Impact of the Sarbanes Oxley Act on Foreign Companies in the United States: An Analysis

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The Sarbanes-Oxley Act of 2002 has been the root of much discussion and debate over the past three years. The purpose of SOX was to restore public confidence in the markets after this confidence was weakened by these scandals through various requirements which include, among other things financial reporting requirements and corporate governance expectations. It imposes additional burdens on doing business in an effort to make the firm and its executives more accountable for the corporate governance, business operations, and financial reporting of the company. The purpose of this paper is to present a brief, recent history of efforts to regulate corporate governance around the world; present the key provisions of the Sarbanes-Oxley Act of 2002; and discuss the impact of this Act on foreign companies doing business in the United States on their operations and reporting worldwide. The paper concludes with some open-ended questions left unanswered which, over time, will be answered based on the future responses to the Act including whether the United States has attempted to impose its laws in other jurisdictions and whether such attempts are overreaching.

Introduction

The accounting scandals of the recent decade have had a major impact on corporate governance as we knew it, for "when seismic events shake investor confidence in large international corporations, the worldwide landscape of public company governance changes" (Green and Gregory, 2005 p. 48). The fact that a ripple effect can cause a company heart burn and consternation is often overlooked in a climate where globalization has resulted in thousands of public companies doing business in different foreign jurisdictions. The result of this globalizing force is that global firms must research the laws of each jurisdiction in which they do business and retain local experts to ensure compliance. This obviously creates a significant financial burden for firms intending to enter global financial markets.

Sarbanes-Oxley Act of 2002

Corporate Accounting Practices Act, more commonly known as the Sarbanes-Oxley Act of 2002 ("SOX") was passed by Congress on July 30, 2002 in response to the corporate scandals of the late 1990's early 2000's. Its purpose was to restore public confidence in the markets after this confidence was weakened by these scandals (Green and Gregory, 2005, p. 50). Accordingly, the major provisions of SOX include:

1. The principal executive officer and principal financial officer must certify the financial statements of the company;
2. The company must document its internal control systems;

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3. The audit committees of the boards of directors must be composed of independent directors and establish "whistleblower" policies to allow questionable accounting practices to be anonymously reported; and
4. Public companies are to adopt and disclose a code of ethics for its key executives (Green and Gregory, 2005).

SOX also drew upon listing standards of the New York Stock Exchange and National Association of Securities Dealers to establish additional governance and reporting requirements for the firms (See Green and Gregory, 2005, p. 50-51). These additional governance and reporting requirements include: (a) creating more accountability for auditor independence; (b) requiring audits of internal controls in addition to those already required of financials statements; (c) limiting the use of pro forma financial information in various ways; and (d) setting minimum standards for professional conduct for attorneys representing issuers in any way before the United States Securities and Exchange Commission (SEC) (See Cohen, Bronson, Edwards and Stegemoeller, 2004 and Madrid, 2004).

Senator Sarbanes, one of the sponsors of the SOX legislation, was clear in the Senate floor debates of his intentions when lobbying for passage of his proposed legislation. He emphasized "simple principles" which are adopted by the SEC in their final regulations illustrated by Ainsworth (2004) as follows:

…the principles of independence with respect to services provided by auditors are largely predicated on three basic principles violations of which would impair the auditor's independence:

- An auditor cannot function in the role of management;
- An auditor cannot audit his or her own work; and
- An auditor cannot serve in an advocacy role for his or her own client.

Recent History of Regulation of Corporate Governance

SOX is not the first attempt to reform corporate governance. Green and Gregory (2005) outline several recent pieces of international legislation aimed at corporate governance. The United Kingdom (UK) explored reform through the adoption of the Cadbury Code (later called the Combined Code) by demanding firms either comply with the regulations or explain and justify their divergence from it. Later in the 1990's, the Paris-based Organization for Economic Co-operation and Development published its *Principles of Corporate Governance* as a guide for policy-makers, corporations, and other bodies. Similarly, corporate crises in Asia stimulated a move for reform during the same period. Additionally, the *King Report on Corporate Governance for South Africa – 2002* was adopted to provide a governance framework for companies listed on the Johannesburg Stock Exchange. Furthermore, rights of minority shareholders remain the most visible issue for Latin American markets, yet enforcement is inconsistent across its nations. However, none of these efforts has received as much attention or criticism as the demands

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instituted by SOX. In fact, the implementation of SOX and its tougher regulations has become the benchmark for many as the best practices in corporate governance (Birchfield, 2004). This best practices benchmark is illustrated by (a) the European Union's ("EU") efforts to phase in its own regulation of corporate governance in 2004 through several reforms related to director independence and executive compensation disclosures (Green and Gregory, 2005, p. 50) and (b) the Canadian securities regulations implemented in 2004 which were similar to SOX (Kraeker and Ritchie, 2003).

