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International

How Has SOX Affected Foreign Private Issuers?

Although some costs have risen, there also have been opportunities to improve financial reporting and disclosure.

BY JOERN SCHLIMM

As management accountants know, the Sarbanes-Oxley Act of 2002 (SOX) was Congress's response to the wave of corporate scandals, such as WorldCom and Enron, that had begun to devastate investor confidence in the U.S. The law was intended to protect shareholders, make financial reporting more transparent, and restore investor confidence. But Sections 302 and 404 have led to debate about this among U.S. companies as well as foreign firms (foreign private issuers, or FPIs) that trade on U.S. stock exchanges.

Prior to SOX, the Securities & Exchange Commission (SEC) had a history of granting exceptions to FPIs because of disparities between the laws and practices in the U.S. and the issuers' home countries. But Sarbanes-Oxley applies to all companies listed with the SEC, including foreign firms.

This has dramatic consequences for many FPIs that are either already listed with the SEC or were planning to list in the near future. Foreign companies now need far more time to fulfill the strict requirements of the Act, so they consequently incur higher costs that often outweigh the

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benefits of being a public company. Section 404, for instance, requires a highly complex internal control system that is costly and time-consuming to establish.

Many FPIs have highly decentralized operations all around the world, which creates a big problem with implementing internal controls. Daimler, for instance, has subsidiaries in multiple locations that operate independently from the headquarters in Germany. Besides language differences, assessing and ultimately monitoring internal control at all locations can be difficult and time-consuming.

Many non-U.S. companies—especially those in Europe—may already have control systems because they are required by national law. Nevertheless, "SOX Around the World," a 2007 study conducted by the University of Magdeburg in Germany that examined the German companies listed on the New York Stock Exchange, showed that 75% of these firms don't believe German legislation is an adequate basis on which specific SOX provisions can be implemented without major efforts. Only 37.5% were able to use synergies between German and U.S. legislation when they implemented Sarbanes-Oxley regulations.

A 2005 Ernst & Young survey, "Emerging Trends in Internal Controls," indicated that 60% of companies with $5 billion to $20 billion in annual revenue anticipated it would take them more than 25,000 hours (excluding external audit hours) just to implement Section 404. More than half the firms with annual revenues of more than $20 billion anticipated working more than 100,000 hours on it. This includes the work of internal experts with extensive financial controls knowledge, information technology (IT) specialists, and many more highly skilled employees.

In addition to the hours their own employees will put in, most companies need the help of expensive outside experts. (Given the heavy reliance on IT-based internal controls, IT is a high-priority area that often requires special knowledge that exceeds the competencies of an ordinary IT department.)

These costs have a particular influence on FPIs because, besides meeting U.S. regulations, FPIs also bear the burden of the regulations of their home countries. Moreover, FPIs from Europe are currently confronted with further regulatory and reporting challenges as they come into compliance with the new International Financial Reporting Standards (IFRS) as well as expanded regulatory requirements of their home countries.

As a result of increasing costs and complexity, many foreign companies are rethinking their approach to the U.S. market and are either delisting or, like German carmaker Porsche, putting their plans to list on hold. According to Georg Stadtmann and Markus F. Wissmann in "SOX Around the World," 51 foreign corporations were listed with the SEC in 2001, but the number decreased to 31 in 2002, the year SOX was signed into law.

Small businesses especially may have to make hard choices between the cost of compliance and the need to access public markets. One of the greatest competitive advantages of the U.S. capital market used to be the ability to grant thousands of small and mid-cap firms access to capital markets at relatively low costs. This has changed drastically for these small and midsized public firms; many might be forced to delist because they lack the resources and the ability to fulfill the new regulations.

REACTIONS OF GERMAN ISSUERS

Despite its slow economic growth over the past decade, Germany is one of the most developed and powerful economies in the world. Seizing the opportunities that globalization provided, many successful German corporations entered U.S. capital markets to increase their capital reserves. Today, well-known German companies that are actively trading on the NYSE or NASDAQ include Daimler, SAP, Schering, Bayer, BASF, Allianz, Deutsche Bank, Altana, Siemens, Fresenius Medical Care, and GPC Biotech.

