Lemons *Into* Lemonade

How the United States turned an ugly accounting scandal into a mighty lever for global financial oversight and regulation.

BY KLAUS C. ENGELEN

In the tumultuous and rapid process of globalization, there are watersheds of historical dimensions. Historians writing about the Pax Americana reaching into the 21st century should include a chapter describing how the United States was able to turn the adversity of the largest wave of corporate bankruptcies it ever experienced into an opportunity to further strengthen its dominant position in the global financial markets via the mighty levers of extraterritorial oversight and regulation.

Who could have imagined that as a consequence of high-profile corporate scandals in the United States, accounting firms the world over would be forced under the supervision of a newly established agency in Washington, the Public Company Accounting Oversight Board? Comprehensive new capital market legislation—the Sarbanes-Oxley Act, authored by Maryland Democratic Senator Paul Sarbanes and Ohio Republican Representative Michael Oxley—has brought about:

- Far-reaching changes in the way major accounting and auditing firms are supervised around the world;
- A push toward aligning corporate governance in Europe and other parts of the world with the standards and practices prevailing in the capital market-based U.S. financial and corporate system;
- EU reform initiatives to modernize company law and enhance corporate governance aimed at strengthening shareholders' rights, reinforcing protection for employees and creditors, increasing the efficiency and competitiveness of European business, and boosting confidence in capital markets; and

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- Governments willing to bring forward on a national level long-delayed legislation on financial disclosure for corporate management and tougher regulations designed to curtail fraud in the financial industry.

Despite spectacular European corporate failures, a critical general public, and mounting pressure from markets, policymakers, and regulators, these changes have not unexpectedly met stiff resistance from powerful interests. After all, these interests are defending corporate governance structures and practices rooted in the different national bank-based systems prevailing in Continental Europe.

How Europe is struggling to handle the spillover effects of Sarbanes-Oxley for Europe's accounting profession was explored by this author in "Preventing European Enronitis" (*TIE*, Summer 2004). The article featured key trans-Atlantic negotiators William McDonough, chairman of the newly established PCAOB, and Frits Bolkestein, the former EU Commissioner for Internal Markets, as they succeeded in defusing a potentially explosive situation arising from extraterritorial conflicts in law and regulation by building on new European oversight structures under which the principle of reciprocity could be accepted.

THE HAMMER FALLS ON FOREIGN ACCOUNTING FIRMS

In this respect, July 19, 2004, marked a watershed in terms of the United States extending its oversight to other jurisdictions and regulatory systems despite far-reaching conflicts in law and regulation. On that day, non-U.S. accounting firms subject to Sarbanes-Oxley and the PCAOB had to be registered "to the same extent as a public accounting firm that is organized and operates under the laws of the United States." McDonough, who took over the helm of the PCAOB in June of last year, told the U.S. Congress that around four hundred non-U.S. accounting firms would fall under the Sarbanes-Oxley oversight.

All over Europe and throughout the world, non-U.S. accountants are concerned about the legal and regulatory uncertainties that the PCAOB registration might bring. Take the example of Germany, Europe's largest economy. Days before the deadline, the major German accounting firms appeared on the Web site of the PCAOB as registered—Bayern Revision, BDO, Deloitte & Touche, Ernst & Young, Grant Thornton, KPMG, Mazars, PricewaterhouseCoopers, and S.Audit.

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But Reiner Veidt, executive director of Germany's Wirtschaftsprüferkammer (WPK), the professional association of accountants in Berlin, points to the risk of "legal conflicts that may arise from regular inspections of the PCAOB." The oversight agency intends to inspect registered firms every three years. "Part of the inspections will be a review of specific engagements and thus access to audit working papers," says Veidt. "This conflicts with German confidentiality rules and data protection law. Until now, the PCAOB has not given adequate solutions as to how to deal with legal conflicts in inspections." Veidt concedes that so far, "The PCAOB tries to follow a cooperative approach by accepting inspections by foreign oversight bodies,

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provided that those oversight bodies follow procedures similar to those in the United States. However, even when fully complying with U.S. procedures, the PCAOB still insists on the participation of its own examiners at inspections of foreign audit firms."

