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Abstract

The first part of the paper will give a very brief background of the collapse of Enron. Secondly, corporate governance issues regarding investor protection, board structure, auditor independence and self regulation will be addressed. Thirdly, the Sarbanes-Oxley Act will be exposed. Provisions regulating board structure, responsibility for financial statements and auditors will be described. Some of the criticism the Act has attracted will also be looked upon. Lastly, the European Union's approach to improving corporate governance will be addressed. We will compare the European Union's approach to board structure, responsibility for financial statements and auditors with the Sarbanes-Oxley Act.

Keywords

corporate governance, European Union, Sarbanes-Oxley Act, United States

CORPORATE GOVERNANCE IN THE EUROPEAN UNION POST-ENRON

*Karolina Eriksson**

Introduction

In August 2000, Enron ranked as the seventh largest corporation in the US. On Fortune Magazine's ranking, Enron held the number one position as the most innovative company in America five years in a row. Enron also came in number one when it collapsed in the wake of revelations of overstated earnings and off-balance sheet frauds. On December 2, 2002, Enron filed for bankruptcy and the largest bankruptcy in American history became a fact.¹ However, a few months later it was outdone by another prominent corporation, WorldCom. After announcing that it had created billions of US\$ in earnings by capitalizing expenses as needed, WorldCom filed for bankruptcy on July 21, 2002.²

The spectacular crashes and frauds of Enron, WorldCom and other companies, have resulted in various corporate governance reforms in the US. Apart from self-regulatory reforms by the New York Stock Exchange, NASDAQ and various trade associations the corporate frauds also triggered a number of legislative initiatives.³ The most important legislative response so far has been the Sarbanes-Oxley Act of 2002.⁴

In order to restore investor confidence and minimize the risk of future Enrons, the US has chosen a heavy regulated approach. The Sarbanes-Oxley Act, which is a

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1 Bratton, "Enron and the Dark Side of Shareholder Value", April 11 2002, p. 1, accessed July 1 2003 at <http://papers.ssrn.com/abstract=301475>, also published; (2002) 77 *Tulane Law Review* 1275, Ide, "Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight", 54 *Mercer Law Review*, 2003, 829, p. 829, Aronson, "ENRON: LESSONS AND IMPLICATIONS: Preventing Future Enrons: Implementing The Sarbanes-Oxley Act of 2002", (2002) 8 *Stanford Journal of Law Business & Finance*, 127, p. 127

2 Aronson *ibid.*, Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", (2002) 28 *The Journal of Corporation Law*, 1, p. 2f,

3 Ribstein, "International Implications of Sarbanes-Oxley: Raising the Rent on US Law", Working Paper 2003, accessed July 1 at http://ssrn.com/abstract_id=401660.

4 Sarbanes-Oxley Act of 2002, PUB. L. No. 107-204.

federal act, includes far-reaching rules within the area of corporate governance. The Act has been criticised for being a “rush job” and an overreaction. It has been argued that the regulation is unlikely to reach its intended effects and that it will impose significant costs.⁵

The need to improve corporate governance has been recognised on the other side of the Atlantic as well. Many countries such as France, Germany and the UK have recently reformed or are about to reform their company laws and capital market regulations.⁶ The issue of corporate governance is also very high up on the political agenda in the European Union. In November 2002, the *High Level Group of Company Law Experts*, appointed by the Commission, reported on company law and corporate governance in the European Union.⁷ The report resulted in an *Action Plan* produced by the Commission in May 2003 on how to modernise company law and enhance corporate governance in the EU.⁸ The Action Plan follows many of the recommendations from the High Level Group. The European Union has chosen another approach than that of the US. The European philosophy is to self regulate as much as possible. At the same time as the Commission introduced the Action Plan it also presented a *Communication on Statutory Audit*.⁹

