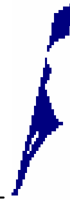
РАЗДЕЛ 3 КОРПОРАТИВНОЕ УПРАВЛЕНИЕ В ГЕРМАНИИ

SECTION 3 NATIONAL PRACTICES OF CORPORATE GOVERNANCE: GERMANY



EXTRATERRITORIAL IMPACTS OF THE SARBANES-OXLEY ACT ON EXTERNAL CORPORATE GOVERNANCE – CURRENT EVIDENCE FROM A GERMAN PERSPECTIVE*

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Abstract

The Sarbanes-Oxley Act (SOX) has not only had tremendous impact on the U.S corporate governance system, but also on other countries with companies subject to SOX. The paper analyzes the major direct impacts of SOX on the European Union (EU) and Germany as a Member State. The focus of the analysis is on rules concerning external corporate governance instruments, i.e. the auditing professions' oversight, auditors' independence and auditing standards. Additionally, the paper investigates whether the contemporary regulatory activities in the EU and Germany concerning external corporate governance can be explained as indirect institutional consequences of SOX. Although the EU Commission says for the record that it has an own long-term strategy of modernizing corporate governance, the paper demonstrates that several rules of SOX quite obviously served as a model for the EU regulatory activities. The same phenomenon can be observed for the new German regulations of external corporate governance.

Key words: Sarbanes-Oxley Act, external corporate governance, auditing, Germany

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Introduction

The Sarbanes-Oxley Act (SOX) and related rules of the SEC are a direct reaction of the U.S. regulatory system to a series of obvious malfunctioning of the established corporate governance system in the U.S. SOX had a huge impact on companies and auditors in the U.S. However, the focus of the paper is on the extraterritorial impacts. The objective of the paper is to reveal, analyze and explain this impact on the European Union (EU) and on one particular country, namely Germany.

The structure of the paper is determined by the assumption that the impact might be two-fold. First, due to the explicit scope of SOX a direct influence of its rules is obvious on companies listed on the U.S.

securities market as well as on the auditors of such companies. Second, because of its strict and somehow revolutionary content, SOX might be used by national regulators and auditing professions as an example or model to tighten up national corporate governance regulations in order to better protect the interests of share- and stakeholders. This will be referred to as indirect influence.

Based on this view of a direct and indirect impact of SOX the first section investigates the major direct impacts on Germany and uncovers arising conflicts with national regulations. In the second section the regulatory activities in Germany which have been undertaken since the adoption of SOX are depicted. As the regulations of the EU Member States have to comply with the rulings of the EU, the post SOX regulatory activities of the EU are described as well. In order to allow a deeper analysis, the paper focuses only on specific topics regulated in SOX, in particular those which are related to the function of auditing within the external spheres of corporate governance; those are the public oversight over the auditing profession, the auditors' independence and auditing standards. The last section of the paper discusses whether the regulatory activities of the EU and the German regulating institutions may be regarded as "spill over effects" and/or indirect institutional consequences of SOX.

Direct Extraterritorial Impacts of SOX

Applicability of SOX

The Sarbanes-Oxley Act of 2002 applies to any company ("issuer") registered on U.S. stock exchanges under either the Securities Act or the Securities Exchange Act, irrespective of the country of the company's domicile or incorporation (see Sec. 2(7) of SOX). The Act itself does not contain exemptions for foreign private issuers[1]. Therefore, SOX has an impact on all U.S. and non-U.S. companies that are registrants with the Securities and Exchange Commission (SEC) (see Perino, 2003, p. 221). Besides the registered companies, SOX addresses the auditors of those companies and financial analysts and covers issues of internal and external corporate governance, financial disclosure and criminal penalties for the concerned companies and people. Figure 1 gives an overview of the major provisions of SOX.

Concerning the auditors, SOX requires that any public accounting firm[2] involved in the preparation of audit reports of any issuer listed on a U.S. stock exchange is subject to the provisions of the Act and to the oversight of the Public Company Accounting Oversight Board (PCAOB). This includes non-U.S. public accounting firms performing auditing services for registrants on the U.S. capital markets (see Sec. 106(a)(1) of SOX). As the extraterritorial impact of SOX may provoke conflicts for non-U.S. companies and auditors with their national regulations, the SEC, and the PCAOB, subject to the approval of the SEC, are empowered to exempt any foreign accounting firm from any provision of SOX when they determine necessary or appropriate in the public interest or for the protection of investors (Sec. 106(c)). Moreover, SOX gives the SEC the authority to promulgate rules and regulations in considerations of the public interest, the protection of investors and the purpose of the Act (Sec. 3(a)). This provision allows for exemptions for foreign private issuers. Nevertheless, there is no specific directive requiring the SEC to create such exemptions. SOX departs from the traditional policy of the SEC to provide accommodations and exemptions for foreign private issuers and their auditors (for details refer to Perino, 2003, p. 8). One reason for this might be that general exemptions for non-U.S. issuers would have created loopholes and therefore were politically unacceptable (see Morrissey, Bostelman and Clayton, 2003, p. 14). Another reason might be that Congress did not consider the impact of SOX on the affected companies, accounting firms and regulators because it wanted to react quickly to the financial breakdowns in the U.S. As evidence for this hypothesis the fast legislative process (29 days) and the very few references to this issue in the Congressional Record (see Perino, 2003, p. 9-11) could be cited. The next section depicts the major impacts of SOX on the German auditing profession as well as German companies and explains resulting conflicts with existing national rules. As already noted, the focus is only on external corporate governance issues covered by SOX: those are rules on the auditing profession's oversight, on auditors' independence and auditing standards. This restriction of the investigation does not mean that all the other issues referred to in SOX have no influence on German entities or do not provoke conflict with national German rules.

Auditors' Profession Oversight

SOX established the Public Company Accounting Oversight Board (PCAOB), an independent private non-profit organization under the control of the SEC.

[1] The term „foreign private issuer" is defined as any issuer, that does not have more than 50 percent of its outstanding voting securities held by U.S. residents and that does not satisfy any one of the following conditions: (1) the majority of directors or executive officers are U.S. citizens or residents; (2) more than 50 percent of the issuer's assets are located in the U.S.; or (3) the issuer's business is administered principally in the U.S. (see 17 C.F.R. Art. 240.3b-4(c) (2003).