The big hope for accounting firms in the European Union? That in time for the first PCAOB inspections in 2007, new oversight structures will be in place that could take over much of the inspection work under new agreements of reciprocity. Such an overhaul also advances on a national level. In Germany, for instance, the Federal Ministry of Economics and Labor has recently put forward proposals for legally implementing a new oversight system on German accountants (Wirtschaftsprüfer). The oversight structure would be supervised by a public oversight board formed by non-professionals.

WPK's president, Hubert Graf von Treuberg, says: "The new law will contribute to more transparency and confidence in the work of statutory auditors in Germany. The proposed amendments to the existing oversight regime are therefore also in the interest of the German profession. The new Act will combine the established oversight system in Germany with international requirements, both from U.S. and EU perspectives."

At present, oversight of the audit profession in Germany is organized in a two-tiered system. First, WPK is in charge of examination, licensing, registration, quality assurance, and disciplinary oversight in case of minor violations of professional rules. Second, the Chief Public Prosecutor investigates cases of severe violations of professional rules, especially all cases related to statutory audit engagements, and brings these cases to an independent state court at the District Court in Berlin.

The new law will create additional oversight elements, supervising all activities of WPK related to statutory auditors. The new Public Oversight Board on Statutory Auditors will have the ultimate responsibility for the activities of WPK, which is of special importance in the areas of disciplinary oversight and quality assurance.

Six to ten individuals will be members of the new board. All members must be independent from the audit profession and should not have been members of WPK for at least five years prior to their appointment. They will be experts in the fields of accounting and auditing from industry, academia, and law. They will be appointed by the Federal Ministry of Economics and Labor for four years. The new Board will originate from the existing Public Oversight Board on Quality Assurance with additional members and enhanced competencies.

WPK's Veidt points out: "With the new Public Oversight Board on Statutory Auditors, the German legislature anticipates the EU requirements as proposed for a modernized Auditor Directive. In addition, the new German oversight regime will be in line with U.S. requirements. All this will ease recognition of the German system by the United States and relieve German public audit firms registered in the United States as far as possible from oversight by the PCAOB."

This is why getting an agreement on the new EU proposals for the Eighth Company Law Directive (on annual and consolidated accounts and statutory audit) is so important. "The proposal will considerably broaden the scope of the existing Eighth Council Directive. It basically deals with the approval of auditors, by clarifying the duties of statutory auditors, their independence and ethics, by introducing a requirement for external quality assurance, by ensuring robust public oversight over the audit profession, and by improving cooperation between competent authorities in the European Union," says Veidt. "Moreover, a new decision-making structure including an audit regulatory committee will allow for swift regulatory responses via the adoption of measures on certain provisions on the proposed Directive. The Proposal also foresees the use of international standards on auditing for all statutory audits conducted in the European Union. While most of the Directive deals with enhancing audit quality within the European Union, the external dimension has been significantly enhanced. The proposal provides a basis for balanced and effective international regulatory cooperative approaches with oversight bodies of third countries such as the U.S. PCAOB."

A LEVER TO PUSH EUROPE'S CORPORATE GOVERNANCE REFORMS

While former EU Commissioner Bolkestein started negotiating with U.S. authorities to soften the blow of Sarbanes-Oxley conflicts with European regulation, he also was pushing the EU Commission Action Plan of May 23, 2003, to modernize company law and enhance corporate governance. Signs that Europe was not free from "Enronitis"—Vivendi Universal, ABB, Royal Dutch Ahold, and the Parmalat disaster—gave Bolkestein's reform agenda a high level of urgency.

When presenting the Action Plan, Bolkestein said: "Company law and corporate governance are right at the heart of the political agenda, on both sides of the Atlantic. That's because economies only work if companies are run efficiently and transparently. We have seen vividly what happens if they are not: investment and jobs will be lost; and in the worst cases, of which there too many, shareholders, employees, creditors and the public are ripped off. … The Commission is shouldering its responsibilities: Corporate Europe must shape up and do the same."

