corporate Governance in the EU – a Survey*, 7 International Journal of Auditing 2003, at 255

²¹⁶ “External audits” are also referred to as “statutory audits” (typically in EU texts).

²¹⁷ See Appendix F below for a description of non-audit services, and the restrictions on provisions of such services.

²¹⁸ “external audit”, also known as a *financial audit*, as opposed to an *operational audit* conducted by Internal Audit.

external auditors are contractually obligated to the corporation retaining their services,²¹⁹ they also hold a fiduciary responsibility to the shareholders, creditors, investors and other third-party users of audited financial statements...²²⁰ In contrast, internal auditors focus on operational effectiveness/efficiency and regulatory/procedural compliance, and their duty is to their internal corporate management (notwithstanding any professional or ethical duties to report misconduct).

Audit Committee

This committee is typically staffed by non-executive or “independent”²²¹ directors who serve on the Board of Directors. Their role and responsibilities vary according to company, corporate culture and jurisdiction.²²² However, the annual report of a large Dutch public company succinctly describes the widely-accepted core conventional activities of an audit committee, as follows:

[t]he Audit Committee assists the [...] Board in its oversight of the quality and integrity of the accounting, auditing, reporting, and risk management practices of the Company. Audit Committee members are appointed by and from among the [...] Board members. The Audit Committee reports its findings to the [...] Board.²²³

Auditing practices

For the purposes of this document, auditing practices refer to the collective function of auditing, encompassing all of the auditing activities performed by:

- the **internal audit** department within a company;
- the **external audit** firm for the company;
- the **Audit Committee** of the company.

²¹⁹ “Theoretically, auditors are supposed to be agents of the shareholders. But in practice, it is management that engages the auditor and ultimately pays for his services and hence determines auditing and consulting fee structures [...]” [Source: Ronen J. and Berman A., *Musings on Post-Enron Reforms*, 19 *Journal of Accounting, Auditing & Finance*, Summer 2004, at 339]. Formally, e.g. in the UK and US, it is the AGM (Annual General Meeting of shareholders) which appoints/confirms the external auditor. However, it is management (e.g. CFO) who manages the auditor relation.

²²⁰ D. Applegate, *The U.S. Corporate Audit Function*, Internal Auditor, October 2004, at 23..

²²¹ The requirement for and definitions of “independence” differ according to jurisdictions. See sections 4.4 and 4.5.

²²² For example, one French corporate governance code (Vienot I) states that the audit committee should be charged with “ensuring the appropriateness and consistency of accounting policies applied in consolidated and company financial statements, and with verifying that internal procedures for collecting and checking information are such that they guarantee accuracy.” [H. Gregory and R. Simmelkjaer of Weil, Gotshal & Manges LLP, *Comparative study of corporate governance codes relevant to the European Union and its member states* (2002), at 75].

²²³ *Akzo Nobel 2003 Annual Report*, at 25

4.2. Auditing practices: scope, type and objectives

Given that the effectiveness, efficiency and reliability of a major company's financial and operational performance are critical for many stakeholders²²⁴, it is clear to see why the scope of activities undertaken by the various audit functions is so broad. As a collective function, their role is to ensure that every aspect of every department in every location within a large public company, is operating lawfully, in compliance with corporate policies, in an efficient, effective and risk-astute manner. Given such breadth, the scope of this section needs to be limited, and it will focus on those auditing practices that are subject to external regulation (law) or code (of corporate governance).

Internal controls and internal audit

These internal activities are critical to the health of a large public company. However, since their methods and quality are not normally subject to external review²²⁵, and their effectiveness is typically a responsibility of the Audit Committee, then these matters shall not be addressed separately to those of the Audit Committee. "Audit committees are depending on the work of [...] the internal audit department, and others to ensure that their company's financial reporting, financial statement audit, and compliance policies adhere to all applicable standards."²²⁶

Noteworthy is the fact that given the recent growth of several enterprise-wide process-related activities²²⁷ that now exist in the typical multinational, the independent role of the internal auditor has become more difficult to maintain as s/he is requested to get involved in operational projects.

External audit

Below are external audit practices/issues that are often subject to national regulations or codes.

Eligibility to perform external audits

There exist various requirements that need to be satisfied prior to an external audit firm being eligible to perform an audit of a public company. These requirements primarily relate to the audit firm's business form, its registration and location, the qualifications and education of its staff.

²²⁴ Shareholders, creditors, employees, banks, suppliers, customers, government, local communities, families, etc.

²²⁵ Although for a NYSE listing, a company must have an internal audit function [S. Green and H. Gregory of Weil, Gotshal & Manges LLP, *The Ripple Effect* [of Sarbanes-Oxley Act], Internal Auditor, February 2005, at 51]

²²⁶ Matraia M., *Governance Perspectives: A Critical Eye*, Internal Auditor, June 2005, at 35

²²⁷ E.g. ERP Enterprise Resource Planning (e.g. SAP), ERM Enterprise Risk Management, Shared Services, SOX.

Auditor independence

Limitations are placed on the types of (non-audit) services²²⁸ that an audit firm can offer the same client. The logic of such limitations is that an audit firm would have a conflict-of-interest if during an external audit s/he discovered a (control) weakness that originated from a (non-audit) service provided by her/his firm. Similarly, limitations are placed on the “influence” that a client may have over an external audit firm and/or its staff, so as to minimise any risk of coercion.

Internal controls

The external audit firm may be required to report on the company’s management assessment of the effectiveness of its internal control structure and accounting procedures. The external auditor will have its own opinion (based on its audit) which it can compare to the company’s assessment.

Auditor disclosure requirements

The extent to which auditors must engage in fraud detection and the reporting thereof is a matter of both professional ethics and regulatory obligation, depending on the fraud and jurisdiction.

Rotation of external audit firms and/or their partners

The extent to which a jurisdiction requires a company to change its external auditor (and/or its staff) will often involve “balancing the need to bring a ‘fresh look’ to the audit engagement with the need to maintain continuity and audit quality”²²⁹. The issue of mandatory audit firm rotation is a contentious one. The chairman and CEO of one “Big Four” firm summed it up as follows:

[a]udit firm rotation, as distinct from audit partner rotation, is a particularly difficult issue. Academic studies support the view that audit firm rotation undermines audit quality. In the US, statistical evidence suggests that three times as many audit failures occur in the first two years of an audit relationship as at anytime in the third and subsequent years. [...] Compulsory [audit firm] rotation removes the threat – and [red flag warning to investors] impact – of voluntary rotation.²³⁰

One study, by the largest professional accountancy body in Europe,²³¹ gave an upbeat assessment:

[t]he perceived benefits of mandatory rotation are: an improvement in audit quality due to the avoidance of over-familiarity with the client; the opportunity for a fresh approach to the audit; a better perception of auditor independence; and the benefits of competition.²³²

²²⁸ For a specimen list of “non-audit” services, please see Appendix F.

²²⁹ SEC Release No. 8183, *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*, 28 January 2003, at Section I.C.

²³⁰ Ernst & Young Chairman & CEO J. Turley, *Get Ready for the EU’s 8th Directive*, Directorship, June 2004, at 20

²³¹ The ICAEW: The Institute of Chartered Accountants in England and Wales

However, this positive assessment is tempered with such practical issues that the learning curve in the early years will have negative implications for audit costs, quality and risk of audit failure.²³³

Oversight

External audit firms have traditionally been self-regulating. The tasks of establishing and adopting standards of auditing, quality control, ethics, independence and other related matters have, in the main, been handled by professional bodies or by peer-monitoring mechanisms. According to one US report: “no Big 8/6/5/4 auditing firm ever produced a negative peer review of its brethren.”²³⁴ SOX brought an end to audit firm self-regulation in the US, with the establishment of the PCAOB. Since then, several other jurisdictions have moved from self-regulation to independent oversight.²³⁵

Audit Committee

Below are audit committee practices/issues that are often subject to statute, national regulations or corporate governance codes (depending on the specific jurisdiction). Furthermore, they may be subject to, e.g., stock exchange listing requirements,²³⁶ company bye-laws and bank/debt covenants.

Composition of Audit Committee

Requirements for the members of this committee to be “independent” and/or non-executive is formally a matter for external regulation.²³⁷ Similarly, the required expertise or profile may be defined. The logic of these requirements is to ensure that the Committee can make meaningful challenges and contributions to the actions of a Board of Directors.

It is widely accepted that for directors serving an audit committee to have a level of “independence” and “financial expertise” is positive. E.g., the Blue Ribbon Committee²³⁸ indicates “the rationale is that independent directors serving audit committees are more likely to be free from management’s

²³² ICAEW study, reported in Fearnley S. and Beattie V., *The Reform of the UK’s Auditor Independence Framework after the Enron Collapse: An Example of Evidence-based Policy Making*, 8 International Journal of Auditing 2004, 124
²³³ *Id.*, at 124

²³⁴ Klein A., *Likely Effects of Stock Exchange Governance Proposals and Sarbanes-Oxley on Corporate Boards and Financial Reporting*, 17 Accounting Horizons 2003, at 352

²³⁵ These jurisdictions are discussed in section 4.5 later in the chapter.

²³⁶ See, e.g., DeZoort F.T., Hermanson D., Archambeault D. and Reed S., *Audit Committee Effectiveness: A Synthesis of the Empirical Audit Committee Literature*, 21 Journal of Accounting Literature 2002, at 40: “The major US stock exchanges require that audit committees be composed of at least three independent, financially literate directors, one of whom must have accounting or related financial-management expertise.”

²³⁷ Although these requirements may be reflected/incorporated into a company’s byelaws (or adopted voluntarily).

²³⁸ The US Blue Ribbon Committee (BRC) on Improving the Effectiveness of Corporate Audit Committees [1999]

influence in ensuring that objective financial information is conveyed to shareholders.”²³⁹ Similarly, there are plenty of studies advocating financial expertise on the audit committee. However, there remains considerable debate regarding what is meant or desirable within the frameworks of “independence” and “financial expertise”, and to what degree are they needed, in terms of the types of experience that makes for an effective audit committee. One study concluded that:

[...] greater independent director experience and greater audit knowledge was associated with higher audit committee member support for an auditor who advocated a “substance over form” approach in the dispute with client management. Conversely, concurrent experience as a board director and a senior member of management was associated with increased support for management.[...] The results provide justification for calls that audit committees be completely composed of independent directors.²⁴⁰

The extent to which the US and the EU heed these calls is discussed in sections 4.4 and 4.5 below.

Oversight of CEO, CFO, internal controls and external audit activity

The extent to which the Audit Committee has this responsibility will depend on each jurisdiction.

Establishment of critical procedures

The committee may be required to establish procedures that may not be perceived as being in the best interest of the company, although they may be in the interests of certain stakeholders. Such procedures may facilitate, for example, capturing complaints about company misconduct²⁴¹.

Access to company funds, company information and outside resources

The extent to which the Audit Committee has this access will depend on each jurisdiction.

²³⁹ Karamanou I. and Vafeas N., *The Association between Corporate Boards, Audit Committees, and Management Earnings Forecasts: An Empirical Analysis*, 43 *Journal of Accounting Research* 2005, at 457

²⁴⁰ DeZoort F.T. and Salterio S., *The Effects of Corporate Governance Experience and Financial-Reporting and Audit Knowledge on Audit Committees Member’ Judgments*, 20 *Auditing: A Journal of Practice & Theory*, Sept. 2001, at 31

²⁴¹ Commonly known as “whistle-blowing”, whereby an employee informs external person about internal problems.

4.3. The regulation of auditing practices and the influence of culture and crises

There are several ways in which the auditing practices desired by an authority²⁴² are actually implemented and enforced. Typically they involve a mix of legislation and self-regulation. More specifically, the source of any auditing practice can usually be traced to one of the following:

Statute

Legislative acts and the secondary legislation and regulations that emanate from them. Sometimes the act will delegate implementation and enforcement to a public body (e.g. to the SEC²⁴³), and that body will decide whether to mandate specific standards (i.e. rules) or merely issue guidelines. Governance of those matters would be for the *discretion* of that public body.

Voluntary code

In a system of self-regulation, reputable firms and their advisors will subject themselves to various non-binding forms of conduct, such as a corporate governance code, an ethics or professional code of conduct or recommended practice from relevant authorities/bodies. Although non-binding, failure to adhere to the norm can have severe negative consequences for the entity involved (e.g. capital markets or investigatory authorities may have negative suspicions and react accordingly).

An example of this is the UK “comply or explain” approach to corporate governance, as explained in a major pan-European survey of corporate governance practices:

[...] in the United Kingdom two of the codes (first the Cadbury Code, and then the Combined Code which superseded Cadbury) were linked to listing rules to require listed companies to disclose whether they follow the code recommendations or explain why they do not (“comply or explain”). Thus, listed companies on the London Exchange need not follow the recommendations of the Combined Code (or Cadbury before it). However, they must disclose whether they follow its recommendations and must provide an explanation concerning divergent practices.²⁴⁴

The (EU) Winter Report also recommended²⁴⁵ such an approach for certain matters. On commending the Winter Report for taking such a pragmatic approach to matters of corporate

²⁴² E.g. a political body (e.g. US Congress, EU, UK Govt.), regulatory authority (e.g. SEC), public oversight body.

²⁴³ The SEC is formally an *independent regulatory commission* [P. Strauss, Administrative Justice in US 133 (2002)]

²⁴⁴ H. Gregory and R. Simmelkjaer of Weil, Gotshal & Manges LLP, Comparative study of corporate governance codes relevant to the European Union and its member states (2002), at 17.

²⁴⁵ “The Winter Report”: A modern regulatory framework for company law in Europe (2002) at 4: “Directives...not easy to modify”; “we can see a movement in Member States to use alternatives for primary legislation”; “Disclosure can be a

governance, a “Big Four” audit firm said: “...ethical behaviour and good management cannot be legislated for.”²⁴⁶ However, PwC went on to say that while “it is not necessary to develop a detailed [statutory] EU code of governance...A single capital market should have a common, minimum standard of transparency and accountability”²⁴⁷. Disclosure can enhance that minimum.

Disclosure

As observed from the preceding paragraphs (and related footnotes), disclosure (of a company’s adopted auditing or corporate governance practices) is closely associated with a “voluntary code”. However, the approaches should be distinguished here, since not all voluntary codes require disclosure of the adopted practice. When there is a requirement for disclosure, this can lead to an “incentive to comply with best practice”²⁴⁸, and hence enhance or go beyond minimum standards.

One example of this in practice can be seen from an extensive survey of the 100 largest US public companies²⁴⁹, e.g. “Forty-two companies disclosed the name of more than one financial expert on their audit committee, even though the U.S. Securities and Exchange Commission rules require public companies to disclose the name of only one such expert”²⁵⁰. Please refer to Appendix L.