[2] SOX uses the term "public accounting firm" for any proprietorship, partnership, incorporated association, corporation, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports (see Sec. 2(11) of SOX). In contrast the proposed modernization of the 8th Directive of the EU Commission uses the term "audit firm", which means an entity that is approved in accordance with the provisions of the Directive by the competent authorities of a Member State of the EU to carry out statutory audits regardless of its legal form. Both terms, "public accounting firm" and "audit firm", are used synonymously in this paper.

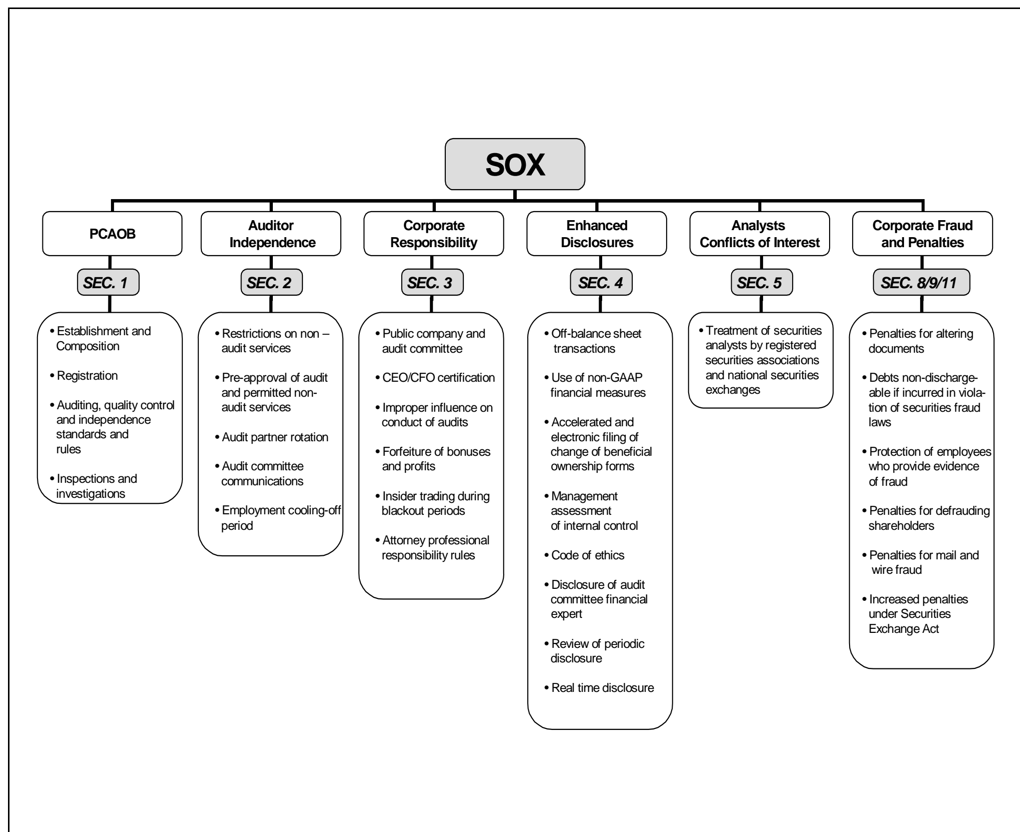

Figure 1. Major provisions of SOX

The remainder of the Sections of SOX covers technical details concerning the resources and the authority of the SEC (Sec. 6), requires several studies to be conducted (Sec. 7) and states a sense of the Senate regarding the singing of corporate tax returns (Sec. 10). Since these Sections do not refer to issues of corporate governance they are omitted in the figure.

As mentioned above, the PCAOB has to oversee the auditors that are engaged to provide audit services for companies subject to the Act or play a substantial role in such audits. The Act clarifies that this applies to U.S. as well as to foreign public accounting firms (see Sec. 106(a)(1) of SOX). These accounting firms are required to register with the PCAOB (see Sec. 102 of SOX). SOX directs the PCAOB to conduct inspections and investigations at least once every three years to assess the degree of compliance of a registered accounting firm with the Act, the rules of the SEC and the PCAOB or professional standards. Thereby the Board has to evaluate the sufficiency of quality control system of the firm and the manner of the documentation and communication of that system and has the authority to impose disciplinary or remedial sanctions (see Sec. 104 and 105 of SOX).

This registration with the PCAOB imposes – in general – a considerable pressure on the particular public accounting firm. A failure results directly in the loss of all clients which are subject to SOX (see Sec. 102(a) of SOX). Additionally the registration and obeying of SOX and PCAOB requirements cause direct costs, which may not completely be outweighed by higher auditing fees. In addition, there may be indirect costs due to conflicts with national rules and standards. Such conflicts arise concerning the transfer of information and data to the PCAOB, because registration of accounting firms with the PCAOB includes a consent to cooperate and comply with any demand by the Board for testimony or the production of documents in the case of requested information about particular clients (see Sec. 102(b)(3) of SOX). This consent could contravene the German auditors' legal duty to maintain strict confidentiality (see Art. 323 Para. 1 of German Commercial Code (*Handelsgesetzbuch*, HGB), Art. 404 Para. 1 of the German Stock Corporation Act (*Aktiengesetz*, AktG) and Art. 9 of the German Law Regulating the Profession of Auditors (*Wirtschaftsprüferordnung*, WPO)). A breach of this duty may result in sanctions being imposed by professional disciplinary proceedings and in fines or imprisonment under Art. 203 of the German Criminal Code (*Strafgesetzbuch*, StGB), unless the client has given permission to the auditor to disclose the information. Moreover, German auditors are entitled and even have the duty to refuse to give evidence in lawsuits (see Art. 383 Para. 1 of the German Code of Civil Procedure (*Zivilprozessordnung*, ZPO), Art. 53 Para. 1 of the German Code of Criminal Procedure (*Strafprozessordnung*, StPO)). The management board of a company can release the auditor from these duties by giving an explicit permission (see Hilber and Har-

tung, 2003, p. 1056). However, the management board is required to balance the benefits and costs of all decisions. Declaring releases for a company's auditors from their duty to maintain strict confidentiality and to refuse evidence in lawsuits could conflict with this requirement of the German Stock Corporation Act in case the company has no direct advantages of the decision, e.g. the company is not an foreign issuer itself but a subsidiary of a foreign issuer (see Kersting, 2003, p. 241).