The Action Plan was based on recommendations of the final report, presented in November 2002, of the High Level Group of Company Law Experts appointed by Bolkestein and chaired by Jaap Winter, partner in the firm of De Brauw Blackstone Westbroek and professor at Erasmus University of Rotterdam.

The stated objectives of the Action Plan are:

- To strengthen shareholders' rights and protection for employees, creditors, and parties with which companies deal, while adapting company law and corporate rules appropriately for different categories of company;
- To foster the efficiency and competitiveness of business, with special attention to some specific cross-border issues.

Presenting the Action Plan with a short-term agenda running from 2003–05, the Commission stated that it "does not believe that a European Corporate Governance Code would offer significant added value but would simply add an additional layer between international principles and national codes. However, a self-regulatory market approach, based solely on non-binding recommendations, would not be sufficient to guarantee sound corporate governance. In view of the growing integration of European capital markets, the European Union should adopt a common approach covering a few essential rules and should ensure adequate coordination of national corporate governance codes."

The Commission sees the following initiatives as the most urgent ones:

- Introduction of an Annual Corporate Governance Statement. Listed companies should be required to include in their annual documents a coherent and descriptive statement covering the key elements of their corporate governance structures and practices;
- Development of a legislative framework aimed at helping shareholders to exercise various rights (for example asking questions, tabling resolutions, voting in absentia, participating in general meetings via electronic means). These facilities should be offered to shareholders across the European Union, and specific problems relating to cross-border voting should be solved urgently;
- Adoption of a Recommendation aimed at promoting the role of (independent) non-executive or supervisory directors. Minimum standards on the creation, composition and role of the nomination, remuneration and audit committees should be defined at EU level and enforced by Member States, at least on a "comply or explain" basis;
- Adoption of a Recommendation on Directors' Remuneration. Member States should be rapidly invited to put in place an appropriate regulatory regime giving shareholders more transparency and influence, which includes detailed disclosure of individual remuneration; and
- Creation of a European Corporate Governance Forum to help encourage coordination and convergence of national codes and of the way they are enforced and monitored.

Other corporate governance initiatives proposed in the Action Plan cover: achieving better information on the role played by institutional investors in corporate governance; giving further emphasis to the principle of proportionality between capital and control; offering to listed companies the choice between the one-tier and two-tier board structures; and enhancing directors' responsibilities for financial and key non-financial statements. The Action Plan notes that there is a strong medium- to long-term case for aiming to establish a real shareholder democracy and that the Commission intends to undertake a study on the consequences of such an approach.

As was to be expected, Bolkestein's ambitious Action Plan and his efforts to move forward with its implementation met strong opposition from various quarters. But at the same time in certain EU member states such as Germany, Brussels-inspired laws on improving accounting firms' oversight, forcing more timely disclosure, and curtailing fraud in the financial industry are moving ahead. "Germany taking lead on financial disclosure—It is first in EU to pass tougher laws," reads a recent headline in the *International Herald Tribune*. "Becoming the first EU country to wrap up its work on

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a series of European directives, the German Parliament's upper chamber, the German Bundesrat, approved a law intended to force corporations to disclose more information that might jolt share prices and to divulge more details of senior executives finances," says the paper. "Seldom has there been such a collection of laws that protect investors," admits Jürgen Kurz, spokesman for DSW, the main shareholder activist association. Additional legislation—inspired by Sarbanes-Oxley and the Brussels Action Plan—is winding its way through Berlin's legislative machinery that would require corporate managers to become personally liable for publishing false company reports and that would alter shareholder voting structures.

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In July of this year, on the final stretch of Bolkestein's term in the Prodi Commission, UNICE, the EU industry lobby group, criticized that the "EU Commission has now embarked on frantic consultations and has presented a number of different proposals in the area of company law and corporate governance," but that "after a careful assessment of the above consultations and proposals, UNICE believes that the Commission is losing sight of one of its originally stated objectives: foster the global efficiency and competitiveness of businesses in the European Union. UNICE reminded the EU Commission that "excessive regulatory burdens may ultimately restrict the freedom of companies to do business, thereby holding them back from releasing their potential. This is detrimental to business, to company shareholders, and more generally to the EU as a whole."