Peer pressure

The “financial expert” example above may be seen as a situation where mandated disclosure combined with “peer pressure” to result in a better²⁵¹ practice that required. However, there are situations where there are no requirements for compliance (voluntary or otherwise) or disclosure, and yet certain companies still sense a need to communicate certain policies and practices. Such examples can be categorised as emanating from peer or societal pressure, a recent example being that “more than half of big companies reveal [their Corporate Social Responsibility] policies”²⁵².

powerful tool: it creates an incentive to comply with best practice, and allows members [states] and third parties to take necessary actions...Disclosure was particularly suited in the area of corporate governance”.

²⁴⁶ PricewaterhouseCoopers: 2004 Building the European Capital Market, at 13

²⁴⁷ PricewaterhouseCoopers: 2004 Building the European Capital Market, at 13

²⁴⁸ “The Winter Report”: A modern regulatory framework for company law in Europe (2002) at 4

²⁴⁹ Shearman & Sterling LLP, Corporate Governance Practices of the 100 Largest U.S. Public Companies (2004)

²⁵⁰ J. Whitley, *U.S. Corporate Governance Practices Compared*, Internal Auditor, October 2004, at 20

²⁵¹ I am not saying that an Audit Committee “full” of financial experts is the *best* practice; just that 2 is better than 1.

²⁵² Extract of KPMG survey of the top 250 companies in Fortune 500, written jointly with University of Amsterdam, to be found in: T. Buck, *More than half of big companies reveal social policies*, Financial Times, 15 June 2005, at 8

Principles versus Rules

A different, but typical, way of analysing a jurisdiction's approach to regulation (of auditing and corporate governance practices) is to contrast a "principles" versus a "rule-based" system. The US is said to have a "rule-based" or "check-the-box" approach (to corporate governance). Whereas, Europe is said to have a "principles-based" approach, whereby the governed entity complies with the "spirit" and "intent" of a practice, rather than with the "letter" or the specific "rule" of a law.

It is not so clear cut, but the contrast highlights the bias and general approach. SOX illustrates this "check-the-box" approach, e.g., by requiring that audit committees have at least one financial expert on board. Once recruited, the entity may "check-the-box": we complied with that. On the other hand, a UK corporate governance code of conduct may require an entity to have *adequate* financial expertise available in all deliberations. One can foresee situations where the US financial officer may have obsolete or irrelevant expertise (and yet still the entity would be in compliance). Whereas, in the UK situation, compliance with the requirement for *adequacy* would mean the principle would not be satisfied unless – through whatever means necessary: consultancy, education, etc. – the UK entity engaged a suitably knowledgeable resource to participate in the deliberations at hand.

Both approaches have their advantages and disadvantages. However, Europe clearly favours the "principles-based" approach. As a previous EU Internal Market Commissioner said:

[...] a "soft-law approach", a self-regulatory market approach combined with disclosure and transparency obligations should be the guiding principle for any initiative in corporate governance.²⁵³

And it would appear that this approach is finding favour in the US too. As required by the Sarbanes-Oxley Act, the SEC had to study the merits of "principle-based" accounting. The deputy chief accountant at the SEC who conducted the study had a favourable opinion²⁵⁴.

Similarly, of a favourable opinion, the American Chamber of Commerce to the EU wrote:

"We firmly agree that a principles-based framework should be preferred to prescriptive rules. Prescriptive rules may lead to a box-ticking culture, whereas a principles-based framework provides more incentives for companies go beyond minimum requirements."²⁵⁵

²⁵³ F. Bolkestein, *Corporate Governance in Europe*, Address to conference at Clifford Chance Amsterdam, Jan. 2003

²⁵⁴ A. Bailey Jr. of the SEC: "The objectives-oriented approach... is a reasonable melding of principles, objectives, and guidance of sufficient detail and clarity to permit reasonable judgment..." [R. Jackson, *Principles versus Rules*, Internal Auditor, October 2004, at 61]

²⁵⁵ AMCHAM EU, *Position Paper on Description of Corporate Governance and Relevance*, August 27, 2003, at 1

The influence of culture and crisis

It has been argued that it was this “rules-based” culture in the US that facilitated corporate scandals such as *Enron* and *WorldCom*, insofar that these companies and their advisors believed that their corrupt activities complied with the letter (of the law or rule). It was in reaction to those crises that the Sarbanes-Oxley Act of 2002 was rapidly drafted, enacted and implemented.

As the widespread influence of Sarbanes-Oxley began to be felt outside of the US jurisdiction, and the “rules-based” culture began to infringe on the “principles-based” approach of European corporate governance,²⁵⁶ so the impetus for the EU to come up with its “own” reaction to corporate malfeasance²⁵⁷ grew²⁵⁸. This impetus manifested itself in what some call are now calling “Europe’s Sarbanes-Oxley”: i.e., the EU 8th Directive on Company Law²⁵⁹. The next sections examine to what extent this description is justified (with regards to auditing practices), by comparing key aspects of relevant Sarbanes-Oxley provisions with their counterparts in the EU.

But before moving on to this analysis, this section will close by sharing with you how the then EU Internal Market Commissioner Frits Bolkestein summed up this “clash of cultures”:

[...] I want European solutions tailored to our needs, respectful of our different cultures with the full support of the European profession. I do not accept the imposition of US standards on our firms and that is why the EU strongly opposes registration of EU audit firms with the United States' Public Company Accounting Oversight Board. The EU will regulate its own businesses."²⁶⁰

²⁵⁶ The difference between the US and EU approaches is officially recognised in EU commentaries on directives, e.g. “Of a more fundamental nature is the difference in approach. Whereas the EU follows what is basically a principles based approach, the US-SEC favours a more rule based approach. It should be noted that the US Independence Standards Boards (ISB) has applauded the EU for its conceptual approach.” [Source: European Commission, Auditor independence FAQ (EU website, May 2002) – under the FAQ: “Mandatory external rotation”]. Similarly, the US also officially recognises the difference, as indicated by SOX Section 108(d) concerning principles-based accounting. This Section called on the SEC to “study and report on [the US] adopting principles-based accounting”. The SEC reported that this principles-based system would contain: “fewer bright-line tests, less checklist-style detail, better-defined scopes, and clearer descriptions of objectives.” [Jackson R, *Principles versus Rules*, Internal Auditor, October 2004, 61]

²⁵⁷ Well-publicised examples of recent European corporate scandals include the companies: Parmalat, Ahold, Vivendi.

²⁵⁸ Although in its introduction to proposed legislation, the EU says: “This proposal is not a knee-jerk reaction to recent corporate scandals. It is the logical consequence of a reorientation of the EU policy on statutory audit started back in 1996. However, the initial thinking has been adapted to take account of the most recent scandals.” [Proposed eight EU Directive, Grounds and objectives, Section 1.1 – see the following footnote for the full description of the legislation].

²⁵⁹ Two points to note about this legislation: First, this is not *the* 8th Directive, but rather an expansion of the original 1984 8th Directive. Second, the legislation that was proposed on March 16, 2004 [*Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC* – see Appendix J] is still some way off from being effective. The Proposal must first be approved. Then the Directive needs to be incorporated in Member States national legislation, since the Directive will not have *direct effect* (unlike an EU Regulation).

²⁶⁰ F. Bolkestein, June 2003 speech: *EC Audit of Company Accounts: Ten Priorities to Improve Quality*

4.4. Auditing practices within the US context

Overview

This section outlines the key auditing practices in effect within the US today. As in the previous section, it focuses on those practices that are governed by regulation or code²⁶¹, as opposed to those (auditing) activities that are conducted at management's discretion. By default therefore, the activities of the external auditor and audit committees are our main interest. Sarbanes-Oxley is the key legislation now governing these activities.²⁶² Therefore, the analysis that follows will focus on the provisions²⁶³ of Sarbanes-Oxley where they are effective and relevant.

External audit

Independence

SOX enhances the "independence" of the external auditor from its client in various ways, such as prohibition of certain non-audit services²⁶⁴ (SOX Section 201), and restrictions on the company's employment of their auditor's staff (SOX Section 206).

Rotation

The audit partner and the reviewing partner must rotate off a company's audit every five years (per section 203). SOX Section 207 also mandated the General Accounting Office (GAO) to investigate the merits of a mandatory rotation of a company's audit *firm* (i.e. not just *partner*). In November 2003, the GAO concluded against such action, stating that:

[t]he report concludes with the GAO's belief that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality—while potential benefits are hard to predict and quantify, there is a fair amount of certainty there will be additional costs. The GAO believes the SEC and PCAOB should monitor and evaluate the effectiveness of existing requirements for enhancing auditor independence and audit quality over the next several years. And the GAO believes audit committees—with their increased responsibilities under Sarbanes-Oxley—can play an important role in ensuring auditor independence. To fulfil this role, audit committees must themselves be independent and have adequate resources.²⁶⁵

²⁶¹ For a full discussion of such "codes, standards and good practice" in the US, see, K. Waring and C. Pierce, *The Handbook of International Corporate Governance*, a definitive guide, Institute of Directors publication (2005) at 187

²⁶² Since "the Act does not specifically address the role of internal auditors" [IIA, *Internal Auditing's Role in Sections 302 and 404 of the U.S. Sarbanes-Oxley Act of 2002*, 26 May 2004, at 6], this activity is conducted at management's discretion and is therefore not addressed in this section. Please see footnotes/references 200,201,202,225,226 for details.

²⁶³ The text of relevant provisions can be found in Appendix F.

²⁶⁴ Some audit firms were restricting non-audit services for other reasons: "...in response to the marketplace, we are limiting the scope of services we provide beyond levels required by the regulators." (Ernst & Young Chairman & CEO James S. Turley, *Get Ready for the EU's 8th Directive*, Directorship, June 2004, at 19)

²⁶⁵ As reported in PricewaterhouseCoopers: 2004 Current Developments for Audit Committees, at 41

Special responsibilities – fraud detection

The Private Securities Litigation Reform Act of 1995 requires that “audits by [external auditors] must include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct impact on the determination of financial statement amounts.”²⁶⁶

Oversight

SOX established the PCAOB, with effect from 25 April 2003. All external auditors (or, more precisely, *registered public accounting firms* that conduct audits of US publicly listed companies and their subsidiaries), are required to register with the PCAOB and be subject to its rules. These rules mainly relate to the PCAOB authority to inspect and investigate external auditors with a view to establish whether they are adhering to relevant professional standards (re: auditing, ethics, independence, supervision, etc.). The SEC has oversight responsibility for the PCAOB [as per SOX, Section 107(a)].

Audit Committee

Independence

The Audit Committee is required to be composed entirely of “independent”²⁶⁷ directors.

Expertise

Companies are obliged to disclose whether their Audit Committee has at least one member who is a “financial expert”.²⁶⁸ According to a recent survey,²⁶⁹ 54% of the US largest 100 companies had one such expert, and a further 42% had two or more such experts on their Audit Committee. However, a separate study²⁷⁰ concluded that the appointment of “financial experts” to the Audit Committee is only likely to improve corporate governance if s/he is an *accounting* financial expert who is appointed to a company that had strong corporate governance before the appointment. The study also concluded that *accounting* financial experts appointed to companies without prior strong corporate governance, and *non-accounting* financial experts or directors without financial expertise did not – in a statistically-significant way as per their research – improve corporate governance.²⁷¹

²⁶⁶ R. Hamilton, *The Law of Corporations in a Nutshell* 571, 5th ed. (2000)

²⁶⁷ For definition of “independence”, see Appendix F: SOX, Section 301. Also see the stringent standards for

“independence” as set by the NYSE and NASDAQ: PwC: 2004 Current Developments for Audit Committees, at 13

²⁶⁸ “financial expert”, as defined by the SEC. Or see, PwC: 2004 Current Developments for Audit Committees, at 1.

²⁶⁹ See Appendix L: Corporate Governance Practices of the 100 Largest U.S. Public Companies (2004)

²⁷⁰ Defond M., Hann R. & Hu X., *Does The Market Value Financial Expertise on Audit Committees of Boards Of*

Directors, 43 Journal of Accounting Research May 2005, at 187

²⁷¹ *Accounting* financial experts were the original recommendation of SOX. The SEC final rule implementing the Act eventually adopted a much broader definition of financial expertise to capture *non-accounting* financial experts as well.

This relevance of this link to strong prior corporate governance experience is apparently explained in a different study, during which it was “found that [Audit Committees] with greater independence and governance expertise are more likely to shield external auditors from dismissal...”²⁷²

Another possible implication for the recent focus on having financial experts is higher legal liability for the individual concerned. A letter from the New York State Bar Association to the SEC stated:

[b]eing the designated expert on the audit committee also may be argued by plaintiffs’ attorneys to create a higher standard of care for the specific director with a resulting increase in exposure to liability. [...] it can only lead to increasing the potential for litigation and discouraging directors from serving on audit committees.²⁷³

Responsibilities and rights

The Audit Committee is solely responsible of the appointment, compensation, retention and oversight of audit work performed by the external auditor. It has the right to engage outside counsel as it sees fit²⁷⁴. The Audit Committee must be provided with appropriate funding as it sees necessary to perform its duties.

In addition to the general management of the company’s relationship with its external auditor (as summarised in the preceding paragraph), the Audit Committee has the specific mandate to “pre-approve” audit and non-audit services to be provided by the external auditor. The Audit Committee should not approve any non-audit service that is listed as a “prohibited activity”²⁷⁵ under SOX Section 201, unless exempted in accordance with that provision.

Finally, it has been argued, that in addition to the specific responsibilities summarised above and stipulated under SOX Section 301, the Audit Committee has oversight responsibilities over the CEO, CFO and all other Board members. Proponents²⁷⁶ of this view cannot cite any specific provision, but resort to the definitions (Section 2 of SOX) which states that an Audit Committee means: “(A) a committee [...] *overseeing* the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to [a company], *the entire board of directors* of the [company]”. [emphasis added]

²⁷² Gendron Y., Bedard J. and Gosselin M., *Getting Inside the Black Box: A Field Study of Practices in “Effective” Audit Committees*, 23 *Auditing: A Journal of Practice & Theory*, March 2004, at 155

²⁷³ Burrowes A., Kastantin J. and Novicevic M., *The Sarbanes-Oxley Act as a Hologram of Post-Enron Disclosure: a Critical Realist Commentary*, 15 *Critical Perspectives on Accounting* 2004, at 809

²⁷⁴ 46% of AC used outside advisors in 2nd-half 2003 (Matraia M., *A Critical Eye*, *Internal Auditor*, June 2005, at 35).

²⁷⁵ For list of “prohibited activities”, see Appendix F: SOX: Section 201: Services outside the scope of [...] auditors.

²⁷⁶ For example, see: Waring K. and Pierce C., *The Handbook of International Corporate Governance*, a definitive guide, Institute of Directors publication (2005) 181. See also, Klink F., *Director Risk after Sarbanes-Oxley*, in Campbell D. (Ed.), *Trends and Developments in Corporate Governance* 198 (2003)

Special responsibilities – “Whistleblower” protection

The Audit Committee must also set-up procedures for the confidential submission by employees of concerns regarding dubious company practices, e.g. questionable accounting or corporate misconduct. Such reporting (known as “whistle-blowing”) and the employee making it, is protected by SOX Section 806. If the Audit Committee fails to take this special responsibility seriously, the PCAOB has and will gladly step in. The PCAOB Director of Enforcement and Investigation said in a recent interview²⁷⁷: “We want to make sure that [whistleblowers] have an easily accessible way of reporting any information...”