According to an article by Hudson Hollister in the *Northwestern Journal of International Law & Business*, "Shock Therapy for Aktiengesellschaften: Can the Sarbanes-Oxley Certification Requirements Transform German Corporate Culture, Practice and Prospects?" German FPIs such as electronics giant Siemens or specialty chemicals group Altana, whose CEOs have already filed SEC certifications, believe the Act represents an opportunity to enhance their financial reporting and attract investors.

Others argue that SOX imposes an unnecessary burden on companies and that its benefits can't be justified by its costs. SOX has been widely criticized by several German firms not only because of the additional costs, but also because German FPIs argue that it attempts to impose U.S.-style governance without considering national differences in corporate structures.

According to the German view, several requirements of SOX, such as Section 302 (which makes chief executives personally liable for financial reporting), are inconsistent with German provisions and regulations. Under current German law, the chairman of a company can't be held personally responsible for corporate fraud. Unlike leaders of American firms, the chairmen of German companies

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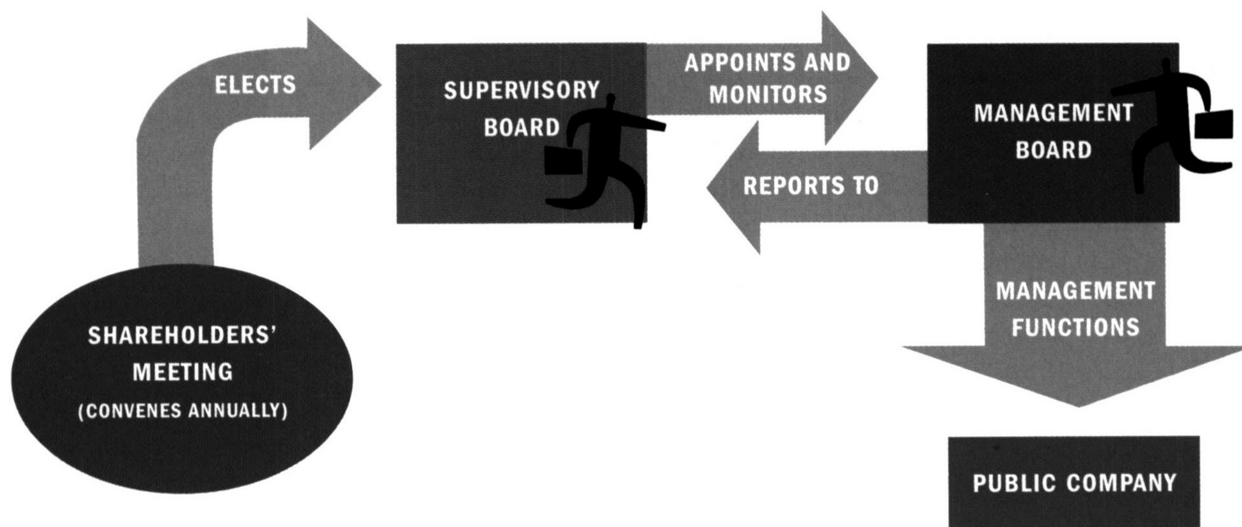
Figure 1: **German Public Company Structure**



often don't have privileges and are frequently referred to as the "spokesman" of the management board.

Consequently, annual reports of publicly traded companies must be passed by the entire management board and finally presented to a separate supervisory board that monitors management. Under German law, the overall responsibility for a firm's accurate reporting rests with the management board *and* the supervisory board, involving more than 20 people. Therefore, any special treatment of the chairman, such as holding him or her personally responsible, would seem illogical. Many other European countries besides Germany also tend to have less centralized management structures, making it hard for them to hold a single person responsible for financial reports.

SOX has been further criticized for not considering other national differences, such as the way firms finance their operations. U.S. firms must attract investors to secure their financing, while, in Germany, banks generally provide loans to most publicly traded firms. Because of their dependence on equity capital, U.S. businesses have more incentive to "manage" earnings to attract private investors.

In Germany, however, companies would be more likely to provide banks with incorrect financial information to obtain credit because they are the major financing source. Nevertheless, this is hardly possible because of the banks' right to have access to all financial information of their debtors stated in applicable regulatory frameworks.

SOX supporters among the German corporations listed in the U.S. argue that better disclosure and improved financial reporting can have positive effects on German corporate structures, as well as corporate financing, by attracting more private investors and reducing the dependence on bank financing.

