

# CORPORATE GOVERNANCE, PUBLIC ACCOUNTING FIRMS AND MULTINATIONAL CORPORATIONS: THE US SARBANES-OXLEY ACT PERSPECTIVE

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## Abstract

The purpose of this paper is to review US corporate governance systems and to highlight the mandated roles of audit committee and external auditor within the SOX Act. In addition, it discusses requirements and implications of the SOX Act for the foreign accounting firms and multinational corporations. Finally this paper provides a perspective on improvement of corporate governance and financial integrity. In order to regain trust from the financial market, the SOX Act mandates (1) to improve auditor's independence by reducing conflicts of interest; (2) to increase corporate financial reporting responsibility by requiring a CEO or a CFO certify accuracy of annual report; and (3) to enhance financial disclosures. It also significantly increase criminal penalty for non-compliance. The authors believe that the combination of strengthening auditor's independence, increased corporate responsibility and severe penalty and restored corporate governance would create an environment that is intended by the SOX Act. Volker and Levitt (2004) put it very forceful way: "While there are direct money costs involved in good corporate governance, we believe that an investment in good corporate governance, professional integrity and transparency will pay dividends in the form of investor confidence, more efficient markets and more market participation for years to come." We concur with them and believe that the SOX Act will help in restoring trust in corporate governance and improve financial integrity and quality of financial information. We also agree that the benefits of the SOX Act will outweigh the costs of compliance in the long-run.

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## Introduction

The US historically has had the most robust capital markets in the world in large part due to better corporate governance systems. It is undeniable now that most US capital markets participants including financial analysts, accountants and regulators are under attack. As more and more disclosures have come to light, many of these market participants have shown to behave irresponsibly, unethically and/or illegally.

"Shortly after the Enron scandal, other scandals involving corporate giant (Tyco, WorldCom, Xerox, Adeptia, Ahold, etc), brokerage firms (e.g., Merrill Lynch), stock exchanges (e.g., New York Stock Exchange), large public accounting firms (e.g., Arthur Anderson, Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers) and managers of mutual funds (e.g., Piper Jaffray) were uncovered." (Corporate Governance and SEC, Skousen, Glover and Prawitt, 2005, p.5)

Confidence in our capital markets has been undermined. Restoring the trust and credibility of markets is one of the most important missions for all parties concerned. Investors and public were initially

misled and then punished as the bubble expanded and burst amidst a blaze of corporate misdeeds. Major fraud cases over the last three years have destroyed over \$200 billion of equity value (Gadiesh, 2004).

Recently, we all have heard the same questions over and over again: What happened to the US capital market systems? Where were the board of directors and the corporate governance? Where were the competent and self-governing external auditors? Where were the lawyers, the guardians of the systems? Where were the investment bankers and the financial analysts, the prodigies of the fuel that fed the bubble?

Perhaps greed and conflict of interests prevented the participants from performing their respective functions properly. Many forgot that their actions and in-actions put their most valuable assets, the credibility as well as the interests of their shareholders at risk. Their reputation may never be regained or may take years to refurbish.

The essence of the good governance system is the proper stewardship; monitoring and managing people, processes and activities of a corporation on behalf of owners, shareholders. Good corporate governance creates a system that demands proper stewardship over

invested capital and faithfully reports the economic condition and performance of the enterprise (Skousen et al, 2004. p.7). That money, invested by the shareholders, is to be protected. The board of directors is supposed to monitor the management and external auditor are responsible in providing assurance and in attesting financial integrity and financial well-being of a corporation and in reporting its opinion to shareholders and management.

The purpose of this paper is to review the Sarbanes-Oxley (SOX) Act and to highlight the mandated roles of audit committee and external auditor within the Sarbanes-Oxley Act and to examine whether these requirements will improve corporate governance and financial integrity. In addition, it also discusses requirements and implications of the Sarbanes-Oxley Act for the foreign multinational corporations, required to register with US SEC.