Expectations for the future

The US reaction to pre-2002 corporate scandals was swift and strong. Perhaps too rapid and too strong. Future developments in the regulation of auditing practices and corporate governance in general should have more consultation and less aggression. What evidence is there of a need for a change in stance, and of the authorities recognition of such?

First one can look to the implementation of SOX. The reduced appetite of further mandatory regulation is evidenced by the GAO’s rejection of the need for mandatory audit firm rotation.²⁷⁸ More generally, both the SEC and the PCAOB acknowledged²⁷⁹ the need for a more liberal implementation of SOX than was originally envisaged. Although their May 2005 guidance focussed on SOX Section 404 (internal controls), subsequent guidance expanded the coverage.

Second, consider the over-zealous prosecution of audit firm *Arthur Andersen* by US Department of Justice (with the SEC directing the attack). Although the 31 May 2005 Supreme Court decision²⁸⁰ to overturn the Enron-related conviction of *Arthur Andersen* could not resurrect the firm, there is evidence to suggest that the US Government will not be so aggressive in future, especially given that the (previously) “Big Eight” audit firms are now down to the “Big Four”. On 16 June 2005, the *Wall Street Journal* reported that US prosecutors were debating whether to indict KPMG with respect to criminal charges relating to the sale of abusive tax shelters. The *Financial Times* said the “collapse of *Arthur Andersen* would prompt the Justice Department to avoid bringing charges against KPMG”.^{281 282} The US cannot risk reducing the availability of competitive audit services.

²⁷⁷ Salierno D., *PCAOB Facilitates Whistleblowing*, Internal Auditor, October 2004, at 21

²⁷⁸ See, earlier paragraph on “Rotation” (under External Audit, section 4.4)

²⁷⁹ A. Parker, *Use your judgment on Sarbanes 404*, Financial Times, 17 May 2005, at 20

²⁸⁰ P. Waldmeir, *Andersen conviction overturned*, Financial Times, 1 June 2005, at 15

²⁸¹ E. Kelleher, *KPMG ‘unlikely’ to face [tax] shelter charges*, Financial Times, 17 June 2005, at 20

²⁸² *Id.* J.Coffee, Columbia University: ‘prosecutors would opt to enter into a [...] deferred-prosecution agreement...’

4.5. Auditing practices within the EU context

Overview

As with the discussion on US practices in the preceding section, this section will focus on the activities of the external auditor and audit committee, but now in Europe. Europe, being what it was (EU15) and is (EU25) represents a rather more complex web of rules²⁸³: EU directives, EU recommendations, national laws, regulations, corporate governance codes and established practices. Moreover, the situation is highly fluid²⁸⁴. Just recently, the *Financial Times* reported²⁸⁵ some major changes to a key piece of EU legislation – the 8th Directive²⁸⁶ – further to EU European Parliament activity on 21 June 2005. In view of these uncertainties and complexities, and given the aim of this chapter to facilitate a comparison of ‘concept and culture’ with comparable US auditing practices, the analysis below will focus on the 8th Directive as it stood prior to the June 21st action in the EU. The (political) objectives²⁸⁷ of this draft 8th Directive are summarised (by the EU) in Appendix J.

However, two key points should be noted. First, the 8th Directive is some way off from being effected. (European) Parliament will vote in September 2005, and then it may be 1-2 years before Member States incorporate the Directive into their national legislation²⁸⁸. Second, even if the passage of this legislation is successful and timely, it gives widespread get-outs and exemptions so that member states can maintain existing practices in various areas. As the European MP responsible for the passage of this legislation explained in the June 22nd *Financial Times*: “The idea of this [revised 8th Directive] is that every member state should keep its own system. This also applies to Britain. We did not want any form of [EU] harmonised corporate governance”.²⁸⁹ So

²⁸³ See, Appendix K for an image of the complex web of EU regulations. See, also, for a full discussion of the various corporate governance systems operating in Europe: Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, *Comparative study of corporate governance codes relevant to the European Union and its member states* (2002).

²⁸⁴ In addition to the European Parliament changes to the 8th Directive reported in the June 22nd FT paper (*infra*, at 1), the key European Corporate Governance Forum had only its second meeting on 20 June 2005 since the “Winter Report” and the FSAP established it. Its agenda included a discussion of the 8th Company Law Directive (agenda item 5c).

²⁸⁵ Buck T. and Jopson B., *European Parliament softens its line on mandatory audit committee directives*, *Financial Times*, 22 June 2005, at 1 (front page)

²⁸⁶ March 16, 2004 *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*

²⁸⁷ The proposed 8th Directive aims to address those areas not covered in the original 8th Directive (from April 1984), e.g. how a statutory audit should be conducted; public oversight of external auditors; external audit quality assurance.

²⁸⁸ March 16, 2004 *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*, at 36: Although the draft 8th Directive (Article 53) talks about incorporation by 1/1/06, “The proposed Directive likely will be adopted in its final form by mid-2005 and transposed into the national law of EU Member States by the end of 2006.” (PwC: 2005 Current Developments for Audit Committees, at 32)

²⁸⁹ Quotation from Lambert Doorn, Dutch Member of European Parliament (MEP) “charged with steering the law through [European] Parliament” [Source: Buck T. and Jopson B., *European Parliament softens its line on mandatory audit committee directives*, *Financial Times*, 22 June 2005, at 1 (front page)]

although the analysis below will show some comparability in substance with US Sarbanes-Oxley, an EU Directive of this type will not have the strength of its comparative “federal” enforcement.

Not surprisingly, the 8th Directive reflects many of the ideas and solutions reflected in the “Winter Report”²⁹⁰ (e.g. re. non-audit services, monitoring internal audit, Audit Committee responsibilities). One interesting concept of the “Winter Report” that the 8th Directive expands on, is that of the “open” (not closed, not listed) entity. The 8th Directive is bold, yet logical, to try and capture within its scope of regulation all “significant” entities, irrespective of whether they are “listed”. They introduce the idea of a *Public Interest Entity*, which as a minimum includes all listed firms, but may also capture large companies in view of their employment or strategic interest. Given the growth of private equity taking major (previously-public) companies private, it is surely sensible to recognise that it is not just a company’s appetite for public financing capital that should determine whether good corporate governance is applicable.

External audit

Independence

Audit firms and the relevant staff/partners must be independent from the audited entity. The auditors must not be involved in any management decisions, and must not accept any non-audit engagement that would compromise their independence. Any significant threat to the auditor independence must be avoided, or at least documented and subject to review by independent directors. This would include the situation where the auditor was subject to dismissal by the same function responsible for preparation of the financial statements (e.g. the CFO or Finance Director).

Rotation

Mandatory audit *firm* rotation is every seven years. (Although Member State opt-out is possible).²⁹¹ The audit *partner* and the reviewing partner must rotate off a company’s audit every five years. The EC explains the rationale behind this proposal on its website as follows:

[i]n order to reinforce the independence of auditors of public interest entities, the proposed Directive requires mandatory rotation of auditors. Member States would have the option of requiring either a change of key audit partner dealing with an audited company every five years, if the same audit firm keeps the work (“internal rotation”), or a change of audit firm every seven years (“external rotation”). The Commission believes that mandatory rotation will contribute to avoiding conflicts of interest.²⁹²

²⁹⁰ “The Winter Report”: A modern regulatory framework for company law in Europe (2002) at 70.

²⁹¹ “Italy is currently the only EU country where [audit firm] rotation is mandatory. Rotation applies every nine years with compulsory competitive tendering every three years.” [Fearnley S. and Beattie V., *The Reform of the UK’s Auditor Independence Framework after the Enron Collapse: An Example of Evidence-based Policy Making*, 8 IJA 2004, at 125]

²⁹² European Commission proposal for a Directive on statutory audit: frequently asked questions [<http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/04/60&format=HTML&aged=0&language=EN&guiLanguage=en>]

Special responsibilities – group audit report

“The group auditor bears full responsibility for the audit report on the consolidated accounts of a group of companies.”²⁹³

Oversight

Audit firms must be subjected to their member state’s systems of registration, quality assurance, investigation and sanctions. Within this category of audit firms, are those non-EU auditors who issue audit reports in relation to securities traded in the EU. Oversight of external audit firms must be carried out by non-practitioners who are knowledgeable about accounting and auditing.

This approach is consistent with certain academic studies²⁹⁴ that suggest that with respect to international regulatory regimes for audit quality, regimes that facilitate “mutual recognition” of other countries’ audit standards/qualifications can result in a higher-quality overall than a regime which tries to achieve “full harmonisation” (most probably via “minimal standards” rather than “best practices”, as a result of the political compromises needed to achieve agreement).

Soon after the US PCAOB was established, some EU member states moved in a similar direction, i.e. away from “self-regulation” of external auditors to some form of “independent oversight”, e.g.,

[t]he structure of regulation in the UK changed when the responsibilities of the Financial Reporting Council (FRC), an independent regulator, were expanded in the aftermath of the accounting scandals in the US.[...] A PCAOB-type regulatory board, the Professional Oversight Board for Accountancy (POBA), was formed to support the work of FRC. The role of POBA is to provide independent regulation of the auditing and accountancy profession.²⁹⁵

The Netherlands is also currently deliberating its own law (*Wet toezicht accountantsorganisaties/WTA* – the Law on Public Oversight of Auditors) that would introduce independent oversight of audit firms, with effect from the first quarter in 2006. However, there is some resistance, with NIVRA being concerned about the “heavy administrative burden which would be imposed on companies”.²⁹⁶ The Authority for the Financial Markets (“AFM”) would eventually derive power from the proposed legislation to oversee Dutch audit firms. “Unlike the [PCAOB], the scope for the

²⁹³ March 16, 2004 Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council [4th and 7th] Directives 78/660/EEC and 83/349/EEC. [http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfinal&an_doc=2004&nu_doc=177]

²⁹⁴ Trombetta M., *International Regulation of Audit Quality: Full Harmonisation or Mutual Recognition? An Economic Approach*, 12 *European Accounting Review* 2003, at 3-27

²⁹⁵ Mintz S., *Corporate Governance in an International Context: legal systems, financing patterns and cultural variables*, 13 *Corporate Governance: An International Review* 2005, at 591

²⁹⁶ Rob Bosman, technical director at NIVRA (the largest Dutch professional accountancy body), as reported in: *The Netherlands: Benefits of oversight still contested in the Netherlands*, *The Accountant*, July 2005, at 1

AFM is not restricted to publicly quoted companies.”²⁹⁷ And in Germany too, proposals have been put forward to legally implement a new oversight system on accountants (*Wirtschaftspruefer*). “The new act will combine the established oversight system in Germany with international requirements, from both US and EU perspectives.”²⁹⁸ This, taken together with the EU 8th Directive, will help to “[...] relieve German public audit firms registered in the US as far as possible from oversight by the PCAOB”²⁹⁹, because the PCAOB allows for oversight by foreign oversight boards in certain cases, “provided that those oversight bodies follow procedures similar to those in the US.”³⁰⁰ EU firms are hoping that these new EU and member oversight structures are in place before the first PCAOB inspections in 2007, so that EU firms could be exempt “under new agreements of reciprocity”.³⁰¹

Pending these developments, many German accounting firms (together with many other EU firms), met the SOX deadline of registering with the PCAOB by 19 July 2004.³⁰² According to testimony given to the US Congress, around 400 non-US accounting firms would fall under SOX oversight.³⁰³

Audit Committee

Independence

The Audit Committee must comprise of non-executive members from the administrative or supervisory boards.

Expertise

At least one of the independent members must have competence in accounting and/or auditing.

Responsibilities and rights

The Audit Committee shall monitor the company’s financial reporting process and the effectiveness of its internal control, internal audit and risk management systems. The Committee shall oversee all aspects of the company’s relationship with its external auditor, including their appointment, their provision of non-audit services, the statutory audit and the independence of the external auditor.

²⁹⁷ *The Netherlands: Benefits of oversight still contested in the Netherlands*, The Accountant, July 2005, at 1

²⁹⁸ Engelen K., *Lemons into Lemonade: How the US turned an ugly accounting scandal into a mighty lever for global financial oversight and regulation*, International Economy, Fall 2004, at 58

²⁹⁹ *Id.*, at 58

³⁰⁰ *Id.*, at 58

³⁰¹ *Id.*, at 58. See, also, EC press release, *Audit of company accounts: Commission sets out ten priorities to improve quality and protect investors*, EU website, 21 May 2003: “Rapid progress [on the changes to the 8th Directive] will be a sound bedrock for exempting EU auditors from unnecessary and burdensome US [PCAOB] regulatory outreach[.]”

³⁰² Approximately two million statutory audits are conducted annually in the EU. [Source: EC press release, *Audit of company accounts: Commission sets out ten priorities to improve quality and protect investors*, EU website, 21 May 2003]. Many of these relate to entities subject to SOX; hence the need for EU accounting firms to register with PCAOB.

³⁰³ *Supra* note 298, at 57

Expectations for the future

EU regulation of auditing practices is likely to be slow and represent the lowest common denominator of member states' interests rather than "best practice" corporate governance. Two examples to demonstrate this stance were seen in June 2005. The 23 June 2005 press release, regarding the 2nd meeting of the EU European Corporate Governance Forum, confirmed that:

[b]efore any further legislative measures [regarding the 4th, 7th and 8th Directives] are taken, there should be a careful examination of [...] how to strike the balance between the benefits of additional requirements and the costs and burdens that would result from these for companies.³⁰⁴

This reflects similar language to the UK DTI concerns expressed in their consultative process.³⁰⁵ Secondly, again in relation to the 8th Directive, "a key committee of the European Parliament voted in favour of a [21 June 2005] proposal to soften the controversial EU auditing directive"³⁰⁶.

On the other hand, the extraterritorial impact of US legislation – both directly via public law and stock exchange regulation, and indirectly via export of corporate policies of US multinationals – will exert pressure on EU authorities and governments to design and implement European solutions.

This US pressure was acknowledged by the EC, when in May 2003, it proposed ten priorities for harmonising the quality of EU external audits, which it said was "crucial to the EU-US regulatory dialogue on audit issues"³⁰⁷. The ten priorities were captured under the following headings:

[s]ummary of the short-term priorities:

- Modernising the 8th Company Law Directive
- Reinforcing the EU's regulatory infrastructure
- Strengthening public oversight of the audit profession
- Requiring International Standards on Auditing (ISAs) for all EU statutory audits

Summary of the medium-term priorities:

- Improving disciplinary sanctions
- Making audit firms and their networks more transparent
- Corporate governance: strengthening audit committees and internal control
- Reinforcing auditor independence and code of ethics
- Deepening the Internal Market for audit services
- Examining auditor liability.³⁰⁸

³⁰⁴ EU corporate governance website (June 23, 2005):

<http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/779&format=HTML&aged=0&language=EN&guiLanguage=fr>

³⁰⁵ See Appendix J for an extract of the UK DTI consultative document highlighting need for cost-benefit analysis.