Another problem might result from the information required to register with the PCAOB about criminal, civil, administrative or disciplinary proceedings against the applicant or its associated persons including employees involved in performing audits at least ten hours for any company subject to SOX during the last calendar year (see PCAOB, Rule No. 001, Section 001-3). The accounting firm has to request such information from its employees and to ask for a written permission to disclose it to the PCAOB according to the Federal Data Protection Act (*Bundesdatenschutzgesetz*). These requests lead to mandatory involvement of the workers' council which could be a time-consuming process (see IDW and WPK, 2003, p. 6). Moreover, data shall not be given to persons or institutions outside the EU without a guarantee that the data are treated confidential accompanied by an approval by German authorities in charge (see Art. 4b of Federal Data Protection Act). These additional costs and conflicts with national regulations obviously had not been considered and no regulatory counterpart in Europe or elsewhere had been consulted before SOX came into effect on July 30, 2002. Realizing the potential impacts of SOX the EU Commission made an effort to obtain exemptions for EU companies and public accounting firms (see Van Hulle and Lafermann, 2003, p. 103). Due to the lobbying of the EU commission and of single Member States and professional groups of the EU the SEC and the PCAOB promulgated accommodations for foreign companies and public accounting firms (see Engelen, 2004 p. 42-46). Another reason for granting exemptions might be the SEC's delayed perception of the economic and political impacts on the affected parties. Concerning the registration requirements, File-No. PCAOB 2003-3 allows accounting firms to withhold information from its application for registration with the PCAOB when disclosure of the information would force them to violate non-U.S. laws. In this case the applicant has to submit a copy of the relevant portion of the conflicting non-U.S. law, a legal opinion that there would be a conflict and an explanation of the applicant's efforts to eliminate the conflict (see File-No. PCAOB 2003-3, Rule 2105). Furthermore, foreign public accounting firms need to disclose information on criminal, civil and administrative proceedings not for all employees associated with issuers subject to SOX (like U.S. public accounting firm have to). They need to disclose these information only for their proprietors, partners, principals, shareholders, officers or managers providing audit services to issuers (see File No. PCAOB 2003-03, July 16, 2003). In Germany there has been a system of self-regulation carried out by the Chamber of Public Accountants (*Wirtschaftsprüferkammer*) which operates under the oversight of the Federal Ministry of Economics and Labour. In 2001 a system of external quality assurance came into effect. According to this system, all auditors and public accounting firms have to submit themselves to quality assurance based on peer review methodology every three years (see Art. 57a WPO). Recently, Germany has established a system for the registration and professional oversight of auditors (for details see 3.3.1. of this paper). Therefore, German accounting firms subject to SOX are affected by both the U.S. and the German professional oversight systems. To prevent conflicts of laws the SEC and the PCAOB developed criteria to determine to what extent the PCAOB could rely on a non-U.S. oversight system. Therefore, the PCAOB will evaluate the level of independence and rigor of the non-U.S. oversight systems in the countries of registered auditors. Depending on this evaluation the PCAOB will determine the degree to which it may rely on inspections, investigations and sanctions of particular non-U.S. oversight system (see Release No. 34-50047, July 20 2004). At present the outcome of an assessment of Germany's (new) oversight system by the PCAOB remains unclear.

Independence of Auditors and Auditing Standards

SOX states independence requirements for auditors. According to Section 201, public accounting firms are obliged not to provide certain enumerated non-audit services contemporaneously with the audit. The list includes, inter alia, bookkeeping, valuation and actuarial services, internal audit as well as legal or human resource services. Other non-listed services, as for example tax services, may be provided only if pre-approved by the audit committee of the particular company. In addition, SOX requires the audit committee of a company to pre-approve all audit and non-audit services. In Germany it is also unlawful for accounting firms to be involved in the bookkeeping and/or preparing of the annual accounts of a client (see Art. 319 Para. 2 No. 5 HGB) and – due to the Accounting Law Reform Act (*Bilanzrechtsreformgesetz*, BilReG) – in several other services. However, it is not forbidden to provide human resources, and legal services not related to the audit. Therefore German accounting firms have to limit their services provided to companies subject to SOX.

To assure a personal independence within the client-auditor relationship, the Act prescribes a mandatory audit partner rotation. A public accounting firm is not allowed to provide audit services to a company if the lead audit partner, or the audit partner responsible for reviewing the audit, has performed audit services for that company in each of the five previous years (see Section 203 of SOX). Final rules

of the SEC extend this requirement by imposing a five year cooling off period on rotated partner (which means that the rotated partner must step down from the particular audit for a period of at least five years). In addition, the rules require audit partners that have responsibility for significant accounting and auditing matters (e.g. assessment of the internal control system or review of major positions of the annual accounts) to rotate after no more than seven years and they are subject to a cooling off period of two years (see SEC, Release No. 33-8183). Taking into account that in many jurisdictions audit partners until now have not been subject to rotation requirements the SEC has made accommodations to this rotation requirements for foreign public accounting firms. In contrast to U.S. public accounting firms 2004 constitutes the first of the five year rotation period for partners of foreign public accounting firms, without regard to the time period the partners had previously served in a company (see SEC, Release No. 33-8183). According to a new provision of the German Commercial Law (introduced by the BilReG, see section 3.2.), an auditor having expressed an opinion on the financial statements of a listed company more than seven times is not allowed to provide audit services to that company for a cooling off period of three years (Art. 319a Para. 1 No. 4. HGB). Prior to the BilReG an auditor was not allowed to express an opinion more than six times in ten years.

Pursuant to Section 206 of SOX a public accounting firm shall not provide audit services for a company, if a CEO, CFO, CAO or controller of that company was employed by the public accounting firm and performed audit services for that company during a one year period preceding the initiation of the audit. Final Rules of the SEC expand this cooling off period to each member of an audit engagement team that has a direct responsibility for, or oversight of, the preparation of a former client's financial statements and related information (see SEC, Release No. 33-8183). The German Commercial Law prescribes no such cooling off period.