For UNICE, a major bone of contention is the EU Commission's drive for "EU harmonization action" and the development of "minimum standards." UNICE supports the use of "framework Directives, setting the general principles for harmonization but leaving the final choice for implementation to Member States. This is not the case with the latest Commission proposals on company law that are much too detailed." A key complaint by Europe's corporate world: By requiring member states to "at least" introduce the recommended criteria in their national framework on a comply-and-explain basis as a set of principals, the European Commission is aiming "at a Brussels-controlled centralized development of European Standards, which would eliminate the foundation of the national codes."

There is mounting opposition to the surrender of national European governance and auditing practices to pressures from the United States or the over-expanding Brussels bureaucracy.

And what do Europe's top corporate managers expect from the recent moves toward tougher corporate governance codes and rules? Not much! Only a minority of those who actually sit on corporate boards believe that many of the recent laws and rules have made a real difference in investor protection, according to a survey of board members by the trade magazine *Corporate Board Member Europe*. The survey queried 319 chief executives, chief financial officers, and other top managers in fourteen European countries. "This shows how far governments still have to go to impress corporate Europe that they intend to shake up the clubby network of boardrooms and put more power into the hands of shareholders," says the European edition of the *Wall Street Journal*.

Sharp criticism is also coming from leading researchers. Karel Lannoo and Arman Khachaturyan of the Centre for European Policy Studies (CEPS) criticize the European Commission's proposal to mandate compliance with a local corporate governance code and set minimum criteria for these codes. In their paper "Reform of Corporate Governance in the EU," they argue that the Commission missed an opportunity to set a European corporate governance code in the mid-1990s, and that most of the latest spate of proposals—with Bolkestein as

Internal Market Commissioner—"are simply reactions to recent fallouts and new legislation in the United States." For the Commission to come up with a long series of legislative proposals and reforms—twenty in total plus almost as many proposals for recommendations and further studies—boils down to a hefty dose of inconsistency. "The corporate governance debate has been going on for over ten years in Europe and flourished at national level," argue the authors. "The Commission repeatedly emphasized that there was no need to intervene at the EU level as the codes that were set at national level were fairly similar in their scope and recommendations. It was argued that corporate governance was an excellent area in which to apply the 'soft law' approach and that harmonization in their area would jeopardize the strength of the diversity of the national systems. Moreover, the arguments advanced in support of EU intervention were not convincing." Lannoo and Khachaturyan say rather than embarking on a complex exercise in harmonization, Europe should have built on the strength of its diversity. They also make the point that the basic principles of corporate governance are better implemented in the European Union than they are in the United States.

In the post-Enron world and under the shadow of Sarbanes-Oxley, the new EU Commissioner for Internal Markets will find it easier to push reform initiatives that for many years have been blocked by national governments or powerful private-sector interests.

AFTER FRITS BOLKESTEIN, ENTER CHARLIE MCCREEVY

How will Europe's adaptation to new tougher corporate governance standards move forward under the new EU Commission? When expressing their expectations for the coming term of Charlie McCreevy as Internal Market Commissioner under the new European Commission President José Manuel Barroso, most European policymakers, financial executives, regulators, accountants, and corporate lawyers hedge their bets—in several respects.

First, not many think that the former Irish finance minister will slow the Commission's rule-making machinery. While some of his followers are advertising McCreevy as a "Celtic Thatcher" because of his strong free-market convictions, many EU commissioners began as celebrated market liberals yet left Brussels as overzealous regulators and interventionists. Their legacy has added layers of strangling directives and regulations on businesses in Europe. Consider Frits Bolkestein, who is leaving with a mixed record and a lot of enemies. He came to Brussels as a Dutch liberal who worked for the Shell oil group before entering politics in the late 1970s. In his five-year term as coordinator of the EU single market, Bolkestein was an outspoken champion of liberal open markets. But he also was despised in some larger EU countries as an out-of-control regulator with super-cop ambitions and a hidden agenda when battling big countries while advancing the interests of smaller countries like his own. He improved his battered image when the outrageous extraterritorial transgressions of Sarbanes-Oxley became a nightmare for the European business community and a skilled negotiator with U.S. authorities was needed.