³⁰⁶ T. Buck and B. Jopson, *European Parliament softens its line on mandatory audit committee directives*, Financial Times, 22 June 2005, at 1 (front page)

³⁰⁷ Extract from: European Commission press release, *Audit of company accounts: Commission sets out ten priorities to improve quality and protect investors*, EU website, 21 May 2003.

³⁰⁸ *Id.* - Full details available from weblink in bibliography. Official EC brief descriptions can be found in Appendix O.

The March 2004 proposed 8th Directive was the first EU legislation to evolve from these priorities. Future legislation will ideally converge the US-EU differences that can be summarised as follows:

Overview: The EU 8th Directive compared with the US Sarbanes-Oxley³⁰⁹		
ISSUE	EU COMPANY LAW 8TH DIRECTIVE	US SARBANES-OXLEY ACT
Audit committee	Mandatory for listed companies. Must be independent and have at least one financial expert. Appoints or dismisses the auditor.	Also requires procedures for complaints from whistleblowers and others.
Internal controls	Requires audit firm report on key matters arising from the audit, particularly material weaknesses in internal controls related to financial reporting.	Requirements are more detailed.
Public oversight of auditors	25 EU member/accession states to appoint oversight boards for auditors, register firms and establish investigative/disciplinary systems.	PCAOB oversees audit of public companies; establishes standards for auditing, registration, quality control, ethics and independence of audit firms.
Auditor independence	Raises the possibility of “total prohibition” on non-audit services.	Proscribes specific services and requires audit committee pre-approval for other non-audit services.
Firm vs. Partner rotation	Provides for either audit firm or key audit partner rotation, audit firm at seven years and audit partner at five years.	Requires lead and concurring audit partner rotation every five years; no requirement for firm rotation.
Group auditor responsibility	Group auditors bears full responsibility for the audit of the consolidated accounts; responsibility extends to the work of other audit firms.	None.

Concurrently, it is expected that auditing practices, traditionally considered the first line of defence for investors,³¹⁰ will probably represent one of the initial battlegrounds between the US “rule-based” and EU “principle-based” cultures (up there with financial reporting standards). Both approaches have a lot to offer, and one can be mildly optimistic that a degree of convergence is possible, if only because global multinationals who bear the brunt of dual-regulation, want it.

This chapter started by clarifying the various auditing activities, both internal and external to an EU entity. It went on to set-out the way in which different jurisdictions regulate these activities, taking account of the important differences between principle-based and rules-based cultures. Having established this framework and basis for comparison, the chapter then outlined how SOX governs auditing practices in the US. The following section then outlined how current proposed EU legislation and practices would need to be changed if it was to be aligned with SOX, and thereby minimise SOX impact on EU auditing practices. This EU (8th Directive) and other member state (e.g. Germany, Netherlands and UK) legislation are undergoing changes in order to accommodate or align with SOX, and these changes demonstrate that SOX is influencing EU auditing practices.

³⁰⁹ Based on table in: Ernst & Young Chairman & CEO James S. Turley, *Get Ready for the EU's 8th Directive*, Directorship, June 2004, at 20

³¹⁰ Auditors are often referred to as the “gatekeepers” to a company’s assets.

5. CONCLUSION

The US legislative reaction to the corporate scandals of the early 2000's was swift and strong. Perhaps Sarbanes-Oxley came too quickly and too strong. After all, the investor protection statutes following the 1929 *Wall Street* crash only materialised years later in 1933/34. Nevertheless, there is a statute, and that is an achievement. Europe's company law reforms to corporate crises of the same period are still "under discussion". It is the threat of SOX impending impact that is forcing the EU to speed up its own legislative process. Proposed changes to EU's 8th Directive are a case in point.

The 8th Directive regulates auditing practices. If the proposed changes to it are effective by 2007, together with corresponding member state legislation, then EU audit firms may escape oversight from the US regulator PCAOB. The EU's goal is to achieve "mutual recognition" with the US regarding oversight authority, and therefore exempt EU firms from US oversight. To achieve this, it cannot avoid the influence from SOX and the PCAOB, since the EU and its members are designing legislation that will satisfy the US authorities. For full exemption foreign oversight procedures must resemble the PCAOB approach.³¹¹ This is one instance of SOX's extraterritorial impact in the EU.

Another example demonstrating the extraterritorial reach of SOX into EU firms concerns the SOX provision on internal controls. A Dutch subsidiary of a UK multinational must comply with US law because the UK company has a certain type or number of US investors. Such is the controversy and complexity regarding the application of SOX Section 404 that the US regulator SEC has delayed compliance deadlines three times and issued implementation guidance on numerous occasions. EU companies are now gearing up for compliance, and the impacts are observable from US experience. Those impacts are higher costs, more regulation and disclosure and enhanced corporate governance.

SOX enhanced corporate governance is positive. Audit committee independence, restrictions on non-audit services provided by public company auditors, strong internal controls, CEO/CFO certification of financial statements, have all been recognised as such by EU firms and EU corporate governance codes for over a decade. Europe's resistance to SOX's imposition is mainly just that; the EU does not want the US to mandate 'good governance', even if it is. The shortcoming in Europe's alternative approach to corporate governance is twofold. First, some companies choose to "explain" rather than to "comply" with Europe's voluntary corporate governance codes. Second, there are too many codes; more than 35 for the EU15. SOX will induce more consistency in the EU.

³¹¹ A fuller description of the US requirements are outlined in: Public Company Accounting Oversight Board, PCAOB Release No. 2003-020: Briefing Paper; Oversight Of Non-U.S. Public Accounting Firms, October 28, 2003, at 1-6

Greater consistency – or harmonisation – is already happening. This is another positive aspect of SOX extraterritorial reach into EU companies. A set of core corporate governance standards is emerging. And they are transparent, consistent and universal, because of SOX' detailed legislation, wide broadcast and extensive application. This broad application is being propelled in three ways.

The three ways in which SOX extraterritorial influence is being spread is via “copy-cat” legislation, voluntary compliance and the internal policies used by foreign subsidiaries of SOX multinationals. Non-US countries may not admit to modelling their laws on SOX, but we have seen the evidence. Voluntary compliance may not be so “voluntary” if your banker or insurer insists on dealing with SOX-compliant firms only, but the impact is the same. SOX has the powerful potential to spread good corporate governance to all corners of the globe, to private and public companies alike. The harmonisation effect from these various forms of SOX application implies that it cannot be avoided.

Some firms have delisted from US stock exchanges, but they still find themselves subject to SOX or SOX-comparable corporate governance. Becoming a private company or listing on a non-US stock exchange does not necessarily give escape from SOX' jurisdiction, such is its reach beyond the US.

We have shown above the direction that SOX is going, spreading its influence way beyond its legislated scope. It is too early to conclude that SOX will achieve global dominance in the sphere of corporate governance. After all, many of its provisions are not yet effective for foreign companies. Nonetheless, what is clear, from the analysis in this paper and the synopsis above, is that Sarbanes-Oxley is impacting the way that EU entities manage themselves, and there is no escape from that.

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7. GLOSSARY

Accelerated filers: US companies with a market capitalisation in excess of \$ 75 million.

ADR: American Depositary Receipts, a “receipt for the shares of a foreign-based corporation held in the vault of a U.S. bank and entitling the shareholder to all dividends and capital gains.”³¹² There are three types of ADR: “Level 1” is the most basic type. They are not listed on an exchange, but trade Over-The-Counter, and they have the least stringent requirements from the SEC. “Level 2” ADRs are listed on an exchange or quoted on NASDAQ. “Level 3” is the most prestigious, allowing the issuer to actually raise capital in the US markets (rather than just to trade its securities).

AeA: American Electronics Association, represents 2,500 companies, and is a major critic of SOX.

Big Four: The accountancy/audit firms: Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers.

AICPA: American Institute of Certified Public Accountants, a professional body of US accountants.

CAE: Chief Audit Executive, the key executive within a company, responsible for internal auditing.

Comply or explain: “Some corporate governance codes advocate [...] disclosure by listed companies of the degree to which they comply with code recommendations, together with an explanation of any areas of non-compliance. [...] such disclosure against a code is referred to as disclosure on a “comply or explain” basis. [...] The Cadbury Report was the first [corporate governance] code to suggest disclosure on a “comply or explain” basis as a means of encouraging companies to follow best practice recommendations.”³¹³

Cooling-off period: “[...] rules that an accounting firm would not be independent if certain members of management of [the auditee] had been members of the accounting firm's audit engagement team within the one-year [or cooling-off] period preceding the commencement of audit procedures. [...]. The cooling-off period only will apply to the lead partner, [...] or any other member of the audit engagement team, unless exempted, who provides more than 10 hours audit [...] services.”³¹⁴

³¹² Downes J. and Goodman J., Barron's Dictionary of Finance and Investment Terms, 5th ed. (1998), at 22

³¹³ Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, Comparative study of corporate governance codes relevant to the European Union and its member states (2002), at 2 and 69

³¹⁴ Securities and Exchange Commission, E.Tafara, Acting Director, Office of International Affairs speech: “Addressing International Concerns under the Sarbanes-Oxley Act”, 10 June 2003

Corporate governance: “Corporate governance is the system by which companies are directed and controlled” - This is the definition taken from the Cadbury Report (UK) on Corporate Governance. There are various other definitions; please refer to section 1.2 in the main text for overview on this.

COSO: Committee of Sponsoring Organisations. “Under the COSO Framework for internal control, there is a direct relationship between objectives, which are what an entity strives to achieve, and the components of internal control, which represent what is needed to achieve the objectives.”³¹⁵ The COSO Framework for internal controls underlies Sarbanes-Oxley Section 404 controls.³¹⁶

EC: European Commission, the executive body of the European Union.

EU and EU15: European Union: before May 2004, was made up of 15 member states (the “EU15”): Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, United Kingdom.

EU25: The EU25 comprises the original EU15 plus the 10 new members who joined in May 2004: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia.

External audit: “Professional examination and verification of a company’s accounting documents and supporting data for the purpose of rendering an opinion as to their fairness, consistency, and conformity with Generally Accepted Accounting Principles [GAAP].”³¹⁷

FDIC: Federal Deposit Insurance Corporation, a US federal agency “that guarantees (within limits) funds on deposit in member banks and thrift institutions [...]”³¹⁸

Foreign private issuer: “Companies that are domiciled in countries other than the United States and whose securities are traded on the U.S. exchanges. [...] companies that are owned by the public, not the government.”³¹⁹

³¹⁵ Fédération des Experts comptables Européens (FEE), *Risk Management and Internal Control in The EU: Discussion Paper* (March 2005), at 15. See Appendix I for fuller description of COSO Framework

³¹⁶ Alles M., Kogan A. and Vasarhelyi M., *The Law Of Unintended Consequences? Assessing The Costs, Benefits And Outcomes Of The Sarbanes-Oxley Act*, 1 *Information Systems Control Journal* 2004, at 19

³¹⁷ Downes J. and Goodman J., *Barron’s Dictionary of Finance and Investment Terms*, 5th ed. (1998), at 35

³¹⁸ Downes J. and Goodman J., *Barron’s Dictionary of Finance and Investment Terms*, 5th ed. (1998), at 195

³¹⁹ Rouse R.W., *How will Sarbanes-Oxley affect foreign companies*, 14 *Journal of Corporate Accounting & Finance*, September 2003, at 55

GAAP: Generally Accepted Accounting Principles which determine the approach and standards used to compile a company's financial statements such as balance sheets and profit & loss reports. The three key types are: US GAAP (used by American corporations and their foreign subsidiaries); IAS/IFRS International Financial reporting Standards (used as a basis in many developing countries as well as being mandatory within the EU since 2005); local or domestic GAAP, e.g. UK GAAP (which may be used to prepared an additional set of accounts, or used to supplement e.g. IFRS).

ICAEW: The Institute of Chartered Accountants in England and Wales is the largest professional accountancy body in Europe with 125,000 members.

IFRS: International Financial Reporting Standards, which became mandatory accounting standards for public companies listed in the EU which are reporting financial results after 1 January 2005.

Internal control: As defined by COSO: "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, (c) compliance with applicable laws and regulations."³²⁰

IPO: Initial Public Offering, i.e. when a private company goes to the stock market to raise financing from public shareholders for the first time.

Issuer: A company or entity that has "issued" (or listed) debt or equity on a securities exchange.

M&A: Mergers & Acquisitions, a generic term describing the corporate finance activities and profession related to corporate takeovers, bids, mergers, divestures, leveraged buyouts, etc.

Non-accelerated filers: Foreign companies and smaller US companies

Non-audit services: "[...] means any professional services provided to an issuer by a registered public accounting firm, other than those provided to an issuer in connection with an audit or a review of the financial statements of an issuer."³²¹

Non-US public company: A corporation with its primary share listing and headquarters outside US.

³²⁰ Protiviti, Guide To The Sarbanes-Oxley Act: Internal Control Reporting Requirements (2003), at 20

³²¹ Sarbanes-Oxley Section 2(a)(8)

PCAOB: Public Company Accounting Oversight Board, a five-member board established by the Sarbanes-Oxley Act, overseen by the SEC, overseeing audit firms, audit report standards and rules.

PQE: Post-Qualification Experience: the quantity and type of work experience that an accountant has gained subsequent to his passing of professional examinations. (Also relevant for lawyers, etc.).

SEC: Securities and Exchange Commission, the main US federal agency with oversight responsibility for stock exchanges and their members, as well as for the PCAOB now.

SEC Forms: SEC reporting requirements include the submission of certain forms/reports³²², e.g.

- **Form 6-K:** Foreign private issuers must furnish on Form 6-K material information (i) distributed to stockholders or to a national exchange (if the information is made public by that exchange), or (ii) required to be made public by domestic laws.
- **Form 8-K:** This is the "current report" that is used to report the occurrence of any material events or corporate changes which are of importance to investors or security holders and previously have not been reported by the registrant. It provides more current information on certain specified events than would Forms 10-Q or 10-K.
- **Form 10-K:** This is the annual report that most reporting companies file with the Commission. It provides a comprehensive overview of the registrant's business. The report must be filed within 90 days after the end of the company's fiscal year.
- **Form 10-Q:** The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is due within 45 days of the close of the quarter.
- **Form 20-F:** Foreign private issuers are required to file an Annual Report with the SEC on form 20-F. (This is equivalent to the Annual Report on form 10-K which a US company has to file).

Service organisations: "[...] for example, bank trust departments that invest and service assets for employee benefit plans or for others, mortgage bankers that service mortgages for others, and application service providers that provide packaged software applications in a technology environment that enables customers to process financial and operational transactions."³²³

SOX: Sarbanes-Oxley Act of 2002 (United States law). Less often referred to as SOA (A for Act). Named after US Senator Paul Sarbanes and Congressman Michael Oxley who sponsored the law.