The remainder of the papers is as follows: The second section will provide an overview of the Sarbanes-Oxley Act and the required role of audit committee and external auditor. The third section discusses the requirements and implications of the Sarbanes-Oxley Act to the foreign accounting firms and multinational corporations. The fourth section discusses corporate governance of UK and Germany. The final section provides perspectives and implications of the SOX Act.

### **The role of audit committee and external auditors within the Sarbanes-Oxley act for US corporations**

McEachern and Massoud (1990) suggest that “the main role of the audit committee is to oversee the financial reporting process and enhance the credibility of that process.”

The SOX Act establishes new responsibilities for the audit committee in its capacity as a committee of the board of directors. The responsibilities include the appointment of the external auditor, determination of audit fees and oversight of the auditor. The audit committee must pre-approve all services provided by external auditor, after determining that the services do not pose conflict with the auditor’s independence. Moreover, audit committee must be comprised of independent directors and, among other things, whether at least one member have to meet the specified criteria of an “audit committee financial expert.” In addition external auditor is required to directly report to the audit committee which has new and expanded obligations to serve on behalf of the board of directors as the watchful guardian of shareholders interests. Thus the SOX Act strengthened and expanded the audit committee responsibilities. Table 1 summarizes the responsibility and relationship of Audit Committee and external auditor.

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In addition, the Sarbanes-Oxley Act mandates establishment of the Public Company Accounting Oversight Board (PCAOB). The Board is a non-profit organization to oversee the accounting and auditing standards of the public companies. The purpose of PCAOB is to protect the interests of the investors and to further the public interests by monitoring for an informative, fair and independent audit report. In March 2004, the PCAOB approved the first important standard, “An Audit of Internal Control over Financial Reporting Performed in conjunction with an Audit of Financial Statement.” Section 404 (a) of SOX and SEC’s related implementation rule require the management of public company to assess the effectiveness of the company’s internal control on financial reporting. Section 404(b) as well as Section 103 directed PCAOB to establish the professional standards governing independent auditor and assessing the effectiveness of internal controls. The new standard requires auditors to review management assessment of the effectiveness of company internal controls, run their own tests of those controls and judge the effectiveness of corporate board members who sits on a firm’s audit committee (www.pcaobus.org). The PCAOB in effect ended self-regulations of auditing and attestation standards, Generally Accepted Auditing Standards (GAAS).

### **The Sarbanes-Oxley act requirements and implications to the foreign accounting firm and multinational corporations**

According to Section 106 of the SOX Act, foreign public accounting firms who audit a U.S. company required to register with the PACOB. This would include foreign firms that perform some audit work, such as in a foreign subsidiary of a U.S. company, that is relied on by the primary auditor. The Board exercises authority over these foreign accounting firms. Foreign accounting firms that "prepare or furnish" an audit report involving U.S. registrants are subject to the authority of the Board. Additionally, if a registered U.S. accounting firm relies on the opinion of a foreign accounting firm, the foreign firm's audit workpapers must be supplied upon request to the Board or the Commission (AICPA, 2004).

The Securities and Exchange Commission adopted rules that the national securities exchanges and national securities associations should prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements established by the SOX Act. Table 2 summarizes the detailed requirement:

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Generally, listed issuers are required to comply with the new listing rules by the date of their first annual shareholders meetings after Jan. 15, 2004, but in any event no later than Oct. 31, 2004. Foreign private issuers and small business issuers will be required to comply by July 31, 2005. Many will argue that those

requirements will lead to a decrease in number of foreign company listed in the US exchange. Until now it is difficult to speculate about the effect of this requirement.

**Corporate governance in the UK and Germany**

One of major issues about requiring foreign companies to adopt the SOX Act is that many foreign companies have their own country’s corporate governance rules. According to section 301 of the SOX Act, foreign corporations listing security in the US national securities exchanges and national securities associations should adhere to the audit committee requirements. The following presents a highlighted summary of corporate governance of UK and Germany.