Global Response to SOX

Corporate governance is an animal largely dictated by local laws. Therefore, since the laws that regulate corporate governance differ among countries, it is not surprising that corporate governance practices differ among countries as well (*See* Green and Gregory, 2005, p. 49). Not only do the practices differ among countries, they also differ within countries based on the various needs of the organizations involved. In fact, past practice in the EU has been that corporate regulation and oversight of auditors were conducted at the national level, resulting in little conformity among the member states. In May, 2003, however, the EU offered a plan aimed at improving corporate governance and audits among its member states. However, unlike the mandate of SOX, the EU plan adopts the "comply or explain" approach of the UK's Combined Code.

Green and Gregory (2005) point out that "[r]ules, regulations, and norms around the world influence the way public companies operate globally" (p. 48). Although the EU has begun to harmonize governance and audit regulation, the European Commission has expressed concern to both the European Council and the European Parliament about the "unnecessary outreach effects" of SOX on European companies and auditors as well as the failure of the United States (U.S.) to "mutually recognize the equivalence of high quality regulatory systems" (Green and Gregory, p. 54).

In 2003, the French authorities overhauled their regulatory system against insider trading through the Financial Security Law but did not follow the tough tactics instituted by the U.S. (Cafritz and Gillespie, 2003). French penalties are generally lower and, of 11 defendants charged with insider trading who were convicted and had their convictions upheld on appeal since 1991, five were fined less than the profits they realized and only two were imprisoned for their crimes. Additionally, while SOX increased the SEC budget by approximately 50%, France's Financial Security Law did not increase financial support to its regulatory body. (Cafritz and Gillespie)

Cafritz and Gillespie (2003) note that French corporate culture may be more resistant to insider dealing, thereby reducing the inclination of the French legal system to engage in "extravagant prosecutorial campaigns" such as those that recently have taken place in the U.S. Additionally, New Zealand realized that it could not afford to wait for its own scandals to begin implementing prescriptive regulation. In addition, it realized the importance of New Zealand companies participating in the global economy. Lastly, Canadian securities regulators proposed rules similar to SOX which were implemented in 2004 (Kraeker and Ritchie, 2003).

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Global Impact of SOX

On Foreign Issuers

The global impact of SOX is apparent by the fact that the U.S. capital markets account for about 60% of the world's capital markets (McCall, 2004). Firms that must comply with SOX include all firms who: (a) have registered securities under the Securities Exchange Act of 1934; (b) are required to file reports under Section 15(d) of the Securities Exchange Act of 1934; or (c) have filed a registration statement under the Securities Act of 1933 that has not yet become effective are subject to SOX (Cohen *et al.*, 2004). Not only are foreign issuers required to comply, but foreign auditors are also required to meet the SOX requirements when working on firms that fall under its jurisdiction (Ainsworth, 2004). Most important to the purpose of this paper is that there is no exemption or accommodation made for foreign entities in SOX (Green and Gregory, 2005 p. 51). Therefore, these foreign entities which are listed on U.S. exchanges or traded in U.S. markets (whether or not listed) must meet the same standards set by SOX for U.S. firms (Cohen *et al.* 2004). Not only must a firm meet the requirements of SOX, but its affiliates must meet the requirements as well (Briault, 2004). Briault notes that any multinational firm in Germany with a U.S. company in its group "must obtain internal audit committee approval for any tax advice its auditor wishes to provide" (p. 8). This means that close affiliations between accounting firms and law firms around the world must be closely monitored to prevent violation of the SOX restrictions.