³²² These descriptions are based on information from SEC webpages <http://www.sec.gov/info/edgar/forms/edgform.pdf> and Downes J. and Goodman J., Barron's Dictionary of Finance and Investment Terms, 5th ed. (1998), at 220-221 and [http://www.ey.com/global/download.nsf/International/EY_Summary_FirstTimeApplication_IFRS.pdf/\\$file/EY_Summary_FirstTimeApplication_IFRS.pdf](http://www.ey.com/global/download.nsf/International/EY_Summary_FirstTimeApplication_IFRS.pdf/$file/EY_Summary_FirstTimeApplication_IFRS.pdf) and http://www.irs.gov/pub/irs-utl/iii.d.3_-_sec_reports.pdf

³²² Baker & McKenzie North America, The Sarbanes-Oxley / Outsourcing Intersection: An Introduction, US Outsourcing Client Alert, Se" http://www.irs.gov/pub/irs-utl/iii.d.3_-_sec_reports.pdf

³²² Baker & McKenzie North America, The Sarbanes-Oxley / Outsourcing Intersection: An Introduction, US Outsourcing Client Alert, September 2004, at 5

Baker & McKenzie North America, The Sarbanes-Oxley / Outsourcing Intersection: An Introduction, US Outsourcing Client Alert, September 2004, at 5

US GAAP: "...are the Generally Accepted Accounting Principles in the US. They comprise a massive volume of standards, interpretations, opinions and bulletins and developed by the FASB (Financial Accounting Standards Board), the accounting profession (AICPA) and the SEC[...]."³²⁴

US public company: A corporation that has its shares quoted on a US securities exchange.

Whistle-blowing: The "confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."³²⁵ (Narrow definition for SOX purposes.) In general, an employee (or former employee) informing authorities about employer's wrongdoing.

Winter Report: A comprehensive assessment of how to progress corporate governance and company law reforms within the EU. Named after Professor Jaap Winter who chaired the committee of the *High Level Group of Company Law Experts* which issued the report in November 2002 with the official title: "A Modern Regulatory Framework for Company Law in Europe".

³²⁴ European Commission, Update of the Accounting Strategy FAQ (EU website, June 2000)

³²⁵ SOX Section 301

8. LIST OF APPENDIXES

- APPENDIX A:** *US Sarbanes-Oxley Act of 2002: Main title headings*
Reference*: Sections: 1.1, 2.4
- APPENDIX B:** *Overview of International Financial Reporting Standards in the EU*
Reference*: Sections: 1.1
- APPENDIX C:** *The wide variety of corporate governance frameworks in the EU*
Reference*: Sections: 1.2, 3.8
- APPENDIX D:** *The Political and Corporate Climate leading up to Sarbanes-Oxley*
Reference*: Sections: 2.1
- APPENDIX E:** *The increasing costs and employment related to Sarbanes-Oxley*
Reference*: Sections: 3.4, 3.5
- APPENDIX F:** *US Sarbanes-Oxley Act: Selected extracts (related to auditing practices)*
Reference*: Sections: 3.5, 3.6, 4.1, 4.2, 4.4
- APPENDIX G:** *The potential “cascading” affect of EU states widening the use of IFRS*
Reference*: Sections: 3.8
- APPENDIX H:** *The cost-benefit of Sarbanes-Oxley compliance according to non-US issuers*
Reference*: Sections: 3.4, 3.9
- APPENDIX I:** *The COSO Framework which underlies Section 404 internal controls*
Reference*: Sections: 7.0
- APPENDIX J:** *EU 2004 Proposal to expand the 8th Company Law Directive*
Reference*: Sections: 4.3, 4.5
- APPENDIX K:** *The complex web of EU regulations, with the UK as example*
Reference*: Sections: 1.4, 3.8, 4.5
- APPENDIX L:** *Audit Committee Composition*
Reference*: Sections: 4.3, 4.4
- APPENDIX M:** *EU multinationals’ annual reports: references to the impact of SOX*
Reference*: Sections: 1.4, 3.9
- APPENDIX N:** *Companies reporting internal control weaknesses, as per SOX Section 404*
Reference*: Sections: 3.3
- APPENDIX O:** *Statutory audits: EU ten priorities to improve quality and protect investors*
Reference*: Sections: 4.5

(*) The references shown above indicate whereabouts in the thesis’ main text, this particular appendix is cited. This will provide the reader with the context and relevance of the appendix. There may be multiple citations to the same appendix within any one section; only one citing is indicated.

APPENDIX A: US Sarbanes-Oxley Act of 2002: Main title headings (from the SEC website)

TITLE I--PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

- Sec. 101. Establishment; administrative provisions.
- Sec. 102. Registration with the Board.
- Sec. 103. Auditing, quality control, and independence standards and rules.
- Sec. 104. Inspections of registered public accounting firms.
- Sec. 105. Investigations and disciplinary proceedings.
- Sec. 106. Foreign public accounting firms.
- Sec. 107. Commission oversight of the Board.
- Sec. 108. Accounting standards.
- Sec. 109. Funding.

TITLE II--AUDITOR INDEPENDENCE

- Sec. 201. Services outside the scope of practice of auditors.
- Sec. 202. Preapproval requirements.
- Sec. 203. Audit partner rotation.
- Sec. 204. Auditor reports to audit committees.
- Sec. 205. Conforming amendments.
- Sec. 206. Conflicts of interest.
- Sec. 207. Study of mandatory rotation of registered public accounting firms.
- Sec. 208. Commission authority.
- Sec. 209. Considerations by appropriate State regulatory authorities.

TITLE III--CORPORATE RESPONSIBILITY

- Sec. 301. Public company audit committees.
- Sec. 302. Corporate responsibility for financial reports.
- Sec. 303. Improper influence on conduct of audits.
- Sec. 304. Forfeiture of certain bonuses and profits.
- Sec. 305. Officer and director bars and penalties.
- Sec. 306. Insider trades during pension fund blackout periods.
- Sec. 307. Rules of professional responsibility for attorneys.
- Sec. 308. Fair funds for investors.

TITLE IV--ENHANCED FINANCIAL DISCLOSURES

- Sec. 401. Disclosures in periodic reports.
- Sec. 402. Enhanced conflict of interest provisions.
- Sec. 403. Disclosures of transactions involving management and principal stockholders.
- Sec. 404. Management assessment of internal controls.
- Sec. 405. Exemption.
- Sec. 406. Code of ethics for senior financial officers.
- Sec. 407. Disclosure of audit committee financial expert.
- Sec. 408. Enhanced review of periodic disclosures by issuers.
- Sec. 409. Real time issuer disclosures.

TITLE V--ANALYST CONFLICTS OF INTEREST

- Sec. 501. Treatment of securities analysts by registered securities associations and national securities exchanges.

TITLE VI--COMMISSION RESOURCES AND AUTHORITY

- Sec. 601. Authorization of appropriations.
- Sec. 602. Appearance and practice before the Commission.
- Sec. 603. Federal court authority to impose penny stock bars.
- Sec. 604. Qualifications of associated persons of brokers and dealers.

TITLE VII--STUDIES AND REPORTS

- Sec. 701. GAO study and report regarding consolidation of public accounting firms.
- Sec. 702. Commission study and report regarding credit rating agencies.
- Sec. 703. Study and report on violators and violations
- Sec. 704. Study of enforcement actions.
- Sec. 705. Study of investment banks.

TITLE VIII--CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY

- Sec. 801. Short title.
- Sec. 802. Criminal penalties for altering documents.
- Sec. 803. Debts nondischargeable if incurred in violation of securities fraud laws.
- Sec. 804. Statute of limitations for securities fraud.
- Sec. 805. Review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud.
- Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.
- Sec. 807. Criminal penalties for defrauding shareholders of publicly traded companies.

TITLE IX--WHITE-COLLAR CRIME PENALTY ENHANCEMENTS

- Sec. 901. Short title.
- Sec. 902. Attempts and conspiracies to commit criminal fraud offenses.
- Sec. 903. Criminal penalties for mail and wire fraud.
- Sec. 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.
- Sec. 905. Amendment to sentencing guidelines relating to certain white-collar offenses.
- Sec. 906. Corporate responsibility for financial reports.

TITLE X--CORPORATE TAX RETURNS

- Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by chief executive officers.

TITLE XI--CORPORATE FRAUD AND ACCOUNTABILITY

- Sec. 1101. Short title.
- Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.
- Sec. 1103. Temporary freeze authority for the Securities and Exchange Commission.
- Sec. 1104. Amendment to the Federal Sentencing Guidelines.
- Sec. 1105. Authority of the Commission to prohibit persons from serving as officers or directors.
- Sec. 1106. Increased criminal penalties under Securities Exchange Act of 1934.
- Sec. 1107. Retaliation against informants.

APPENDIX B: Overview of International Financial Reporting Standards in the EU³²⁶

Financial Reporting



By setting a target date of 2005 for the adoption of International Financial Reporting Standards (formerly International Accounting Standards – IAS), the European Commission has arguably done more than any other institution to advance the cause of convergence of global accounting standards.

This means that, for the vast majority of European listed companies, IFRS implementation is just around the corner. In order to produce their first IFRS accounts for 2005, companies will need to prepare comparative information for 2004, and an opening position under IFRS as at 1 January 2004. The key dates are included in the table below.

Months left	Period start/end	Publication date	Action
Now	1 January 2004	-	Start IFRS record keeping. Determine opening position for 2004 comparatives
12 months	1 January 2005	-	IFRS changeover date
18 months	30 June 2005	30 August 2005	First half-year interim reports under IFRS
24 months	31 December 2005	30 April 2006	First published annual IFRS financial statements

Use of a common standard for financial reporting helps economic development by providing a single basis of measurement and comparison of financial performance. This facilitates competition in the allocation of capital. Ultimately, as well as lower cost of capital, it should also reduce companies' cost of compliance with different accounting rules.

IFRS countdown to 2005

The EC's IAS Regulation was passed in June 2002. It requires that all EU incorporated companies that are listed on EU regulated markets prepare their first full consolidated IFRS accounts for 2005. The only exceptions are that individual member states can permit their companies already reporting under full US generally accepted accounting principles (GAAP), and those that have only listed debt, to extend the deadline for implementing IFRS until 2007.

There are no additional exemptions for listed companies of the ten Enlargement countries being admitted to the EU in 2004. It is expected that they will implement the IAS Regulation directly with no special transitional provisions.

Individual EU member states have the option to extend the use of IFRS to other companies. They can require, or permit, non-listed and private companies to prepare their statutory accounts on the basis of IFRS.

³²⁶ Reprint from: PriceWaterhouseCoopers: 2004 Building the European Capital Market, at 8

APPENDIX C: The wide variety of corporate governance frameworks in the EU³²⁷

TABLE A		
CODES IDENTIFIED: EU MEMBER STATES		
Nation	Code	Languages
Belgium	<ul style="list-style-type: none"> • Recommendations of the Federation of Belgian Companies (January 1998) • Recommendations of the Belgian Banking & Finance Commission (January 1998) • Cardon Report (December 1998) • The Director's Charter (January 2000) 	<ul style="list-style-type: none"> • Dutch, French and English • Dutch, French and English • Dutch, French and English • French and English
Denmark	<ul style="list-style-type: none"> • Danish Shareholders Association Guidelines (February 2000) • Norby Report & Recommendations (December 2001) 	<ul style="list-style-type: none"> • Danish and English • Danish (English summary available)
Finland	<ul style="list-style-type: none"> • Chamber of Commerce/Confederation of Finnish Industry & Employers Code (February 1997) • Ministry of Trade & Industry Guidelines (November 2000) 	<ul style="list-style-type: none"> • Finnish (English summary available) • Finnish and English
France	<ul style="list-style-type: none"> • Viénot I Report (July 1995) • Hellebuyck Commission Recommendations (June 1998; Updated October 2001) • Viénot II Report (July 1999) 	<ul style="list-style-type: none"> • French (English translation available) • French (English translation available) • French (English translation available)
Germany	<ul style="list-style-type: none"> • Berlin Initiative Code (June 2000) • German Panel Rules (July 2000) • Cromme Commission Code (draft, December 2001) 	<ul style="list-style-type: none"> • German and English • German and English • German (English translation available)
Greece	<ul style="list-style-type: none"> • Mertzanis Report (October 1999) • Federation of Greek Industries Principles (August 2001) 	<ul style="list-style-type: none"> • Greek and English • Greek (English translation available)
Ireland	<ul style="list-style-type: none"> • IAIM Guidelines (March 1999) 	<ul style="list-style-type: none"> • English
Italy	<ul style="list-style-type: none"> • Preda Report (October 1999) 	<ul style="list-style-type: none"> • Italian (English translation available)
Netherlands	<ul style="list-style-type: none"> • Peters Report (June 1997) • VEB Recommendations (1997) • SCGOP Handbook & Guidelines (August 2001) 	<ul style="list-style-type: none"> • Dutch (English translation available) • Dutch (English translation available) • Dutch (English translation available)
Portugal	<ul style="list-style-type: none"> • Securities Market Commission Recommendations (November 1999) 	<ul style="list-style-type: none"> • Portuguese and English
Spain	<ul style="list-style-type: none"> • Olivencia Report (February 1998) 	<ul style="list-style-type: none"> • Spanish (English translation available)
Sweden	<ul style="list-style-type: none"> • Swedish Shareholders Association Policy (November 1999) 	<ul style="list-style-type: none"> • Swedish (English translation available)
United Kingdom	<ul style="list-style-type: none"> • Institute of Chartered Secretaries & Administrators Code (February 1991) • Institutional Shareholders Committee Statement of Best Practice (April 1991) • Cadbury Report (December 1992) • PIRC Shareholder Voting Guidelines (April 1994; Updated March 2001) • Greenbury Report (July 1995) • Hermes Statement (March 1997; Updated January 2001) • Hampel Report (January 1998) • Combined Code (July 1998) • Turnbull Report (September 1999) • NAPF Corporate Governance Code (June 2000) • AUTIF Code (January 2001) 	<ul style="list-style-type: none"> • English • English • English • English • English • English • English • English • English • English • English • English

³²⁷ Reprint from: Gregory H. and Simmelkjaer R. of Weil, Gotshal & Manges LLP, Comparative study of corporate governance codes relevant to the European Union and its member states (2002), at 14-15

APPENDIX D: The Political and Corporate Climate leading up to Sarbanes-Oxley³²⁸

Extracts from remarks given by US Senator Levin in a Senate debate on the Sarbanes-Oxley Act.