The purpose of this paper is to expose how the European Union intends to improve corporate governance in the aftermath of recent crisis, and compare the European approach with the response in the US, the Sarbanes-Oxley Act. Corporate

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- 5 See Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.*, “International Implications of Sarbanes-Oxley: Raising the Rent on US Law”, Branson, “Enron – When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform”, Working Paper, January 2003, p. 11, accessed at June 6 2003 at <<http://papers.ssrn.com/abstract=366841>>.
 - 6 Hopt, “Modern Company and Capital Market Problems Improving European Corporate Governance”, Workingpaper November 2002, p. 3, accessed July 1 at http://ssrn.com/abstract_id=356102. See also Higgs *Report of the Role and Effectiveness of Non-Executive Directors*, p. 15 referring to Cromme Code in Germany and Bouton Report. Higgs Report accessed July 5 2003 at <www.dti.uk/cld/non_exec_review/index.htm>
 - 7 *Report of the High Level Group of Company Experts on a Modern Regulatory Framework for Company Law in Europe*, November 4 2002, accessed June 6 2003 at <http://www.europa.eu.int/comm/internal_market/en/company/company/news/index.htm>
 - 8 *Communication from the Commission to the Council and the European Parliament, “Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, May 21 2003, accessed June 6 2003 at <http://www.europa.eu.int/comm/internal_market/en/company/company/news/index.htm>
 - 9 *Communication from the Commission to the Council and the European Parliament, Reinforcing the Statutory Audit in the EU*, May 21 2003, accessed June 6 2003 at <http://www.europa.eu.int/comm/internal_market/en/company/audit/news/index.htm>

governance is a system. Subsequently it may be difficult and dangerous to deal with certain parts of the corporate governance system in isolation from a wider context. However, this paper will focus on certain issues that have been highlighted as key elements for good corporate governance both by the US and the European Union. These issues include the need for a more independent monitoring of management, the importance of trust in financial statements and the importance of a proper audit.

The first part of the paper will give a very brief background of the collapse of Enron. Secondly, corporate governance issues regarding investor protection, board structure, auditor independence and self regulation will be addressed. Thirdly, the Sarbanes-Oxley Act will be exposed. Provisions regulating board structure, responsibility for financial statements and auditors will be described. Some of the criticism the Act has attracted will also be looked upon. Lastly, the European Union's approach to improving corporate governance will be addressed. We will compare the European Union's approach to board structure, responsibility for financial statements and auditors with the Sarbanes-Oxley Act.

The Collapse of Enron

Enron was formed in 1985 and had its roots in natural gas and pipelines. In the beginning of the 1990s, the company became successful in creating an energy market that took away the need for utility companies to get involved in potentially costly vertical integration. The innovation was later applied in other markets as well, such as water and broadband. Enron's investments were substantial and it often took years before the company could account for any significant earnings. Assuming that exceptional returns would come eventually, Enron's management started setting up and using off balance sheet partnerships. These partnerships were known as Special Purpose Entities (SPEs) and they were managed by officers of company. By using extensive derivatives trading and transactions with the SPEs, Enron gave the impression of ever-increasing earnings and stable finances. In fact the profits were illusionary. Derivatives and SPEs were used in order to hedge the risk of having to report losses on some of the investments and further, to transfer substantial assets and debt obligations of the company's balance sheet to unconsolidated SPEs. Enron and its insiders made substantially earnings from the transfer of financial assets between Enron and its SPE:s. Gains that did not reflect the real value of the assets were booked at both ends.¹⁰

10 Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.* p. 4f, Gillian and Martin, "Financial Engineering, Corporate Governance, and the Collapse of Enron", Working Paper 2002, p. 2ff, accessed July 16 2003 at <http://ssrn.com/abstract_id=354040>, Bratton, *ibid.*, p. 13ff

Enron rapidly collapsed after restating its earnings in October 2001. Investment losses could no longer be covered as the stock price declined.¹¹ In an investigation made by the Enron board's special committee, it is argued that a significant part of Enron's reported profit during a four year period was a result of accounting manipulations.¹² The company that had been one of the most admirable companies had succumbed to a massive breakdown; minus US\$30 million of self-dealing by the chief financial officer, US\$700 million of net earning disappeared, US\$1.2 billion of shareholders equity gone up in smoke and more than US\$4 billion in hidden liabilities.¹³ How could Enron's management conceal the company's financial condition for such a long time?