One of McCreevy's biggest challenges will be to implement the memoranda of understanding that Bolkestein signed with the U.S. authorities to mitigate the impact of the new U.S. capital market laws on European business and to push major convergence projects like a new European oversight structure for the accountant profession.

McCreevy will also play a key role in advancing the conversion of different accounting standards toward a global set of standards on financial instruments. But implementing the ambitious legislative and rule-making proposals of Bolkestein's plan will test his mettle.

There is growing concern among veteran observers about the trend toward regulatory overkill coming from Brussels in such areas as corporate governance and company law, even with McCreevy calling the shots. As Peter M. Wiesner, Brussels representative of the Federation of German Industries (BDI), predicts: "From what the EU Commission is putting on their Web sites in terms of consultation papers and questionnaires and what has been announced in terms of proposals and directives for this fall, we might expect a wave of new regulation much larger than what has been put on the books under Sarbanes-Oxley in the United States." Brussels' top lobbyist for German industry predicts that "in corporate governance there is a real threat that the EU Commission is out to finish off national codes in the member states." According to Wiesner, the EU Commission bureaucracy has become resistant to taking advice from those who must operate in the real world of corporations and markets.

In major EU member countries, particularly in Europe's largest economy, there is mounting opposition to the surrender of national European governance and auditing practices to pressures from the United States or the over-expanding Brussels bureaucracy. Theodor Baums, head of the German Corporate Governance Commission, is leading the fight by pursuing a double strategy: Stop Brussels from unifying national corporate governance rules and practices, and force EU member states to modernize corporate governance laws and regulations. Germany's leading corporate governance academic offers some advice to McCreevy: Give up Bolkestein's plans to unify corporate governance laws and regulations. Instead concentrate EU activities on dismantling existing cross-border impediments and focus more on strengthening the principle of subsidiarity and the community-wide competition of regulatory systems. Professor Baums rejects complaints from Germany's corporate leaders about "too much regulation." He points to the much higher regulatory density under Sarbanes-Oxley in the United States. He warns that if Germany's flexible corporate governance isn't being taken seriously by management, the German government will force company executives to publish their salaries and other remunerations on an individual basis under a new law.

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But his colleague Uwe H. Schneider points out that a major economy like Germany has no alternative but to adjust to the international requirements of company law, accounting, and corporate governance. Germany must take into account the requirements of its multinational companies and financial institutions, which was not the case in the old German corporate governance code.

Stopping the Brussels regulatory machinery in the area of corporate governance and regulatory oversight at this stage will be difficult. As the example of Germany shows, it has become "good politics" to ask for top managers to disclose their salaries and make them liable for false company figures as Sarbanes-Oxley requires in the United States. No wonder those who represent the small shareholders set themselves ambitious goals. The statement of Jella Benner-Heinacher, who represents the 28,000 members of the leading German shareholder activist association DSW, is a case in point. "Germany and Europe altogether are still way behind with respect to accountability and supervision," she argues. "What we need is a common level playing field regarding corporate governance and shareholder rights. As long as a German shareholder cannot exercise his shareholder rights on a cross-border level without limits, a common level playing field in Europe is an illusion. If a Dutch manager gives wrongful information on his company, he is liable by Dutch law, but not so in Germany: German managers still live in a world of untouchables at least with respect to their liability. Although the American system does not fit 100 percent to the German two-tier board system, there still is a lot to improve in Germany. The next important issue we have to take care of will be the independence of the supervisory board and the election of their members, topics the SEC just recently dealt with."

From this we can draw one conclusion. In the post-Enron world and under the shadow of Sarbanes-Oxley, the new EU Commissioner for Internal Markets will find it easier to push for more regulation through modernization directives in areas like EU financial market supervision, accounting oversight, or corporate governance standards—reform initiatives that for many years have been blocked by national governments or powerful private sector interests. ◆