[Arnold & Porter Legislative History: Sarbanes-Oxley Act of 2002 (116 STAT.745)]

DEBATE: THE NEED TO ENACT ACCOUNTING AND CORPORATE REFORMS, REMARKS BY MR. LEVIN
IN THE SENATE, July 10, 2002 (pp. S6561-S6567)

Mr. LEVIN. Madam President, this week we will hopefully act with strength and unity to help bring confidence back to the investing public. The last 18 months have shaken the foundation of the public's belief in the accuracy of the financial statements of our major U.S. corporations, beginning with the precipitous fall of Enron last year. The Public Company Accounting Reform and Investor Protection Act sponsored by Senator SARBANES and reported last month by the Banking Committee, will make significant headway in restoring the needed confidence in our financial markets, and I strongly support it. Senator SARBANES and the supporters of this bill on the Banking Committee have shown vision and leadership in tackling the tough issues of corporate and auditor misconduct, and the Congress needs to enact this legislation as quickly as possible.[...]

The plain truth is that the system of checks and balances in the marketplace designed to prevent, expose, and punish corporate misconduct is broken and needs to be repaired. Action is critically needed on a number of fronts to restore these checks and balances.[...]

Lies about income and profits, hidden debt, improper insider trading, tax evasion, conflicts of interest--the list of recent corporate malfeasance is an alphabet of woe.

Adelphia Communications. This is a publicly traded company, but the company founders, the Rigas family, are accused of using the company treasury as if it were the family piggy bank. The allegation is that the family borrowed from the company over \$2 billion--yes, billion--and has yet to pay it back. The company recently declared bankruptcy under Chapter 11.

Dynegy. This high tech energy firm is under SEC investigation for possibly inflated earnings and hidden debt. The questions include how it valued its energy derivatives, whether it booked imaginary income from capacity swaps with other companies, and whether it manipulated the California energy market. Senior executives, including CEO Chuck Watson, have recently been forced out.

Enron. This high tech company epitomizes much of the corporate misconduct hurting American business today, from deceptive financial statements to excessive executive pay. Its executives, directors, auditors and lawyers all failed to prevent the abuses, and many profited from them.

Global Crossing. This is another high tech corporate failure with outrageous facts. Less than 5 years old, Global Crossing was founded in 1997 by Chairman of the Board Gary Winnick. In 1998, the company went public, touting its plans to establish a worldwide fiber optic network. Global Crossing gave Mr. Winnick millions of dollars in pay, plus millions more in stock and stock options. In the 4 years the company traded on the stock market. Mr. Winnick cashed in company stock for more than \$735 million. Other company insiders sold almost \$4 billion in company stock. Then questions began to arise about inflated earnings, related party transactions, insider dealing, and board of director conflicts. In

³²⁸ Extract from Levin C., *The Need To Enact Accounting And Corporate Reforms* (remarks by Senator Levin in the US Senate, July 10, 2002), Arnold & Porter Legislative History: Sarbanes-Oxley Act of 2002, at 1-14 (abridged version above, with bold *emphasis added* on company names)

January 2002, the company suddenly declared bankruptcy. The company's shareholders and creditors have lost almost everything, while corporate insiders have so far walked away with their billions intact.

Halliburton. The question here is whether this construction company improperly booked income from contract cost overruns on construction jobs, before the company actually received the income. The company is under SEC investigation.

IBM. This all-American company, once a model of American know-how and can-do, has recently acknowledged misreporting about \$6 billion in revenue and restated its earnings by more than \$2 billion. Another high tech disaster for investors and American business.

ImClone. ImClone's CEO, Samuel Waksal, has been indicted for insider trading. The company produced a new drug whose effectiveness is still in question and whose developer, Dr. John Mendelsohn, was not only an ImClone board member but also the President of M.D. Andersen Cancer Center in Texas. Dr. Mendelsohn arranged for the Center to conduct tests on the drug without telling patients that the Center's President had a direct economic interest in the drug's success. Dr. Mendelsohn was also a board member at Enron.

Kmart. This once successful company, headquartered in my home state of Michigan, is now bankrupt and under scrutiny by the SEC for possible accounting fraud. The pain of the employees who lost their jobs and the investors who lost their savings is ongoing, not only in Michigan but across the country.

Merrill Lynch. Once a highly respected investment advisor, this company has become a poster child for financial advisors who mislead their investors, telling them to buy the stock of companies the advisers privately think are losers. Merrill Lynch recently paid \$100 million and agreed to change how its financial analysts and investment bankers operate to settle a suit filed by New York Attorney General Elliot Spitzer.

Qwest Communications. This is another high tech company under SEC investigation. Questions include whether it inflated revenues for 2000 and 2001 due to capacity swaps and equipment sales. Qwest's CEO Joe Nacchio, made \$232 million in stock options in 3 years before the stock price dropped, leaving investors high and dry. Its Chairman Philip Anschutz made \$1.9 billion.

Rite Aid. Last month, three former top executives of Rite Aid Corporation, a nationwide drugstore chain, were indicted for an illegal accounting scheme that briefly--until WorldCom--qualified as the largest corporate earnings restatement in U.S. business history. The restatement involved \$1.6 billion. The indictment alleges that the company used brazen accounting gimmicks to overstate its earnings during the late 1990s, and when investigators came after them, made false statements and obstructed justice.

Stanley Works. This company is a leading example of U.S. corporations that have pretended to move their headquarters to Bermuda to avoid paying U.S. taxes. It joins a growing number of companies that want to go on enjoying US banks, US laws, and US workers, but do not want to pay their fair share of the costs that make this country work from the costs of public education, to police and the courts, to environmental protection laws. To me, these companies are not just minimizing their taxes, they are demeaning their citizenship. They are taking advantage of this country by enjoying its fruits without giving anything back. No company ought to be allowed to get away with this fiction and throw their tax burden on the backs of other US taxpayers.

Tyco International. Last month, the CEO of Tyco, Dennis Kozlowski, was indicted in New York for failing to pay sales tax due on millions of dollars of artwork. The allegation is that Mr. Kozlowski shipped empty boxes to New Hampshire in a scam to show that \$13 million worth of artwork was sent out of state and exempt from sales tax when, in fact, the artwork never left New York.

This is a millionaire, many times over, who could have easily afforded the tax bill but engaged in a sham to avoid paying it. The question is whether he ran his company the same way he ran his own affairs.

Tyco is one of those companies that has allegedly moved its headquarters to Bermuda. It has numerous offshore subsidiaries, including more than 150 in Barbados, the Cayman Islands and Jersey. The company's U.S. tax payments have apparently dropped dramatically. Allegations of corporate misconduct by insiders have also emerged. There was a \$20 million payment made to one of the company's directors and another \$35 million in compensation and loans paid to the company's former legal counsel. That's \$55 million paid to two corporate insiders, allegedly without the knowledge of the Board of Directors. Added to that is an ongoing SEC investigation allegedly examining whether a Tyco subsidiary paid bribes to win a contract in Venezuela.

WorldCom. WorldCom is the latest in this list of corporate embarrassments. It built a glowing earnings record through the acquisition of high tech companies like MCI and UUNet. It became a favorite investment for pension companies, mutual funds and average investors. Then we learn that the longtime CEO Bernard Ebbers borrowed over \$366 million in company funds and has yet to pay it back. After he's forced out and a new CEO takes over, we learn that the company booked ordinary expenses as if they were capital investments in order to string out the expenses over several years and make the current bottom line look great. The result was \$3.8 billion that had been conveniently left off the books--more than enough to wipe out the company's entire earnings for last year; more than enough for 17,000 workers to lose their jobs; more than enough to wipe out billions in investments across the country. Just one example in Michigan is the Municipal Employee's Retirement System which lost \$116 million that supported workers' pensions. At the same time, we're told that Mr. Ebbers has a corporate pension that will pay him over \$1 million per year for life.

Xerox. This all-American company has already paid \$10 million to settle an SEC complaint that, for four years, the company used fraudulent accounting to improve its financial results. As part of the settlement, Xerox agreed to restate its earnings after allegedly recording over \$3 billion in phony revenues between 1997 and 2000.

This list is painful in part because it includes some icons of American business, symbols of what was right about the American dream. Now they symbolize corporate misconduct damaging to the entire country. The S&P index has plunged. The Nasdaq has been down 20% and even 30%. Mutual funds, the equity of choice for average investors, have dropped in value by more than 10%. The average daily trading volume at Charles Schwab & Co.--a measure of average investor activity--is down 54% from the height of the bull market, according to Fortune Magazine. Investor confidence in the U.S. stock market has dramatically declined. Foreign investment is fleeing. [...]

The Supreme Court put it this way in [United States v. Arthur Young, 465 U.S. 805, 1984](#), a case that contrasts the role of auditors with the role of lawyers. The Court noted that a lawyer is supposed to be a client's confidential advisor, but the:

... independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client ... [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. ... This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

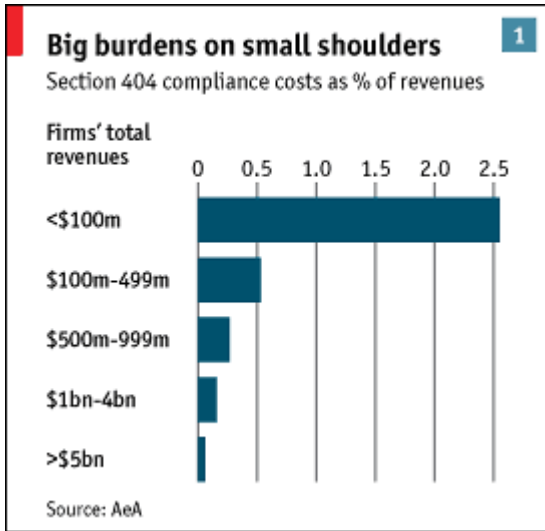
But that's not what has happened recently.

[...]

APPENDIX E: The increasing costs and employment related to Sarbanes-Oxley

Appendix E(i): The high – but falling – costs of complying with Sarbanes-Oxley Section 404³²⁹

“[...] the costs of applying section 404 were exceptional in the first year and will fall in due course. [...] KPMG's American business, has said he reckons auditors' attestation fees related to section 404 should fall by 15-25% this year.”



Appendix E(ii): The increasing popularity of accountancy firms for employment³³⁰

“The accounting firms say that the fall of Enron and Arthur Andersen has done their recruitment no harm: instead, they claim, it has made students realise that accounting is not mere number-crunching, but also involves moral judgments. The “Big Four” accounting firms are all among this year's top 15 ideal employers.”

Company	2005	2004
BMW	1	2
PricewaterhouseCoopers	2	4
Ernst & Young	3	6
Boeing	4	7
Johnson & Johnson	5	17
Deloitte	6	8
Coca-Cola	7	5
Microsoft	8	1
CIA	9	14
FBI	10	138
Merrill Lynch	11	12
IBM	12	11
Apple Computer	13	41
KPMG	14	16
J.P. Morgan Chase	15	18

Source: Universum Communications

³²⁹ Reprint from: *Sarbanes-Oxley – A Price Worth Paying?* Economist, May 19 2005 (website August 2005)

³³⁰ Reprint from: *Undergraduate Recruitment - In Search Of The Ideal Employer*, Economist, 18 August 2005

APPENDIX F: US Sarbanes-Oxley Act: Selected extracts (related to auditing practices)

This 2002 Act includes eleven titled Sections, as follow:

- Title I: Public Company Accounting Oversight Board: Sections 101-109
- Title II: Auditor Independence: Sections 201-209
- Title III: Corporate Responsibility: Sections 301-308
- Title IV: Enhanced Financial Disclosures: Sections 401-409
- Title V: Analyst Conflicts of Interest: Section 501
- Title VI: Commission Resources and Authority: Sections 601-604
- Title VII: Studies and Reports: Sections 701-705
- Title VIII: Corporate and Criminal Fraud Accountability: Sections 801-807
- Title IX: White Collar Crime Penalty Enhancements: Sections 901-906
- Title X: Corporate Tax Returns: Sections 1001
- Title XI: Corporate Fraud and Accountability: Sections 1101-1107

Below are selected Sections and Provisions that have special relevance for auditing practices:

Section 201: Services Outside The Scope Of Practice Of Auditors; Prohibited Activities.

It shall be "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; (9) any other service that the Board determines, by regulation, is impermissible. The Board may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission.

It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee in the following manner. The bill allows an accounting firm to "engage in any non-audit service, including tax services," that is not listed above, only if the activity is pre-approved by the audit committee of the issuer. The audit committee will disclose to investors in periodic reports its decision to pre-approve non-audit services. Statutory insurance company regulatory audits are treated as an audit service, and thus do not require pre-approval.

The pre-approval requirement is waived with respect to the provision of non-audit services for an issuer if the aggregate amount of all such non-audit services provided to the issuer constitutes less than 5 % of the total amount of revenues paid by the issuer to its auditor (calculated on the basis of revenues paid by the issuer during the fiscal year when the non-audit services are performed), such services were not recognized by the issuer at the time of the engagement to be non-audit services; and such services are promptly brought to the attention of the audit committee and approved prior to completion of the audit.

The authority to pre-approve services can be delegated to 1 or more members of the audit committee, but any decision by the delegate must be presented to the full audit committee.

Section 203: Audit Partner Rotation.

The lead audit or coordinating partner and the reviewing partner must rotate off of the audit every 5 years.

Section 204: Auditor Reports to Audit Committees.

The accounting firm must report to the audit committee all "critical accounting policies and practices to be used all alternative treatments of financial information within [GAAP] that have been discussed with management ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Section 206: Conflicts of Interest.

The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period preceding the audit.

Section 207: Study of Mandatory Rotation of Registered Public Accountants.

The GAO will do a study on the potential effects of requiring the mandatory rotation of audit firms.

Section 209: Consideration by Appropriate State Regulatory Authorities.

State regulators are directed to make an independent determination as to whether the Boards standards shall be applied to small and mid-size non-registered accounting firms.

Section 301: Public Company Audit Committees.

Each member of the audit committee shall be a member of the board of directors of the issuer, and shall otherwise be independent.

"Independent" is defined as not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.

The SEC may make exemptions for certain individuals on a case-by-case basis.

The audit committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.

The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

Each issuer shall provide appropriate funding to the audit committee.

Section 407: Disclosure of Audit Committee Financial Expert.

The SEC shall issue rules to require issuers to disclose whether at least 1 member of its audit committee is a "financial expert."

APPENDIX G: The potential “cascading” affect of EU states widening the use of IFRS³³¹

This shows the extent to which EU member states plan to impose IFRS beyond the mandatory EU minimum.