When a major debacle such as Enron occurs there tends to be an inflation of explanations why it could happen. The strange failure of Enron is in the words of John Coffee "a virtual Rorschach test in which each commentator can see evidence confirming what he or she already believed".¹⁴

Poor corporate governance worsened and to some extent facilitated the frauds and the final collapse of Enron. The blame for Enron's failure has been widely spread. The primary wrongdoers were the individual officers who engaged in misleading and sometimes fraudulent transactions. Nevertheless, a good corporate governance system ought to reveal such activity before it carries devastating consequences for shareholders and other stakeholders. There were monitoring failures on various levels, including directors, accounting and law firms, institutional shareholders, debt rating agencies and securities analyst.¹⁵ Although a lot of attention has been on Enron's board of directors, and particularly the audit committee, and on the company's external auditor.¹⁶

11 Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.*, Gillian and Martin, *ibid.*, p. 2f

12 Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", Working Paper, p. 4 referring to Report of Investigation by the Special Investigation Committee of the Board of directors of Enron Corp, February 1, 2002, Working Paper accessed June 20 2003 at <http://ssrn.com/abstract_id=305343>, also published 69 Chicago Law Review, Summer 2003

13 Bratton, *ibid.* p. 7

14 Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid", Working Paper, July 2002, p. 2, accessed June 20 2003 at <http://ssrn.com/abstract_id=325240>, also published (2002) 57 Business Law, 1403

15 Gillian and Martin, *ibid.*, p. 20, Ribstein, "International Implications of Sarbanes-Oxley: Raising the Rent on US Law, *ibid.*, 2, Gordon, "Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley", Working Paper, March 2003, p. 4, accessed July 22 2003 at <http://ssrn.com/abstract_id=391363>

16 See generally; Coffee, *ibid.*, Bratton, *ibid.*, Gillian and Martin, *ibid.*,

Corporate Governance Issues

Corporate Governance and Investor Protection

The focus of corporate governance is fundamentally on investor/shareholder protection. Adolf Berle Jr and Gardiner Means argued in the aftermath of the stock market crash in 1929, that owners of public corporations could not effectively control their corporations.¹⁷ This is due to the separation between ownership and control in the modern corporation. The owners, i.e. the shareholders, of a public company delegate management and control to corporate managers. This creates a principal-agent relationship which involves agency costs because of the opportunities for conflict of interest. In general, agency costs refer to costs laid upon the principal when an agent uses the given authority to help himself, rather than the principal. The principal can try to minimize these costs by monitoring the agent.¹⁸

On a very basic level, the key governance question concerns how investors can make sure that corporate “insiders” maximize the value of the corporation and return profits to the investors.¹⁹ In countries with developed capital markets investor protection is offered through a complex system of corporate, bankruptcy, securities and takeover laws as well as self-regulations, norms of best practice and business ethics.²⁰

There are several factors that help reduce agency costs. The most important internal control on insiders is exercised by the board of directors. The interest of investors is also protected by outside monitors such as auditors.²¹

Board Structure and Directors’ Independence

The board of directors acts as representative of shareholders. The board should supervise the performance of management to ensure that business is conducted

17 Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.* p. 7 footnote 44 referring to Berle and Means, *The Modern Corporation and Private Property*, (1932)