The only way to avoid the provisions of SOX is for the firm to de-register their securities. This requires the firm to de-list from all national stock exchanges and certify that it has less than 300 U.S. shareholders. Due to an increase in the number of foreign issuers listed on U.S. markets indicating they will consider de-listing to avoid the burdens of SOX and other regulations adopted therewith, the SEC has aimed to loosen restrictions on the public offering process by merging the framework for raising capital with reporting (*International Financial Law Review*, 2004). Despite the pending implementation deadline imposed by SOX, as of November 2004, Marshall and Heffes (2004) noted that of the 1,300 companies listed as foreign registrants (most of which are European) in the U.S. markets seven in ten European companies were only in the early stages of planning their SOX internal control projects (p. 10). Many firms argued that they found it difficult to balance SOX compliance efforts with prospective International Financial Reporting Standards and local government regulation in their home country (Marshal and Heffes).

On Doing Business Globally

Not only is SOX affecting foreign issuers, but the internal control requirements add complexity to managing import-export operations and global supply chains (Field, 2004). One example presented by Field (2004) is that a firm may be deemed in violation of SOX if the firm is notified by the U.S. Customs Service that an international trade law has been violated and the firm had no policy or procedure in place to review trade compliance. Not only must the firm have controls in place to comply with U.S. trade laws, it must also be sure it in compliance with trade laws in all countries with which it

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does business (Field, p. 56). Therefore, firms are not only required to comply with the provisions of SOX, but the internal control requirement imposed by SOX "ties together all other applicable bodies of law that bear on corporate conduct [and] requires that management know what these requirements are" (Field, p. 55).

Additionally, Field (2004) notes the provision requiring companies disclose to auditors all "off balance sheet transactions, arrangements, obligations and other relationships" essential to the business imposes a heavy burden on supply-chain managers. This provision requires that these managers be aware of and disclose all relationships or service contracts, including the responsibilities under such agreements and potential penalties should the company fail to fulfill its obligation (Field, p. 55). In essence, "[t]he legislators have taken 'ignorance' as a defense away in the future" (Birchfield, 2004). This particular component of SOX implementation is one that was somewhat overlooked in the early stages as companies were so preoccupied with the implementation of the basic provisions of SOX, resulting in a situation where they had not even begun applying SOX to their global supply chains two years after the passage of the legislation (Field, p. 56). Additionally, it is difficult for senior managers to know all of the company's international trade efforts to properly understand how SOX applies in this area. Not only is the implementation of all of these controls costly, the mandate that the internal controls then be audited and certified by the independent auditor adds to the financial burden of doing business globally. Field notes, however, the effect of this is to essentially mandate good management as the document flow and process that must be used to make the company SOX-compliant is very similar to ISO 9000 standards. In many ways, therefore, it is just a good, common sense way of doing business.

One problem the SOX requirements create is the possible detriment to the company as a whole. Internal controls are a form of risk management and risk management, taken to an extreme, can become risk avoidance and, therefore, a risk in and of itself (Birchfield, 2004). One might argue, however, that this has created a division between public and nonpublic (also known as private) companies rather than large and small companies (Cheney, 2004, p. 20). Standards applied by many national and international jurisdictions tend to focus on the most common denominator and, thus, apply to international public companies that sell equities in other countries. Therefore, one could argue the private company has a financial, and therefore possibly a competitive advantage over public companies entering foreign markets as private companies are not burdened with the extensive reporting and audit requirements of public companies imposed by SOX when doing so.

Cheney notes that "[a]bout half of America's economic output is generated by millions of nonpublic companies, yet FASB [the Financial Accounting Standards Board] writes standards primarily for the complex finances of about 15,000 public companies, establishing the GAAP [generally accepted accounting principles] that the SEC requires for listing on U.S. stock exchanges" (p. 20). The same analysis can be made about applying SOX and the burdens it creates. It is interesting to note that most countries require private companies to file reports under the national GAAP (i.e. the accounting

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principles generally accepted in that country) while the U.S. does not, yet national GAAP in these other countries as it applies to small companies is not as rigorous as that of international or U.S. standards imposed on public companies (Cheney p. 22).

Conclusion

Is the U.S. attempting to impose its laws on firms around the world? Based on the discussion above, it has come pretty close, at least as to those firms over which it can impose jurisdiction, even if based on the smallest of connections to the U.S. Yet, does not the U.S. have a vested interest in protecting investors within its boarders? Or has the U.S. stepped over the line by implementing a law that has "unnecessary outreach effects"? These questions are questions that continue to be asked by the U.S. and global investment communities and will only be answered after years of research on the impact, effect, and legacy of SOX.

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