Section 103 of SOX provides that the PCAOB shall amend, modify or alter auditing and attestation standards, quality control standards, and ethics standards for public accounting firms. Based on this authorisation the PCAOB has already promulgated auditing standards. In Germany independence, quality control and ethics standards are specified in the German Commercial Code and especially in the Law Regulating the Profession of Auditors (WPO), the by-laws (*Berufssatzung*) and the Auditing Standards of the German Institute of Auditors (*Institut der Wirtschaftsprüfer*, IDW), which are based on, but in a few respects still not completely equal to the International Standards on Auditing (ISA) of the International Auditing and Assurance Standards Board (IAASB), which is an independent standard setting body under the control of the International Federation of Accountants (IFAC). Its mission is to establish worldwide high quality auditing, assurance and quality control standards. If these standards differ from the requirements that are provided or will be provided by the PCAOB, legal conflicts may arise for German public accounting firms subject to SOX.

Certain requirements are directly stipulated by SOX. For example the PCAOB shall promulgate requirements demanding that each public accounting firm shall prepare and maintain, for a period of at least 7 years, audit work papers, that an audit report is reviewed and approved by a concurring or second partner, and that in each audit report the scope of the auditor's testing of the internal control structure and procedures of the client are described. Moreover, SOX provides a framework for the audit report on an issuer's internal control system and for auditor quality control standards (Sec. 103 of SOX). In Germany similar requirements concerning the review of a second partner, the report on the internal control system and the quality control exist. However, there is no duty to maintain audit work papers for a specified period. Thus, SOX imposes an additional duty on auditors which are registered under PCAOB.

Post SOX Regulatory Activities in the EU and Germany

The EU – a European Regulatory Institution

The European Union (EU) is the result of a political vision to prevent war within Europe and to create a large prosperous economic and social community of separate states. This vision was formally promulgated by the Treaty of Rome in 1957 and has been fostered by a series of subsequent treaties. The number of Member States has augmented from 6 to now 25. Over its existence the Member States have delegated more and more of their sovereignty to "European institutions", although keeping their identities and still a large portion of independence. Therefore, the EU form a political construct , based on treaties between individual countries, which is more than a confederation of countries but less than a federal state. One aim of the EU is to create an equal level playing field for all participants on economic markets in order to reach a single market within Europe with equal competition (European Union, 2002). In order to meet to this objective the EU has gained a vast legislative power during the last almost 50 years of its existence and has exercised this power through three legal instruments, which are Regulations, Directives and Recommendations. Those differ primarily in their degree of binding. Regulations become directly EU law after their approval and are hence automatically binding for the Member States, whereas Directives have to be transformed into national laws by the individual national regulators and very often contain options to allow country specific particularities in this transformation. Finally Recommendations are of a non-binding nature but Member States are encouraged to implement them into national law. The major political institutions,

which are engaged in this legislative process are the EU Commission (detects the necessity of rulings, develop ideas and prepares drafts), the EU Parliament (discusses, and comments and adopt the rules) and the Council of the European Union (gives the final approval to the rules) (for details about the European Union see European Union – Delegation of the European Commission to the United States, 2004). Besides a lot of other areas, the EU published several legislative enactments dealing with accounting, auditing, corporate governance and company law in the past.

EU's Regulatory Initiatives Concerning Auditing

The first official response after SOX was a communication paper headlined "reinforcing the statutory audit in the EU" in May 2003 (see European Commission, 2003, p. 2 -13). The introduction of this publication contains a clear reference to the fact that beside other things SOX forced the EU to reconsider its priorities on statutory audits (see European Commission, 2003a, p. 2). In this communication a ten point action plan was developed which was divided into short term priorities planned to be fulfilled until 2004 and mid term priorities with a planning horizon until 2006.

Table 1. Overview Action Plan Statutory Audit

Short Term Activities (until 2004)	Mid Term Activities (until 2006)
Ensuring a comprehensive, principle based basis for statutory audits by modernising the 8th Directive	Introducing and improving a system of disciplinary sanctions for statutory auditors
Reinforcing regulatory infrastructure	Enhancing transparency of international networks of audit firms
Strengthening public oversight	Strengthening the role of audit committees and internal control systems
Required application of ISA for all statutory audits	Introducing a code of ethics for statutory auditors (in dialogue with SEC or PCAOB)
	Removing restrictions constricting the internal market for audit services
	Analysing economic impact of auditor liability

Parallel to the communication concerning statutory audit the EU Commission published another communication titled "Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward" (see European Commission, 2003a). This was the first publication of the European Commission dealing solely with the issue of corporate governance (see Haller and Geirhofer, 2005, p. 18). Basis of the communication is the report of a high level group of company law experts chaired by Jaap Winter (European Commission, 2002a).

In accordance with this so called "Winter Report", the communication points out that there is no need for an EU corporate governance code or precise standardized rulings. However, the Commission considers that a common approach should be adopted by the Member States and only a few essential rules should be established to ensure an adequate coordination of corporate governance within the EU (see European Commission, 2003a, p. 12). A direct result of those two communications of the Commission, which are only political statements without legal effect and which were perceived as essential steps towards restoring confidence in capital markets in the public consultation process (see European Commission, 2004a), is the proposal for a Directive on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC (so called modernized 8th Directive)[3] published on March 16th 2004 (see European Commission, 2004), in which a considerable amount of the short- and mid-term actions of the two plans were incorporated (see Annex 2). The modernized 8th Directive is supposed to be approved by the end of 2005. It is left up to the Member States of the EU to substantiate the regulations and to carry out the options included in the Directive (see Haller and Geirhofer, 2004, p. 24).

Reform of Public Oversight

While public oversight for statutory auditors was not in the focus of pronouncements of the EU prior to SOX, the proposal of a modernized 8th Directive (in the following only referred to as "the proposal") covers this issue (see European Commission, 2004, Articles 31-34) as a consequence of the ten point action plan of 2003.

Article 31 of the proposed Directive defines the principles of public oversight and provides a framework for possible national public oversight systems. As the European Commission does not give a detailed prescription, the Member States will be able to

[3] The 8th Directive dates back to the year 1983. The modernization initiative revises and enlarges its content considerably.

create public oversight systems tailor made to their individual legal and economic situation. However, the Member States shall ensure that the cooperation between their national oversight activities is effective (see European Commission, 2004, Article 32).

Although the proposal leaves discretion to the Member States, it nevertheless mentions that exchange of information and cooperate investigation activities are planned as well as the supply of information required for the oversight of statutory audits. Moreover, the public oversight authority of a Member State A should be allowed to communicate the malfunctioning of statutory auditors based in a Member State B to the competent authority in Member State B. How the coordination of the national authorities will be organized and to what extent the coordination will take place is not provided in the proposal (see FEE, 2004).