2/3

Date 17/01/05

Planned Implementation of the IAS Regulation (1606/2002) in the EU and EEA (Published for information purposes only)

European Commission Sumas of the implementation of IAS Article 5(a) of the IAS Regulation	Luxembourg Law proposal	Netherlands Law proposal	Portugal Pre-final Law ³	Spain Final law	Sweden Final law	UK Final law	Norway Final law	Iceland Work group	Lichtenstein Final law
LISTED COMPANIES 1. Will your MS use the option to permit IAS in the annual accounts for listed companies? 2. Will your MS use the option to require IAS in the annual accounts for listed companies?	Yes	Yes	Yes	No	No	Yes	Yes	Yes	Yes
OTHER COMPANIES 1. Will your MS use the option to permit IAS in the consolidated accounts for other companies? If yes, what type of companies? 2. Will your MS use the option to require IAS in the consolidated accounts for other companies? If yes, what type of companies?	No	No	No	No	No	No	No	Probably no	No
3. Will your MS use the option to permit IAS in the annual accounts for other companies? If yes, what type of companies?	Yes	Yes, all types	Yes, all types	Yes, all types	No ⁴	No	Yes, all types	Yes, all types	Yes, all types
4. Will your MS use the option to require IAS in the annual accounts for other companies? If yes, what type of companies?	No	No	No	No	No	No	No	No	No
Article 9 of the IAS Regulation (a) Will your MS use the option to defer the application of IAS until 2007 for companies whose debt securities only are admitted on a regulated market of any MS? (b) Will your MS use the option to defer the application of IAS until 2007 for companies whose securities are admitted to public trading in a non-member State and which, for that purpose, have been using internationally accepted standards since a financial year that started prior to the publication of the IAS Regulation in the OJ?	Yes	No	No	Yes, except for banking sector companies	Yes	No	Yes	Probably yes	No
Miscellaneous Is earlier adoption (before 2005) of IAS allowed? If yes, for what type of companies/ from when?	Derogations on an individual basis	No	Derogations on an individual basis	No	No	No	No	Probably yes	31.12.2002 Yes, all types

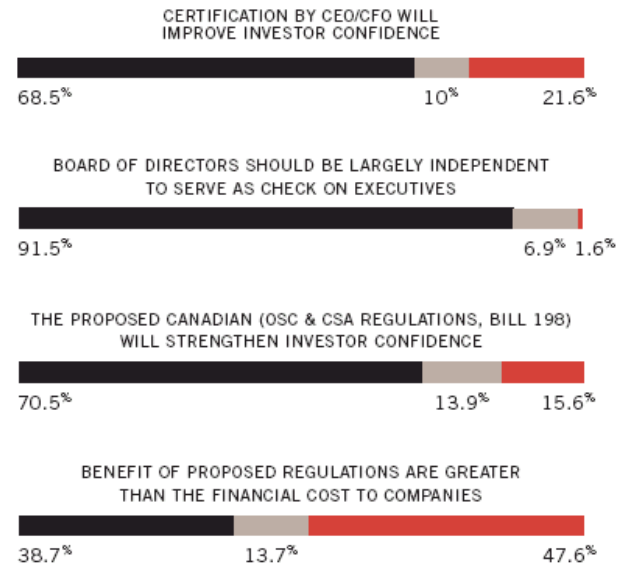
³³¹ Extract from: Deloitte IAS Plus, Planned Implementation of IAS Regulation (1606/2002) in the EU and EEA (2005)

APPENDIX H: The cost-benefit of Sarbanes-Oxley compliance according to non-US issuers³³²

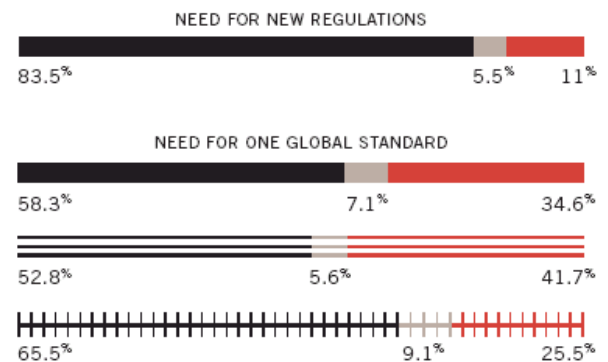
SURVEY HIGHLIGHTS

OVERALL OPINIONS ON THE NEW & PROPOSED CORPORATE GOVERNANCE REGULATIONS

Respondents were overwhelmingly supportive of the need for new regulations and their belief in its role in strengthening investor confidence through increased certifications and independent boards of directors. Their feedback also showed significant concerns over the costs of implementing the new regulations and the perceived benefits of compliance.



83.5% of those surveyed agree that new regulations are needed while only 59.3% seek one global standard for all markets based on the principles of Sarbanes-Oxley and the proposed TSX regulations. In examining the differences between TSX-listed and the interlisted companies, respondents from the companies solely listed in Canada are much less likely to support the adoption of one global standard.

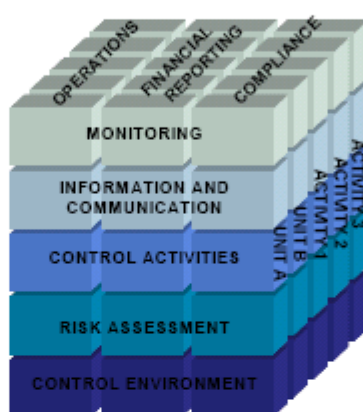


³³² Resources Connection, International Implications Of New Corporate Governance Standards; A Survey Assessing The Implications Of Sarbanes-Oxley And Proposed Canadian Regulations (2003), at 3

APPENDIX I: The COSO Framework which underlies Section 404 internal controls³³³**4.2. Risk management and internal control principles**

As a practical matter, activities related to identifying, evaluating and responding to risks and concluding on the effectiveness of risk management or internal control will need to have regard to an appropriate framework. One of the resultant benefits is that it helps to establish a common language for risk management and internal control and prevents people from talking at cross purposes. An example of a framework is the COSO Framework for internal control represented below. This covers some but not all of the matters included in the matrix shown in Figure 1 above.

Figure 2: COSO Framework



Under the COSO Framework for internal control, there is a direct relationship between objectives, which are what an entity strives to achieve, and the components of internal control, which represent what is needed to achieve the objectives. The process of evaluating an entity's risk management should also take into account the timescale required to perform such a process. The relationship between objectives and components can be depicted by the cube shown above:

- The three COSO objectives categories – operations, financial reporting and compliance – are represented by the vertical columns;
- The five COSO components – monitoring, information and communication, control activities, risk assessment and control environment - are represented by horizontal rows; and
- Business units or activities of the entity are depicted by the third dimension of the matrix.

Other frameworks which build on the COSO framework for internal control are the Canadian CoCo framework and the UK's Turnbull guidance. In September 2004 COSO also published its *Enterprise Risk Management – Integrated Framework* which extends the COSO Framework for internal control to cover risk management and strategic risks.

The US Securities and Exchange Commission (SEC) has recently requested that COSO perform work as a matter of urgency with the aim of issuing a lighter version of its internal control framework for smaller entities. FEE understands that the Canadian Institute of Chartered Accountants (CICA) has no plans to amend or update CoCo.

³³³ Reprint from: Fédération des Experts comptables Européens (FEE), *Risk Management and Internal Control in The EU: Discussion Paper* (March 2005), at 15.

APPENDIX J: EU 2004 Proposal to expand the 8th Company Law Directive

The objectives of the Proposal³³⁴, as explained on the official EU Company Law website:

[p]roposal for a Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts and amending Council Directives [78/660/EEC](#) and [83/349/EEC](#) [[COM\(2004\) 177](#) final - Not yet published in the Official Journal].

The purpose of this proposal is to ensure that investors and other interested parties can be absolutely sure that accounts have been properly audited and to strengthen protection in the European Union against the type of scandal that recently assailed companies such as Parmalat and Ahold. The proposal aims to clarify the duties of statutory auditors and to lay down certain ethical principles designed to guarantee their objectivity and independence, e.g. where audit firms also provide other services to their clients. It introduces a quality assurance requirement and robust public oversight over the audit profession and improves cooperation between oversight bodies in the Union. It also enables the regulatory authorities in the Union to react swiftly to new developments through an audit regulatory committee composed of Member States' representatives that could take or rapidly amend measures implementing the Directive. Lastly, the proposal provides for the application of international auditing standards to all statutory audits carried out in the European Union and lays the bases for effective and balanced international regulatory cooperation with oversight bodies of third countries such as the US Public Company Accounting Oversight Board.³³⁵

³³⁴ March 16, 2004 Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council [4th and 7th] Directives 78/660/EEC and 83/349/EEC.

³³⁵ From the official EU Company Law website: <http://europa.eu.int/scadplus/leg/en/lvb/l26010.htm>

Some Member States are having a consultation process with their nationals about the EU 8th Directive. Below is an extract from the UK consultative document on their Ministry website.³³⁶

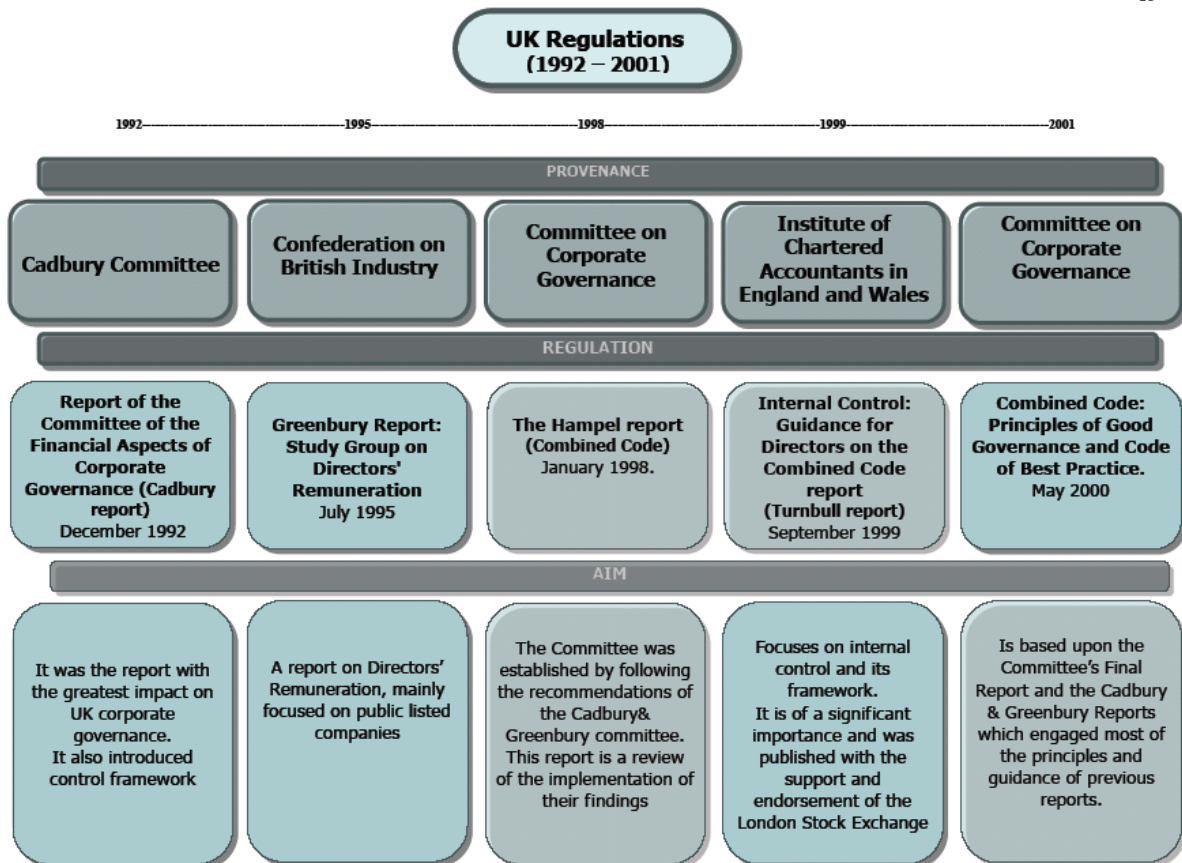
Proposal by the European Commission for a Directive on Statutory Audit of Annual and Consolidated Accounts, August 2004

Article	Costs	Benefits
Q.35 Can you quantify the likely costs on your firm and/or the wider profession? Will the benefits outweigh these costs?		
Article 39 – Audit Committees	<p>This Article requires all PIEs to have audit committees. In the UK, only a small handful of listed companies do not currently have an audit committee, so the cost for listed companies will be limited, PIEs however, also include financial institutions, where the cost may be more significant.</p> <p>There is also a question of whether wholly owned subsidiaries would also be required to create audit committees. Likewise, special purpose vehicles, which they believe would be caught by the PIE definition. Others have pointed out that they are themselves a subsidiary of a non-EU parent.</p>	<p>Audits committees can play their part in ensuring the independence of the auditor and the quality of the audit.</p>
Q.36 Can you quantify the costs of this provision for UK Companies? Do you believe that these costs would be outweighed by the requirement's benefits?		
Article 40 – Independence	<p>The UK already has audit partner rotation. We would not implement the option of mandatory firm rotation. This Article would not therefore give rise to additional costs.</p>	<p>There may be some indirect benefits in having stronger independence regimes across the EU if, as intended, this helps to restore public confidence in audited financial information (and lowers the cost of capital).</p>
Q.37 Can you describe the benefits, if any of this provision?		
Article 41 – Quality Assurance	None	Benefit of improved standards across EU
Article 42 – Public Oversight	None	Benefit of improved standards across EU
Article 44 – Approval of Auditors from Third Countries	There will be a Regulatory cost to the Professional Oversight Board for Accountancy (POBA)	None

³³⁶ Proposal by EC for a Directive on Statutory Audit of Annual and Consolidated Accounts, at 79. (www.dti.gov.uk)

APPENDIX K: The complex web of EU regulations, with the UK as example³³⁷

European Regulations					
International Organization of Securities Commissions	Organization for Economic Co-operation and Development	Commonwealth Association for Corporate Governance	European Commission	Bank for International Settlements (BIS)	International Accounting Standards Board
<ul style="list-style-type: none"> Objectives and Principles of Securities Regulation (IOSCO Principles, 1998, 2002) Multilateral memorandum of understanding (IOSCO MOU, 2002) IOSCO Assessment Methodology (2003) 	<ul style="list-style-type: none"> Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets (Millstein Report, 1998) OECD Principles of Corporate Governance, (1999, 2002) 	<ul style="list-style-type: none"> CACG Guidelines: Principles for Corporate Governance in the Commonwealth (1999), aiming to 'promote excellence in corporate governance in the Commonwealth' CACG Guidelines: Corporate Governance Principles for Annual Reporting in the Commonwealth (2003) 	<ul style="list-style-type: none"> <i>Comparative Study of Corporate Governance: Codes Relevant to the European Union and Its Member States</i>, (27.03.2002), aiming to identify the 'differences and commonalities' of corporate governance regulations that are afoot in the EU Plan on 'Modernizing Company Law and Enhancing Corporate Governance in the European Union' (Action Plan, 21 May 2003), following a preparative Winter Report, (High Level Group of Company Law Experts, 04 November 2002). Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts, (Brussels, Proposal presented on 16 March 2004, directive under discussion) 	<p><i>The International Convergence of Capital Measurement (Basel II Accord, 2004)</i> is a replacement of the original <i>Basel Accord (1988)</i>. It is a framework of banking regulation standards. The Basel Accord does not have a regulatory status and will be implemented in the EU through the <i>Capital Requirements Directive (CRD)</i>.</p>	<p><i>International Financial Reporting Standards</i> which should be adopted by all EU public companies from January 2005</p>



³³⁷ Reprint from: A. Dionysia & B. Dimitris *et al*, *SOXA, The Why's, When's and How's*, February 2005, at 17, 19

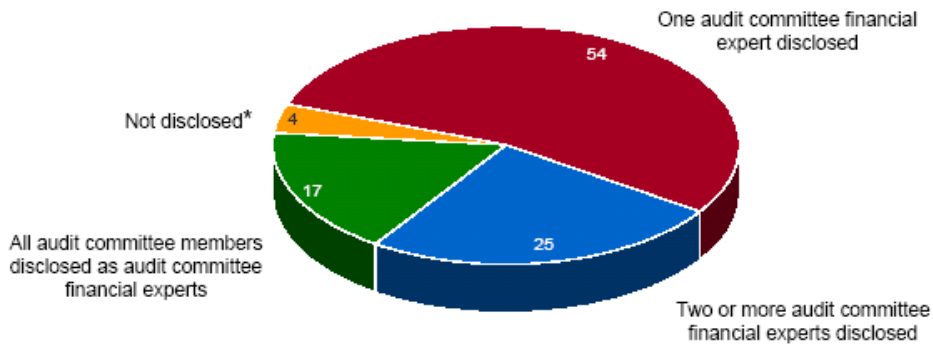
APPENDIX L: Audit Committee Composition (extract from *Shearman & Sterling* report)

This is an extract from survey³³⁸ of US companies indicating their compliance re audit committees.