**United Kingdom.** In 1992, the Cadbury Committee (The Committee on the financial aspect of corporate Governance) investigated the accountability of the Board of Directors to shareholders and to society as a whole. The committee made recommendations to improve financial reporting, accountability and Board of Directors’ oversight. The Cadbury Committee recommendations led to the Greenbury Report in 1995. The Greenbury Report recommended to establish extensive disclosures on directors’ remuneration in the annual report of the UK companies. The Hempel report in 1998 confirmed much of the work of Cadbury and Greenbury Committees. That has led to the Confined Code on Corporate Governance (2003). Compliance with these codes is a part of stock exchange requirement.

This code requires that the annual report of a major UK company should contain a report from the

remuneration committee, a statement on corporate governance, a statement on internal controls, a statement on the going concern status of company and a statement of the directors’ responsibilities. The following is a list of requirement that differs from under the SOX regulations:

1. The chair of the board should meet with non-executive directors without the executive present.
2. Led by the senior independent director, the non-executive directors should meet without the chair present at least annually to appraise her performance and on such other occasions as are deemed appropriate.
3. The chair of the board and CEO should be separated. The division of responsibilities should be clearly established, set out in writing, and agreed by the board.
4. At least half of the board, excluding the chair, should be comprised of non-executive directors and should be independent.
5. The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns that have not been alleviated by top company officials.
6. Shareholders should be invited specially to approve all new long-term incentive arrangements and significant changes to existing schemes unless prohibited by the Listing Rules.

A recent survey of 310 service executives around world indicates that the US is generally ahead of the pack in corporate governance (KPMG, 2003).

	Germany	UK	US
1. Which of the following countries has done most to improve standards of corporate governance over the past year?	7%	16%	71%
2. Which of the following countries has the farthest to go in improving standards of corporate governance?	7%	6%	23%

**Germany.** The German systems of corporate governance reflect their unique structures of legal rights and arrangements. The corporate decision-making process and corporate governance are shared among stakeholders, shareholders, employees, and customers. This broad view “encompasses the product markets, the capital and labor markets, any informal organizational arrangements which may exist and function alongside the formal structure.”

Germany has a strong employee co-determination program. Work councils have extensive participation in decision-makings and employees are also respected in the corporate boardroom. These differences are contrasted with the shareholder-oriented approach to corporate governance in the US.

One of the distinguishing characteristics of German corporate governance is the two-tier board of directors system. The two-tier system of governance creates different rights and obligations for member of

each board that are set out in the German Stock Corporation Act and German Corporate Governance Code. Figure 1 shows the relationships with key stakeholders groups.

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The management board is charged with managing the enterprise for the benefit of a wide array of stakeholders. The supervisory board, whose members are elected by the shareholders at the annual meeting, does not have the formal right to give specific instructions to members of the management board, but management board is required to report to the supervisory board at regular intervals. The major functions of the supervisory board are to appoint and dismiss the members of the management board and to determine management remuneration. The management

board normally takes into consideration on specific position of the supervisory board.

A potential problem in the German corporate governance is the dual obligations of members of the supervisory board. On one hand, they are obliged to act in the best interests of the company while on the other hand they have certain obligations toward their specific constituencies. This conflict of interests may influence the role and actions of the supervisory board.

The German Stock Corporation Act and German Commercial Codes establish the regulations for the preparation of financial statements. The act also details Audit requirements. Table 1 demonstrates these provisions and compares the functions of the management board in Germany and US.

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The functions of the supervisory board are similar to that of the audit committee in the US. A comparison of the German and US requirement indicates two important differences: First, employee participation in decision-making process is an integral part of the German governance systems while no employee participation is presented in the US systems. Second, the German system relies more on a consensus of decision-makers, which take into consideration all the stakeholders in addition to shareholders.

### **Perspective and implication of SOX act**

The SOX Act poses new challenges to management. The new legislation puts on a significant the responsibility for fraud detection, though it does not relieve duties of the audit committee or the auditor. The board of directors and audit committee are ultimately responsible for overseeing management's assessment of fraud and the entity programs and its control systems. The audit committee is expected to investigate alleged wrongdoing brought to its attention.