The public oversight authority shall not only be responsible for approval and registration of statutory auditors but also for the adoption of standards on ethics and internal quality control as well as continuous education and the quality assurance process. The competent authority shall also be in charge of other investigation and sanctions. The activities of the public oversight authority will have to be published annually to ensure transparency.

Finally, the proposal requires that the funding of the authority must safeguard its independence from the auditor profession (see European Commission, 2004, Article 31).

Additionally to the public oversight regime, Article 29 of the proposed Directive obliges the Member States to establish a quality assurance system which is also subject to the public oversight as described above. The quality assurance system is part of the self regulation of auditors but has to assure independence from the reviewed auditor. The quality assurance has to take place at least every six years and a report containing the main conclusions of the review has to be given.

The proposal contains special regulations for statutory audits of public interest entities. Those are "...entities that are of significant public relevance because of the nature of their business, their size or their number of employees, in particular companies governed by the law of a Member State whose securities are admitted to trading on a regulated market of any Member State..., banks and other financial institutions and insurance undertakings" (Article 2 of the proposed Directive).

According to these special regulations, audit firms carrying out statutory audits have to publish an annual transparency report on their website. This report should among other things include an indication when the last quality assurance review took place. Furthermore statutory auditors of public interest entities have to undergo the quality assurance at least every three years (Article 38 of the proposed Directive).

Independence of Auditors and Auditing Standards

The proposal deals with auditor's independence mainly in the Articles 23–25. Member States shall ensure independence of statutory auditors from the audited entity. The proposal does not define activities compromising the independence of statutory auditors, instead it follows a principle based approach (see Schildbach, 2004, p. 252). Thus, any relationship causing possible dependence or bias leads the auditor not to carry out the statutory audit. The statutory auditor shall document possible threats to independence and safeguards to mitigate them in the working papers (in case of a public interest company the auditor has to discuss those with the audit committee and has to confirm its independence to the audit committee annually; see European Commission, 2004, Article 40)).

Statutory auditors (for audit firms the key audit partner responsible for the statutory audit) of public interest entities (only) will be subject to an internal rotation at least in a five years turn or alternatively to an external rotation in a seven year turn. Furthermore, the proposal establishes a "cooling off" period of two years for statutory auditors and respectively key audit partners of audit firms carrying out statutory audits. These persons shall not be allowed to take up a key management position in the audited entity of public interest within the cooling off period.

Another measure to safeguard auditor's independence is the requirement to ensure that audit fees are adequate to allow proper audit quality and are not based on any form of contingency especially not by provision of additional services.

Additionally the audited entity has to disclose fees paid to the statutory auditor for audit and non-audit services (see European Commission, 2004, Article 50 Nr. 1 a).

The proposal also focuses on auditing standards. According to Article 26 of the proposal, the European Commission shall adopt generally accepted auditing standards. The auditing standards have to pass an endorsement process by the European Commission accompanied by an audit regulatory committee (Article 49 of the proposal).

The explanatory memorandum to the proposal states out that the International Standard on Auditing will be subject to this endorsement process. Member states will be allowed to introduce auditing standards additionally to the ones endorsed only if these follow from specific requirements (Article 26 (3) of the proposal). The Member States have to communicate those measures to the European Commission.

Regulatory Initiatives in Germany

Formally independently from the EU initiatives – which become obvious by the timing – the German government unveiled a ten point program to foster the integrity of companies and investor protection

(*10-Punkte-Programm zur Stärkung der Unternehmensintegrität und Anlegerschutzes*) on February 25, 2003 (Ministry of Justice, 2003). This plan was a concretion of the government's strategy to establish an effective regulatory framework to improve financial reporting, corporate governance and capital market conditions. It covers various issues like the strengthening of shareholders´ rights, enhancing responsibilities of directors and members of the supervisory board, regulation for financial analysts and market transparency, aggravating criminal law for white collar crime. Major contents are the introduction of IFRS into the German accounting system (see for detail Haller and Eierle, 2004), the establishment of an independent enforcement body for German accounting practices and the quality enhancement of statutory audits.

The major portion of the issues covered in the action program of the German government has already been adopted through revision or amendment acts or already published proposals to those acts. Table 2 gives an overview of the recent legal activities in 2004 and 2005.

Table 2. Recent Regulations in Germany Concerning Accounting, Auditing, and Corporate Governance

Regulation
Accounting Law Reform Act (*Bilanzrechtsreformgesetz*, BilReG), December 2004
Financial Reporting Control Act (*Bilanzkontrollgesetz*, BilKoG), December 2004
Law on the Supervision of Auditors *(Abschlussprüferaufsichtsgesetz*, APAG), December 2004
Law on Model Proceedings concerning Investors' Actions for Damages (*Kapitalanleger-Musterverfahrensgesetz*, KapMuG), July 2005
Law on Corporate Integrity and Modernization of the Right of Avoidance (*Gesetz zur Unternehmensintregität und Modernisierung des Anfechtungsrechts*, UMAG), July 2005
Law on Publication of Officers' Remuneration (*Vorstandsvergütungs-Offenlegungsgesetz,* VorstOG), July 2005

Reform of Public Oversight

As a direct result of the German government's ten point program, the public oversight of auditors became recently regulated by a law on the supervision of auditors *(Abschlussprüferaufsichtsgesetz*, APAG) which passed the German Parliament unanimously on 3rd December 2004. This law establishes a private board called *Abschlussprüferaufsichtskommission* (APAK), comparable to the PCOAB, and marks the (partial) end of self regulation of the auditor profession in Germany. Although that the modernization of the 8th Directive is not yet approved, the content of APAG anticipates the rulings contained in the proposal (see above).

Previously the Chamber of Public Accountants (WPK) was the authority within the profession to ensure the audit quality. The oversight system was established in the Law Regulating the Profession of *Wirtschaftsprüfer* (WPO). Since a law from 2000 (coming into effect in 2001) statutory auditors haven been obliged to do a peer review by another auditor who is certified by the WPK for being a peer reviewer at least every three years. Because of this, statutory auditors haven been obliged to engage a peer reviewer until 2004. An advisory council for quality assurance was established within the WPK overseeing the self regulation (see Art. 57a-h WPO).