As mentioned previously, German companies traditionally finance their operations through bank loans rather than with equity capital. But, in addition to debt financing, German banks are allowed to own major stakes in publicly traded corporations. This often gives them a high level of influence regarding a public company's strategy. Since banks generate large profits from loans, they aim to obtain enough voting power to influence corporate decisions and strategies. The banks' primary objective is to ensure the company's long-term solvency by fostering a conservative, stable strategy rather than an aggressive, more risky growth strategy.

A large number of a firm's shares gives banks enormous voting power in the election of the supervisory board, which is supposed to monitor management activities (see Figure 1 for a depiction of the structure). Since the supervisory board is consequently dominated by bank representatives, it generally avoids risky, innovative strategies to ensure the long-term solvency of the business. Besides, to maintain good relationships, bank representatives on the supervisory board often tolerate management inefficiency—management isn't monitored efficiently but is treated as an important customer.

The influence of German banks has been recognized as a factor hindering aggressive growth strategies, ultimately resulting in a loss of competitiveness in the global market. Hence, there are attempts to switch from debt financing to equity financing to reduce corporations' dependence on bank loans and increase competitiveness in the global market where companies are forced to take risks in order

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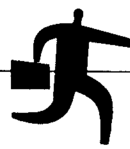
to survive. The Sarbanes-Oxley Act might represent an opportunity for SEC-listed German firms to attract an increasing number of domestic and international investors through improved reporting and disclosure.

SOX supporters also argue that the certification requirements compel executive officers to get personally involved in the preparation of financial statements. Making them, as individuals, liable for failure to provide accurate reporting might be a mighty incentive for executives to improve a company's control structure and do everything possible to prevent fraud. Internal control might have suffered under German corporate collectivism because when a number of people are responsible for accurate reporting, it's possible to escape responsibility by blaming others. Due to missing evidence and the inability to assign responsibilities, several lawsuits against companies have been dropped in the past, and individuals have gotten away with paying a symbolic fine. SOX could prevent this because responsibilities and fines are more accurately and specifically defined.

Others in Europe also stress the benefits SOX might provide. Executives at London-based merchant bank Schroders have decided to follow the Act even though they aren't subject to SEC regulation. Bank executives are reported to believe that the much more prescriptive and rigorous approach to control makes them aware of weaknesses in their internal controls and helps them to avoid costly mistakes and inefficiencies.



Section 302—Corporate Responsibility for Financial Reports
Compliance with Section 302 is mandatory for every company that trades stock on the NYSE and is listed with the Securities & Exchange Commission. It requires leading executive officers, usually the CEO and CFO of a company, to certify that they have reviewed the appropriateness of the financial statements and disclosures and that, based on their knowledge, the reports don't contain any untrue statement of material fact or omission that would make the statements misleading. By providing such certification, the officers become personally liable for inaccuracies.

Section 404—Internal Control over Financial Reporting
Section 404 states that the management of publicly traded companies is responsible for establishing and maintaining an adequate internal control system for financial reporting. Annually, the leading executive officers have to assess the effectiveness of the internal control system and provide a separate Internal Control Report that is audited by the firm's external auditor and presented together with the financial reports of the company.

Section 404 focuses on the effectiveness of the design and operation of internal controls. Effective internal control systems must be based on suitable, approved control frameworks that are established by bodies such as the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework is generally recognized as providing suitable criteria against which management may evaluate and report on the effectiveness of the entity's internal controls for financial reporting.

THE SEC RESPONSE

The SEC has recognized the problems of FPIs and has extended its original deadline for compliance with Section 404 several times. It has even agreed to consider the possibility of exempting European companies from certain requirements. As former SEC Chairman William Donaldson said in his 2004 speech in the European Policy Center in Brussels, the SEC will examine U.S. domestic market structure issues thoroughly before it takes up the issue of possible relief for non-U.S. companies.

At its open meeting on March 21, 2007, the SEC approved new rules that make it easier for FPIs to deregister their securities and terminate the associated reporting obligations. Instead of decreasing the number of U.S. resident shareholders to less than 300 in order to be exempted from U.S. reporting standards, a foreign firm would be able to terminate its SEC registration if the U.S. market does not represent at least 5% of its average daily trading volume. Despite the SEC's efforts to make delisting easier and to decrease the burden on current and prospective foreign issuers, many companies are convinced that the increasing legislation in the U.S. doesn't currently justify the benefits. In addition, Europe's integrated markets increasingly represent an alternative to U.S. stock exchanges.