Audit Committee Composition

Audit Committee Financial Experts

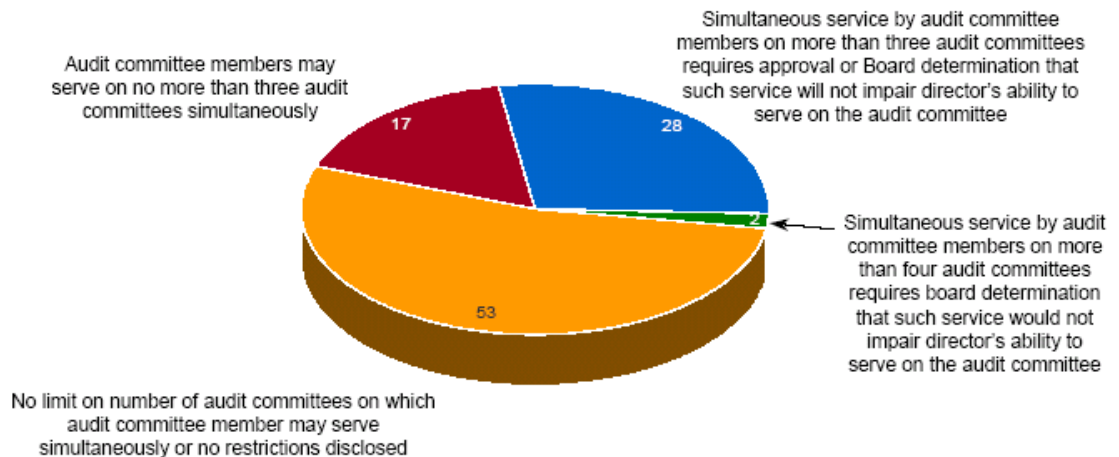
Companies must disclose whether at least one member of the audit committee is an audit committee financial expert or, if not, why not. Although SEC rules require companies with an audit committee financial expert to disclose the name of only one such expert, 42 of the Top 100 companies voluntarily disclosed the name of more than one audit committee financial expert.



* These companies are not yet subject to this disclosure requirement.

Service on Multiple Audit Committees

The NYSE listing standards require that if an audit committee member simultaneously serves on the audit committees of more than three public companies and the listed company does not limit the number of audit committees on which its audit committee members may serve, then the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the company's audit committee and disclose such determination in its annual proxy statement. 47 of the Top 100 companies limit the number of audit committees on which their audit committee members may serve.



³³⁸ Shearman & Sterling LLP, Corporate Governance Practices of the 100 Largest U.S. Public Companies (2004)

APPENDIX M: EU multinationals' annual reports: references to the impact of SOX

Below are selected examples of how EU multinational companies are commenting on the impact of Sarbanes-Oxley Act. These remarks are extracted from their annual reports. The references are not exhaustive; the annual reports often contain additional remarks related to the Sarbanes-Oxley Act.

AEGON - The Netherlands (pages 10, 75, 78, 79, 80, 81 of the 2004 annual report)

Page 10: "Following the adoption of [SOX], the Board amended the Supervisory Board Rules, the Audit Committee Charter, the Pre-approval Policy relating to the services of AEGON's independent auditor, Ernst & Young, and the Rules on Inside Information. The Supervisory Board also adopted a Financial Control Complaints Procedure, which establishes a whistleblower arrangement according to SOX [...]"

Akzo Nobel - The Netherlands (pages 5, 10, 11, 22, 25 of the 2003 annual report)

Page 5: "We are working hard to implement all the requirements of the new U.S. securities laws, including the Sarbanes-Oxley Act." Page 11: "Lars Thunell fulfils the requirements of Audit Committee Financial Expert as defined in the rule adopted by the SEC under the Sarbanes-Oxley Act." Page 22: "Pursuant to the U.S. Sarbanes-Oxley Act, Akzo Nobel has revised its procedures for internal and disclosure controls and auditor independence."

Allied Domecq - United Kingdom (pages 35, 44, 45 of the 2004 annual report)

Page 35: "The profit decline in 'Others' principally reflects increased central marketing costs and the additional costs associated with the implementation of the requirements of the Sarbanes-Oxley Act of 2002 and International Financial Reporting Standards." Page 45: The Company will be required to comply with section 404 of [SOX] for [FY] 2005."

Ericsson - Sweden (pages 15, 23, 24, 97 of the 2004 annual report)

Page 23: "During 2004, actions to further strengthen our corporate governance included: [...] Initiation of a project to comply with relevant sections of [SOX]. Implementation should be completed by the end of 2005." Page 24: Certain Board actions and decisions during 2004: [...] Determined that each of the [...] members of the audit committee qualify as Audit Committee financial expert pursuant to the applicable attributes under the final rules of [SOX]."

France Telecom - France (pages 25 of the 2004 annual report)

Page 25: "The Sarbanes-Oxley compliance program aims to guarantee an efficient internal control environment to meet the requirements of market oversight authorities, to protect investors, and to give France Telecom the means to provide transparent and accurate information. This encompasses operating performance, network and service quality, Group policies [...], the information system, investments and information security. This requires integrated management within the Group and an efficient internal audit function. The function counts 150 qualified auditors throughout the Group."

KPN - The Netherlands (page 80 of the 2004 annual report)

Page 80: "[...] we have to comply with the requirements of the Sarbanes-Oxley Act. During 2004 our compliance efforts focused on further improving our internal controls over financial reporting. [...] Our risk management system was further enhanced and we initiated the set up of a Business Control Framework, based on COSO Internal Control Framework."

Siemens - Germany (pages 36, 37, 40, 41, 44, 45, 46 of the 2004 annual report)

Page 40: "To facilitate our compliance with [SOX], we have, among other things, [...] introduced procedures that require the respective managements of our Groups and subsidiaries to certify certain matters [...] These procedures, and certifications provide a basis on which the [CEO] and [CFO] certify our financial statements to the SEC, as required by [SOX]." Page 44: Additional [SOX] requirements, which will come into effect for Siemens in fiscal 2005, mandate that we include in our management report on internal controls the conclusions of management about the effectiveness of Siemens' internal controls over financial reporting, based on management's review of those controls."

APPENDIX N: Companies reporting internal control weaknesses, as per SOX Section 404³³⁹

Appendix 2(a) Nature of Control Weakness by Company As of April 1, 2005	
Company	Nature of Control Weakness
Delinquent Filers:	
Aaipharma, Inc.	Ineffective personnel
American International Group, Inc.	Characterization of material weakness not yet disclosed.
BearingPoint, Inc.	Various significant deficiencies that constituted a material weakness
Ceridian Corporation	Accruals, Fixed assets - other
Delphi Corporation	Revenue recognition ¹ , Off-balance sheet financing
Fannie Mae (Federal National Mortgage Association)	Derivative accounting, Lease accounting, Loans - Indirect Costs
Flowserve Corporation	Characterization of material weakness not yet disclosed.
Healthcare Realty Trust Incorporated	Characterization of material weakness not yet disclosed.
Highwoods Properties, Inc.	Characterization of material weakness not yet disclosed.
Integrated Alarm Services Group, Inc.	Characterization of material weakness not yet disclosed.
Interpublic Group of Companies, Inc.	Characterization of material weakness not yet disclosed.
Key Energy Services, Inc.	Characterization of material weakness not yet disclosed.
Nortel Networks Corporation	Lease accounting
Shurgard Storage Centers	Ineffective personnel, Pervasive ineffective processes
Southern Union Company	No material weakness expected.
Terex Corporation	Specific intercompany accounts
United Rentals North America, Inc.	Accruals, Income tax accounting, Inventory accounting
Vesta Insurance Group, Inc.	Characterization of material weakness not yet disclosed.
Companies Reporting Material Weakness in 404 Reports:	
AES Corporation	Income tax accounting
Alcan, Inc.	Impairments
Aleris International, Inc.	Derivative accounting, Interest costs- debt, Pension
Alpharma, Inc.	Revenues and related receivables, Accruals, Income tax accounting, Segment reporting
America West Airlines, Inc.	Derivative accounting
American Tower Corporation	Leases accounting
Baxter International, Inc.	Income tax accounting
Blockbuster, Inc.	Lease accounting.
BRE Properties Inc.	Accruals and accounts payable
Calpine Corporation	Income tax accounting
Central European Media Enterprises, Ltd.	Financial instruments - debt vs. equity classification
Chiron Corporation	Accruals, Income tax accounting, Revenue recognition
CIT Group, Inc.	Income tax accounting
Clean Harbors, Inc.	Accruals
Compass Minerals Group, Inc.	Income tax accounting
Countrywide Financial Corp.	Securitization accounting
Covanta Energy Corporation	Ineffective personnel
Crescent Real Estate Equities Company	Accounts payable, Accounts receivable
Crompton Corporation	Income tax accounting
Crown Castle International Corp.	Lease accounting
Denny's Corp.	Lease accounting
Dynegy Incorporated	Income tax accounting
Eastman Kodak Company	Income tax accounting, OPEB, Pension
El Paso Corporation	Technology controls, Fixed assets -other, Impairments, Investment accounting, Various significant deficiencies that constituted a material weakness
First Industrial, L.P.	Income tax accounting
Foster Wheeler Ltd.	Financial information accumulation - Small subsidiary
Friendly Ice Cream Corp.	Lease accounting.
GEO Group, Inc.	Accruals, Income tax accounting, Investment accounting, Lease accounting
Goodyear Tire and Rubber Company	Data access, Various significant deficiencies that constituted a material weakness
Grant Prideco, Inc.	Revenue recognition
Green Mountain Power Corporation	Income tax accounting
Hecla Mining Company	Accounts payable, Inventory accounting
Hertz Corporation	Revenue recognition
Hollywood Entertainment Corporation	Lease accounting
¹ This material weakness related to rebate accounting, which was deemed to be a revenue recognition matter for purposes of this report.	

³³⁹ Extract from: Moody's Investor Service, *Section 404 Reporting on Internal Control: Our Early Experience*, 2005, 7

APPENDIX O: Statutory audits: EU ten priorities to improve quality and protect investors³⁴⁰

Modernising the 8th Company Law Directive

The Commission will propose to modernise the 8th Company Law Directive (84/253/EEC) to ensure a comprehensive, principles-based Directive applicable to all statutory audits conducted in the EU. The modernised Directive would include principles on: public oversight, external quality assurance, auditor independence, code of ethics, auditing standards, disciplinary sanctions and the appointment and dismissal of statutory auditors.

Reinforcing the EU's regulatory infrastructure

The proposals for a modernised 8th Directive will also include the creation of an Audit Regulatory Committee. The Commission will adopt, in accordance with comitology procedures, the implementing measures necessary to underpin the principles set out in the modernised 8th Directive. The present EU Committee on Auditing, renamed the Audit Advisory Committee, composed of representatives of Member States and of the profession, will continue its work as an advisory committee.

Strengthening public oversight of the audit profession

The Commission, together with the Audit Advisory Committee, will analyse existing systems of public oversight and develop minimum requirements (principles) for public oversight. The Commission will define a co-ordination mechanism at EU level to link up national systems of public oversight into an efficient EU network.

Requiring International Standards on Auditing (ISAs) for all EU statutory audits

The Commission and the Audit Advisory Committee will work to prepare the implementation of ISAs from 2005. These will include: an analysis of EU and Member State audit requirements not covered by ISAs; the development of an endorsement procedure; a common audit report and high-quality translations. The Commission will work towards further improvements to the IFAC/IAASB audit standard setting process, notably by ensuring that public interest is taken fully into account. Assuming satisfactory progress, the Commission will propose a binding legal instrument requiring the use of ISAs from 2005.

Improving disciplinary sanctions

The Commission and the Audit Advisory Committee will assess national systems of disciplinary sanctions to determine common approaches and will introduce an obligation on Member States' to co-operate in cross border cases.

Making audit firms and their networks more transparent

The Commission and the Audit Advisory Committee will develop disclosure requirements for audit firms, covering among other things their relationships with international networks.

Corporate governance: strengthening audit committees and internal control

The Commission and the Audit Advisory Committee will work on the appointment, dismissal and remuneration of statutory auditors, and on communication between the statutory auditor and the company being audited. The Commission and the Committee will also examine statutory auditors' involvement in assessing and reporting on internal control systems.

Reinforcing auditor independence and code of ethics

The Commission will carry out a study on the impact of a more restrictive approach on additional services provided to the audit client. The Commission will continue the EU-US regulatory dialogue on auditor independence, with the aim of obtaining US recognition of the equivalence of the EU approach. The Commission and the Audit Advisory Committee will analyse existing national codes of ethics and the IFAC code of ethics and consider further appropriate action.

Deepening the Internal Market for audit services

The Commission will work on facilitating the establishment of audit firms by proposing to remove restrictions in the present 8th Directive on ownership and management. The Commission will exempt the provision of audit services from its proposal on the recognition of professional qualifications (see IP/02/393) by amending the 8th Directive to include the principle for mutual recognition subject to an aptitude test. The Commission will carry out a study on the EU audit market structure and on access to the EU audit market.

Examining auditor liability

The Commission will also study the economic impact of auditor liability regimes.

³⁴⁰ Extract from: European Commission press release, *Audit of company accounts: Commission sets out ten priorities to improve quality and protect investors*, EU website, 21 May 2003. The 1st 4 priorities are "short-term"; others "medium-term". Full text of the Communication from: http://europa.eu.int/comm/internal_market/en/company/audit/index.htm.