The SEC implementation rules for SOX made it clear that increased transparency of financial information is central to the new regulation. "By increasing transparency regarding key aspects of corporate activities and control, the proposals are designed to improve the quality of information available to the investor. ([www.sec.gov/rules/final/33-8177.htm](http://www.sec.gov/rules/final/33-8177.htm))

In order to regain trust from the financial market, the SOX Act mandates (1) to improve auditor's independence by reducing conflicts of interest; (2) to increase corporate financial reporting responsibility by requiring a CEO or a CFO certify accuracy of annual report; and (3) to enhance financial disclosures. It also significantly increase criminal penalty for non-compliance.

**Auditors Independence.** The SOX Act attempts to ensure auditor independence. The law contains significant provisions designed to strengthen both the

fact and perception of auditor independence. The auditor is required to directly report to the company's audit committee which has new and expanded obligations to serve on behalf of the board of the directors as the watchful guidance of shareholder's interests. In the past, management has been a primary contact for the external auditor's communication with the audit committee. However the audit committee is now the appropriate contact for the external auditors.

### **Corporate Responsibility and Severe Penalty**

SOX affirms that CEO and CFO carry primary responsibility for company financial reports filed with the SEC and require them to certify the completeness and accuracy of information and the effectiveness of internal control. If an executive certify a report that turn out to be false and misleading, he/she will be facing severe criminal charges, a possibility of up to 20 years in prison. Certifying officers can also be forced to reimburse all or part of compensations earned based on erroneous financial statements.

**Can the SOX Help Regain Public Trust?** The single most important question is whether the SOX Act will produce what was its primary intended goal: Regain public trust and the elimination of massive companywide abuses and financial fraud that rocked US corporations and capital market participants recently. To name a few: Enron, Global Crossing, Tyco Internationals and WorldCom. So far the law has been good for shareholders, good for companies and good for government. SOX got people focused on quality and integrity of financial reports.

Many companies recently hired Chief Governance Officer (CGO) and Chief Compliance Officer (CCO). The CCO is supposed to monitor company's internal control systems while CGO makes sure that the board properly functions. The companies instituted CGO or CCO includes Hershey Foods, Motorola, Pitney Bowes, Pfizer, Estman Kodak, Sunoco, and American Express. The provision causing the most trouble is Section 404 which requires CEO and CFO to assess the adequacy of their company's internal control. This simply stated goal turns out to require a vast amount of work. In many cases, this led many firms to do massive overhaul of their information technology systems which requires huge expenditures.

The combination of strengthening auditor's independence, increased corporate responsibility and severe penalty and restored corporate governance would create environment that is intended by SOX Act. Volker and Levitt (2004) put it in a very forceful way: "While there are direct money costs involved in good corporate governance, we believe that an investment in good corporate governance, professional integrity and transparency will pay dividends in the form of investor confidence, more efficient markets and more market participation for years to come." We concur with them and believe the benefits of the SOX Act will outweigh the costs of compliance.

## References

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## Appendices

**Table 1.** New Roles for Audit Committees and Auditors. (AICPA 2004).

1. Auditors Report to Audit Committee. Now, auditors will report to and be overseen by a company's audit committee, not management.
2. Audit Committees Must Approve All Services. Audit committees must preapprove all services (both audit and non-audit services not specifically prohibited) provided by its auditor.
3. Auditor Must Report New Information to Audit Committee. This information includes: critical accounting policies and practices to be used, alternative treatments of financial information within GAAP that have been discussed with management, accounting disagreements between the auditor and management, and other relevant communications between the auditor and management.
4. Offering Specified Non-Audit Services Prohibited. The new law statutorily prohibits auditors from offering certain non-audit services to audit clients. These services include: bookkeeping, information systems design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer and investment banking services, legal or expert services unrelated to audit services and other services the board determines by rule to be impermissible. Other nonaudit services not banned are allowed if preapproved by the audit committee.
5. Audit Partner Rotation. The lead audit partner and audit review partner must be rotated every five years on public company engagements.
6. Employment Implications. An accounting firm will not be able to provide audit services to a public company if one of that company's top officials (CEO, Controller, CFO, Chief Accounting Officer, etc.) was employed by the firm and worked on the company's audit during the previous year.