Although slightly modified by the APAG, the quality assurance system established by the WPO remains the same, which means that the statutory auditors have to undergo a peer review at least every three years. Inter alia the modification forces statutory auditors to name three possible peer reviewers to the WPK. Then the WPK is allowed to reject one or more of the proposed peer reviewers.

APAK now replaces the advisory council for quality assurance of the WPK. The members of the APAK are supposed to have experience in either accounting, finance, economics, science or jurisprudence. They must not have been a member of the WPK within the last five years before they became member of the APAK. This measure should obviously ensure the independence of the APAK.

In contrast to the post-SOX U.S. system, the accounting profession through the Chamber of Public Accountants (WPK) is still in charge of the oversight of German statutory auditors in the first step. But the APAK is the final decision authority when it comes to quality assurance of statutory audits. Therefore the APAK has information and inspection rights. The APAK has the right to return decisions back to the WPK with the obligation to modify them.

Furthermore, the APAK is the competent authority for cooperation with public oversight authorities within the EU and other countries. This means the APAK will be the counterpart to the PCAOB for cooperation (see Heininger and Bertram, 2004, p. 1740). Figure 2 gives an overview of the new quality assurance and oversight system for auditors in Germany.

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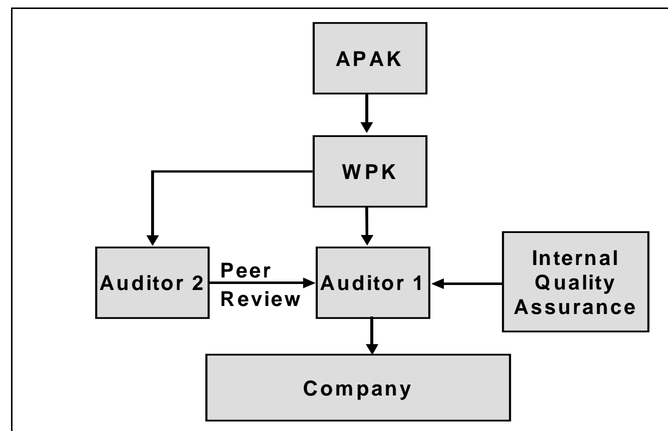

Figure 2. New Quality Assurance and Oversight System for Auditors in Germany

Independence of Auditors and Auditing Standards

The German regulations on auditor independence were substantially modified by the Accounting Law Reform Act (*Bilanzrechtsreformgesetz*, BilReG) from October 2004, which became effective for all fiscal years which begin after 1 January 2005. The BilReG amends the rulings on independence, which are based on a previous Guideline on auditors´ independence of the EU Commission (see European Commission, 2002) and also anticipate parts of the modernized 8th Directive.

The German regulator states that an auditor shall not carry out a statutory audit if his business, financial or personnel relationships cause a lack of objectivity. In addition to this general principle the BilReG explicates – in contrast to the modernization proposal of the EU – reasons for disqualifying from carrying out statutory audits. Besides financial interests in or a position in the board of directors (or supervisory board) of the audited entity or its subsidiaries, the following activities will result in preclusion from carrying out a statutory audit: involvement in bookkeeping and/or preparing of the annual accounts, involvement in internal revision, engagement for management or financial services or material actuarial or other valuation services. Apart from these threats of independence the German regulator regards the income structure of auditors as an essential characteristic of the ability to remain independent. Therefore the BilReG restricts auditors from earning more than thirty percent of the total income from one audited entity and its subsidiaries within the last five years.

Like the proposal of the modernized 8th Directive the BilReG distinguishes between "ordinary" entities and "entities of public interest". However, the definition of the latter differs from the one of the EU Commission. Public interest entities in the sense of BilReG are entities raising capital in an organized market. Statutory auditors of those entities will not only be subject to aforementioned regulations but also to even more restrictive specific rules. The income threshold of thirty percent is lowered to fifteen percent for them. Additionally, the prohibited activities will be extended by tax and legal advisory services with material effect on the true and fair view of the net assets, financial position and results. Furthermore participation in the development, customization and implementation of accounting software systems within the audited company is not allowed (Art. 1 Nr. 24 BilReG).

Statutory auditors will be subject to internal rotation in a seven years turn (see Art. 1 Nr. 24 BilReG). The auditor might be engaged again after a cooling off period of three years. Again, the German BilReG differs from the proposal of the EU, because as described above, the EU proposes a five years cycle for internal rotation or alternatively seven years with external rotation. In contrast to the proposal of the 8th Directive the BilReG defines a cooling off period which misses in the Directive.

German public interest entities are also obliged to disclose the fees paid to the statutory auditor distinguishing between audit fees, acknowledgment and valuation fees, tax advisory fees and other fees for non-audit services for the audited entity or its subsidiaries (see Art. 1 Nr. 18 BilReG).

Until 2005 there was no explicit binding regulation for using certain auditing standards. However, the auditing standards of the IDW (so called IDW AuS) have been virtually binding, because the WPO (2004) states out that, an auditor has to fulfill the obligations of the profession diligently (Art. 43 WPO). According to the IDW, this diligence can only be achieved by applying the IDW AuS. The IDW is member of the International Federation of Accountants (IFAC) and has therefore begun several years ago to transform ISAs into IDW AuS. The APAK oversees this transformation process (Art. 66 (1) WPO).

Due to the above described proposal for a modernized 8th Directive auditing standards endorsed by the European Commission will be directly applicable in the Member States. Therefore the oversight function of the APAK concerning auditing standards will

be limited to necessary additional standards because of national peculiarities. As another consequence, the IDW AuS will loose to be the basis for diligent auditing in Germany.

Analysis of the Impacts

The EU Commission is eager to point out that it had started to develop a long term strategy to improve financial accounting, auditing and corporate governance rules to safeguard shareholders rights, third party protection and efficiency as well as competitiveness already long before the approval of SOX (Van Hulle and Lanfermann, 2003, p. 102; for an overview of the EU strategy concerning financial reporting see Haller, 2002, p. 153-168). Looking at the chronology of legal pronouncements (see Annex 1) gives some evidence to this position. Although it also becomes obvious that the speed of announcements has increased considerably since the emergence of the American and European accounting and auditing scandals and the subsequent major breakdowns of public listed companies in the U.S. and Europe. Those had put political pressure on the EU as well as the regulators of the Member States to expand on existing regulations concerning auditing and other corporate governance issues (Van Hulle and Lanfermann, 2003, p. 102 and 106). Therefore, some commentators argue that at least some of the regulatory measures taken on the EU and Member State level concerning auditing and corporate governance issues are a direct effect of SOX (see e.g. Kulms, 2004, p. 4).