FUTURE CORPORATE GOVERNANCE SYSTEMS

Changes in European corporate governance are also inevitable, especially because the corporate scandals of the past decade weren't solely a U.S. phenomenon. The European Commission has introduced a new pan-European law on statutory auditing called the Eighth Directive, which became effective in June 2006. It introduced several important changes: For instance, each public company is now required to form an audit committee, and an external auditor has to provide this committee with an annual report on the company's internal control.

These measures rumbled through the European Parliament in the face of severe opposition from corporate groups who feared it would become the EU counterpart

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to SOX and significantly increase costs of financial reporting. But the Directive is supposed to give companies much more freedom because it primarily imposes regulations that can be implemented in all European states and that don't interfere with any country's legislation. The European Commission cooperates with regulatory bodies of all member states in order to consider national differences and define pan-European approaches whenever possible. The question of certification and the extent to which businesses have to provide public statements about the effectiveness of their internal controls is therefore not covered by the Eighth Directive because it would be contradictory to national regulations in several member states.

Although the Eighth Directive is less strict than SOX, European companies won't be able to escape more transparent disclosure. In addition to the pan-European Eighth Directive, many European Union member states have produced additional national guidelines or legislation. In France, for instance, the chairman of the board of directors or the supervisory board of a public entity must now publish information about the firm's risk management and internal control systems. Nonetheless, these disclosures are descriptive, and they don't have to be conclusive about the effectiveness of internal controls.

In the future, a company's choice of market in which to issue its shares will be heavily influenced by the benefits weighted against the costs of an initial public offering, which are closely related to the degree of disclosure required. Despite its stricter regulatory framework, the U.S. capital market still provides the advantage of being the most liquid in the world. According to Hank Boerner's 2005 article in *European Business Forum*, "Europe Faces Eagle Eye of U.S. Financial Regulation," half the world's equity shares, by market cap, trade in the United States, with non-U.S. investors having $4.5 trillion invested in U.S. stock markets.

Even though Sarbanes-Oxley has scared some FPIs away, it's likely that foreign companies will eventually consider an IPO in the U.S. beneficial, especially if the SEC cooperates by considering national differences in corporate structures, financing, and legislation.

Recognizing the importance of cooperating with non-U.S. regulators, several American regulatory bodies already work together with bodies in the European Union. The Public Company Accounting Oversight Board (PCAOB), which is responsible for overseeing foreign accounting companies auditing U.S.-listed firms, has proposed several rules to work together with foreign regulators. These rules indicate that the PCAOB envisions a "principles-based approach" to evaluate the degree to which the PCAOB will rely on the oversight system of a foreign country. The evaluation will consider factors such as the adequacy of a company's home-country system, the independence of the system from the accounting profession, or the independence of the system's source of funding. In addition to avoiding unnecessary duplication of work by regulatory authorities in different countries, the PCAOB also stresses that its proposed rules "respect the cultural and legal differences of the regulatory regimes that exist around the world."

Considering these examples, more international cooperation, especially between the U.S. and the European Union, seems probable in the future to release firms from the burden of additional reporting requirements and to avoid a duplication of supervision by regulatory authorities.

Without doubt, corporate governance systems must be designed efficiently to prevent fraud and guarantee that investors can rely on accurate financial reports. But regulatory frameworks must not impose unbearable burdens because too much red tape and the high costs of compliance ultimately scare public firms away from capital markets.

In the long run, an international framework defining minimum standards for financial reporting might be the optimal solution. The development of the Eighth Directive in the European Union has indicated an approach that could serve as an example for the establishment of an international framework in the future. The Directive tries to consider national differences in legislation and corporate governance systems and aims at imposing provisions that are applicable at an international level but that still provide sufficient protection for investors.

An international framework considering differences between economies would be better suited to today's global environment. It would allow multinational corporations to offer their stocks across national borders without having to bear in mind the additional costs that arise from complying with different reporting systems and regulatory frameworks. Furthermore, it would be in the best interests of national stock exchanges and investors to attract successful foreign private issuers because their stock has an enormous potential for soaring returns to shareholders. ■

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