**Table 2.** Requirement for foreign multinational corporations

Under the new rules, national securities exchanges and national securities associations will be prohibited from listing any security of an issuer that is not in compliance with the following requirements.

1. Each member of the audit committee of the issuer must be independent according to the specified criteria in Section 10A(m) of the Securities Exchange Act of 1934.
2. The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and the registered public accounting firm must report directly to the audit committee.
3. The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.
4. The audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties.
5. The issuer must provide appropriate funding for the audit committee.

The new rules will establish Section 10A(m)'s two criteria for audit committee member independence.

1. Audit committee members must be barred from accepting any consulting, advisory or compensatory fee from the issuer or any subsidiary, other than in the member's capacity as a member of the board or any board committee.
2. An audit committee member must not be an affiliated person of the issuer or any subsidiary apart from capacity as a member of the board or any board committee.

The new rules will apply to both domestic and foreign listed issuers. It is important to note that, based on significant input from and dialogue with foreign regulators and foreign issuers and their advisers, several provisions, applicable only to foreign private issuers, have been included that seek to address the special circumstances of particular foreign jurisdictions. These provisions include

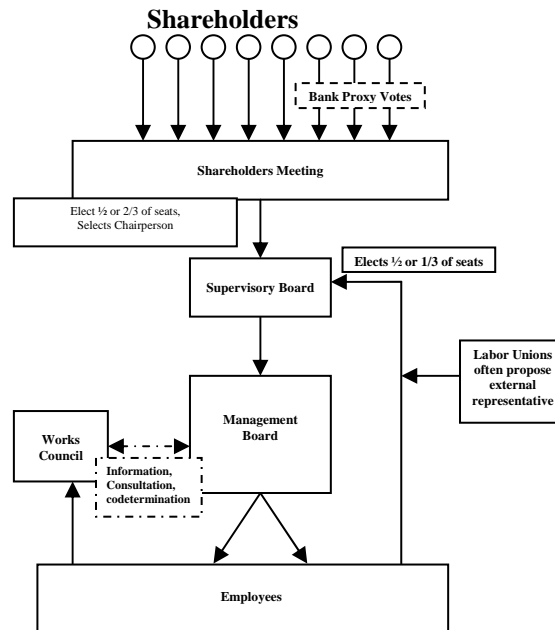
1. allowing non-management employees to serve as audit committee members, consistent with "co-determination" and similar requirements in some countries;
2. allowing shareholders to select or ratify the selection of auditors, also consistent with requirements in many foreign countries;
3. allowing alternative structures such as boards of auditors to perform auditor oversight functions where such structures are provided for under local law; and
4. addressing the issue of foreign government shareholder representation on audit committees.

The new rules also will make several updates to the Commission's disclosure requirements regarding audit committees, including updates to the audit committee financial expert disclosure requirements for foreign private issuers.

**Table 3.** A Comparison of Responsibilities for Financial Reporting Oversight

Financial Reporting Item	Responsible Board	
	Germany*	U.S
Prepare financial statements	Management Board	Management
Assess propriety and appropriateness of accounts	Supervisory Board	Audit Committee
Prepare management report	Management Board	Management
Legal requirement to approve Financial statements	Supervisory Board	Audit Committee
Review and approval of quarterly financial reports	Supervisory Board	Audit Committee
Internal Control system	Management Board	Management
Risk early recognition system (going concern evaluation)	Management Board	External auditors
Appointment of auditors	Supervisory Board	Audit Committee
Role of the external audit	Support Supervisory Board and Perform a control function In the public interest	Protect public interest

\*The source for the Financial reporting and other requirements in Germany is the Institut der Wirtschaftsprüfer's (German equivalent of the AICPA) issues paper *Financial Reporting, Auditing and Corporate Governance* (2003)



**Figure 1.** The Legal Structure of Corporate Governance in Germany\*

\*Jackson, G., M. Hopner, and A. Kurdelbusch. 2004. Corporate governance and Employees in Germany: Changing Linkages, Complimentarities, and Tensions. *RIETI Discussion Paper Series 04-E-009*: 49.