As a starting point for an examination of this argument the following table synoptically enumerates the major rules concerning external corporate governance in the three jurisdictions and thus summarizes sections 2 and 3.

As can be seen from the table, many of the post-SOX regulations that have been promulgated or will be promulgated by the EU and by Germany resemble or are even identical to the provisions of SOX. Especially the move towards a substantive regulation of the auditors' profession induced by SOX (see Ribstein, 2003, p. 4-8) is acceded by the European and German regulators.

Therefore, it is very obvious that SOX does not only have direct extraterritorial impacts on public accounting firm and the internal corporate governance of companies (as shown in section 2) but also indirect influences on European and German regulators. Consequently, SOX can be regarded as a typical example of regulatory spill-over effects, i.e. regulations in one country have consequences beyond national borders (see Engelen, 2004, p. 43). In the case of SOX these spill-over effects concern market participants (e.g. auditors and companies in Germany) as well as regulators (European Commission and German legislator). Figure 3 illustrates this multiple impact of SOX which is a direct one on companies and auditors as well as on the EU and Member States regulators and at the same time an indirect one on the Member States' legislators through the EU legislation and on auditors and companies within the EU through national and EU legislation.

However, the EU as well as Germany do not intend to give up their rulings and concepts of which they are convinced that they are favourable. In Continental Europe the conceptual view of a firm is still based on the stakeholder concept, notwithstanding the shareholder concept has gained importance due to market pressures.

One example for this assumption is that most of the new auditing rulings are not restricted to audits of "issuing companies" but to all statutory audits. In addition, Germany is not willing to give up its strict rules to protect individual rights concerning personal data or the confidentiality of client related data of auditors. Another major difference is the fact, that the primary professional oversight is still left to the auditors' profession (peer review and WPK), whereas in the U.S. the profession has lost this function totally.

Despite this reluctance of change of the EU and Member States in particular areas, a considerable convergence could be observed between the U.S. on the one hand and the EU and its Member State Germany on the other hand. Concerning the investigated issues of external corporate governance, it is a one-sided convergence process with the EU and Germany as a Member State shifting towards the rules of SOX.

Conclusions

The paper demonstrates a two-fold impact of SOX in referring to regulations concerning the auditors' profession oversight, auditor independence and auditing standards.

On the one hand due to the applied market place approach SOX had direct impacts on non-U.S. auditors of companies subject to SOX in terms of conflicts of law and additional costs. The conflicts of law have been lessened by exemptions granted by the SEC and the PCAOB. Nevertheless, the auditors have direct costs in terms of additional duties and restrictions and indirect costs in terms of a high risk because a non-compliance will result in a loss of an auditor's clients subject to SOX.

On the other hand the investigation of external corporate governance issues reveals that SOX has indirect impacts on the German and European legislation serving as a model for new regulations. This finding is to some extent in conflict with the statement of the EU Commission prevailing that it has an own long-term strategy of modernizing corporate governance and therefore does not consider their regulatory activities as direct consequences or even a copy of SOX.

Table 3. Comparison of SOX and Corresponding EU and German Regulations

	Sarbanes-Oxley Act	EU	Germany
Public Oversight	Establishes the PCAOB Registration of all public accounting firms subject to the Act with the PCAOB Investigations by the PCAOB to ensure compliance (Title 1)	Requires establishment and cooperation of public oversight boards in each Member State (Chap. 1 Art. 31-34 Modernized 8th Directive): Registration of statutory audit firms in a public register (Chap. 3 Art. 15-20 Modernized 8th Directive); General principles for investigations and sanctions (Chap. 8 Art. 30 Modernized 8th Directive)	Establishes the APAK (§ 66a WPO due to the APAG) Registration of auditors with the WPK (§ 37 f. WPO) Investigations and sanctions directly by the WPK with the APAK as final decision body (§§57a, 61a WPO, § 67 pp. WPO)
Major differences: Concerning public oversight, SOX applies to auditors of publicly listed companies, the European and German regulations to all auditors. In the EU and in Germany the public oversight is mainly based on the performance and results of the mandatory peer review as well as oversight activities of the WPK. Hence, the degree of the involvement of the auditors' profession in the EU and in Germany is stronger than in the U.S..			
Auditor Independence Prohibited Activities	Specifies non-audit services (bookkeeping, information systems design, valuation, actuarial, internal audit, management, broker or dealer and legal); pre-approval of all audit and non-audit services by the audit committee (Sec. 201 p.)	Services that might compromise the statutory audit firms' independence (Chap. 5, Art. 23 Modernized 8th Directive); Review and monitoring non-audit services by the audit committee (Chap. 11, Art. 39 Modernized 8th Directive); No pre-approval is required.	Specifies non-audit services for all companies (bookkeeping and preparing annual accounts, internal audit, management, financial and material actuarial and valuation) (§ 319 III No. 3 HGB due to the BilReG); Other specified material non-audit services for public interest companies (material legal and tax services, except plain consulting, information system) (§ 319a HGB due to BilReG); No pre-approval is required.
Rotation	Internal rotation after 5 years for lead partners and partners reviewing the audit with a cooling off period of one year (Sec. 203)	For public interest companies internal rotation after 5 years or alternatively external rotation after 7 years with no explicit cooling off period (Chap. 11, Art. 40 Modernized Directive)	For public interest companies internal rotation after 7 years with a cooling off period of 3 years (§ 319a I No. 4 HGB)
Cooling Off Period	Prohibits audit services for one year if an auditor becomes a CEO, CFO, CAO or controller of a client (Sec. 206)	Prohibits for public interest companies key managements positions for two years if an auditor changes to a client (Chap. 11, Art. 40 Modernized 8th Directive)	No cooling off period
Major differences: Concerning the prohibited activities, SOX applies to audits of publicly listed companies, the European regulations to all statutory audits, and Germany has a two level approach for audits of public interest companies (i.e. companies having securities listed) and all other companies. Concerning the other independence requirements, SOX applies to audits of publicly listed companies, the European and German regulations (if existent) apply to public interest companies. Thereby, according to the German regulations, public interest companies include all companies having securities listed at a regulated market and according to the European regulations, additionally all banks, other financial institutions and all companies that are of significant public relevance. Only SOX requires pre-approval of audit and non-audit services by the audit committee.			
Auditing Standards	PCAOB amends and alters auditing and attestation standards, quality control standards, and ethics standards; Specifies certain auditing standards (retention period of 7 years for audit work papers, provision of second partner review, framework for internal control system and quality control standards) (Sec. 103); No reference to the ISA.	Requires auditors' compliance with auditing standards adopted by the EU commission and with ethics standards enacted by the Member States and based on standards of the IFAC (Chap. 6, Art. 26 Modernized 8th Directive)	Standards (in accordance with ISA) issued by a private professional body (IDW) approved by the WPK (§ 4 Art. 1 WPO due to APAG)
Major differences: The auditing standards in Germany are only virtually binding, according to SOX and the European regulations the standards are mandatory. In contrast to the German and the European regulations, the auditing standards promulgated by the PCAOB pursuant to SOX are not necessarily based on the ISA (since the PCAOB is not a body of the accounting profession).			

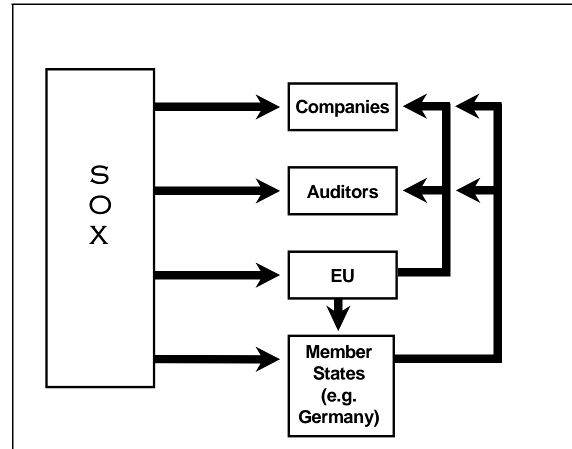

Figure 3. Impacts and influences of SOX

Although differences in the concept of the firm and in the concept of stakeholder vs. shareholder orientation prevail, a one-sided process of convergence between the U.S. and Europe is going on with regard to external corporate governance. The indirect influences of SOX on foreign regulations foster a convergence of the Continental European corporate governance systems towards the U.S. system.

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Appendices

Annex 1. Regulations of the EU Concerning Auditing and other Corporate Governance Issues

Year	Title of Pronouncement	Area
1984	Eighth Council Directive 84/253/EEC based on Article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents	Auditing
1998	Commission Communication "Statutory audit in the European Union, the way forward"	Auditing
2000	Commission Recommendation 2001/256/EC on quality assurance for the statutory audit in the European Union	Auditing
2002	Commission Recommendation 2002/590/EC Statutory Auditors' Independence in the EU: A Set of Fundamental Principles	Auditing
2003	Communication COM/2003/286 "Reinforcing the Statutory audit in the European Union"	Auditing
2004	Proposal for a Directive on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC	Auditing
Year	Title of Pronouncement	Area
1968	First Council Directive 68/151/EEC on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community	Corporate Governance
1976	Second Council Directive 77/91/EEC on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent	Corporate Governance
1978	Third Council Directive 78/855/EEC based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies	Corporate Governance
1982	Sixth Council Directive 82/891/EEC based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies	Corporate Governance
1989	Twelfth Council Company Law Directive 89/667/EEC on single-member private limited-liability companies	Corporate Governance
1989	Eleventh Council Directive 89/666/EEC concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State	Corporate Governance
2001	Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees	Corporate Governance
2003	Directive 2003/58/EC amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies	Corporate Governance
2004	Directive 2004/25/EC on takeover bids	Corporate Governance
2004	Commission Recommendation Directors' pay – Commission sets out guidance on disclosure and shareholder control	Corporate Governance
2004	Commission proposes collective board responsibility and more disclosure on transactions, off-balance sheet vehicles and corporate governance	Corporate Governance
2004	Commission Recommendation to ensure a strong role for independent directors	Corporate Governance
2004	Commission proposes to simplify the formation, maintenance and alteration of companies' capital	Corporate Governance

Annex 2. Content of the Proposal for a Modernized 8th Directive

Subject Matter and Definitions (Articles 1 and 2)	Subject matter are only statutory audits by community law Defining auditor and audit firm separately Defining public interest entities
Approval, Continuous Education and Mutual Recognition (Articles 3 to 14)	Enhancing compatibility with internal market rules and allowing fully integrated EU audit firms Prescribing an aptitude test for the approval of statutory auditors from other Member States Requiring compulsory training on IFRS and ISA
Registration (Articles 15 to 20)	Facilitating a public electronic register containing information about statutory auditors and audit firms
Professional Ethics and Professional Secrecy (Article 21 to 22)	Defining the code of ethics adopted by IFAC as starting point for professional ethics of EU statutory auditors and audit firms
Independence (Articles 23 to 25)	Establishing the principle of independence Defining independence of audit firms Establishing principles for adequate audit fees
Auditing Standards and Audit Report (Articles 26 to 28)	Establishing uniform audit standards for the EU Introducing principle of full responsibility of the group auditor for the audit report
Quality Assurance (Article 29)	Introducing requirements for quality assurance Defining criteria for quality assurance systems
Investigations and Sanctions (Article 30)	Setting up general principles of investigation and sanctions Demanding effective and dissuasive sanctions and disclosure of sanctions to the public
Public oversight and regulatory arrange-ments between Member States (Articles 31 to 34)	Introducing a system of public oversight Regulating the EU coordination mechanism in terms of public oversight Establishing principle of mutual recognition of public oversight of Member States
Appointment, Dismissal and Communi-cations (Articles 35 to 37)	Regulating appointment to ensure independence Regulating dismissal for significant reasons Ensuring documentation of communication between entity and its auditor
Special Provisions for the Statutory Audit of Public Interest Entities (Articles 38 to 43)	Establishing a transparency report Establishing audit committees Additional regulations on independency Additional regulation on quality assurance Additional regulation on public oversight Assistance of the audit committee during the nomination process
International Aspects (Articles 44 to 47)	Regulating the mutual recognition of auditors Regulating registry information for auditors and audit firms of other countries Cooperation with authorities of other countries
Transnational and Final Provisions (Articles 48 to 45)	Founding of an audit regulatory committee Regulating disclosures of fees paid for audit and non-audit services