18 Ribstein and Letsou, *Business Associations*, Matthew Bender, 3rd edition, 1996, p. 3f, Farrar, *Corporate Governance in Australia and New Zealand*, (2001), p. 32, Hopt, “Modern Company and Capital Market Problems Improving European Corporate Governance”, Workingpaper November 2002, p. 5, accessed July 1 [at <http://ssrn.com/abstract_id=356102>](http://ssrn.com/abstract_id=356102)

19 Thorburn, “Corporate Governance Practices in Europe: Antidote to “Enron”, accessed July 15 2003 at <http://www.snee.org/m03aTtho.pdf>

20 *Ibid.*, Farrar, *ibid.*, p. 3f

21 Thorburn, Coffee, “The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence”, Working Paper, May 2001, p. 2, accessed July 21 2003 at http://papers.ssrn.com/abstract_id=270944

consistently with shareholders interest.²² It has been questioned whether the board of directors is efficient in its supervising role. The reason for this, is the fact that the board is controlled by management who are the very people the board is expected to oversee. An attempt to solve this problem and enhance the board's monitoring role has been the introduction of the so called monitoring board. The theory behind the monitoring board, advocated by among others Melvin Eisenberg²³, is that the board should include a majority of "independent" outside directors who are not employed full time by the corporation and therefore are in a position to guard over insiders. The concept of the monitoring board also includes an entirely independent audit committee that works with the corporation's auditor, and a nomination committee, which controls the election of directors.²⁴

The monitoring board model has been recommended for the last twenty years by many self regulating institutes and organisations, for example the New York Stock Exchange. Today the model is followed as a standard by large public corporations.²⁵

The development of audit committees began in the United States in the 1970s and has later spread to other countries. The purpose of an audit committee is to assist the board of directors in its monitoring role. The primary role for the audit committee is to ensure the integrity of companies' financial reports upon which the board will evaluate management.²⁶ The committee is a "specialist monitor" within a monitor. When management, which prepare the financial statements, and the external auditor become too close to each other, this can result in self-serving financial statements that reflect the result that management wants to attain. The audit committee must therefore act as a buffer between management and the external auditor.²⁷ In recent developments where there has been an increasing dependence on stock prices as a way to measure management performance and compensation, the function of the audit committee has become more and more important.²⁸

After accounting scandals in the late 1990s, audit committees became the focus of corporate governance reform. Audit committees are now required by all self-regulatory organisations in the US. The NYSE, that has required all listed

22 Ribstein and Letsou, *ibid.* p. 387

23 See Melvin Eisenberg, *The Structure of the Modern Corporation*, Little Brown Boston, (1976).

24 Ribstein and Letsou, *ibid.*, Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.* p. 11

25 Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.*

26 Ford's, *Principles of Corporations Law*, 11th edition, 2003, Branson, *ibid.* p. 11

27 Grunfeld, "Who Wants to be on the Audit Committee", *New York Law Journal*, May 5 2003

28 Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", *ibid.*, p. 14

companies to have audit committees composed entirely of independent directors since 1979, and NASDAQ, responded by tightening their listing standards.²⁹

After the Enron failure audit committees have again become subject of much attention. The Enron Special Investigation Committee concluded that Enron's board of directors, and in particular the audit committee, failed in its monitoring duties. The passive performance of the board allowed for Enron's executives to engage in innovative and risky business activity as well as aggressive reporting practices.³⁰

The failure of Enron's board occurred even if the structure of the board fulfilled most formal requirements for independence. On paper Enron had a model board, predominantly composed by outsiders. The board had twelve non-employed outside directors and only two insiders. The number of outsiders was higher than the average on a US board. A majority of the outsiders were highly qualified for their task. The board's subcommittees included among others, an audit committee.³¹ The audit committee had as Jeffrey Gordon describes it "a state-of-the-art charter" admired by many that made the committee "the overseer of the Company's reporting process and internal controls" and it had "direct access to financial, legal and other staff and consultants of the Company".³² The audit committee was composed entirely of outside directors and chaired by a professor emeritus in Accounting of Stanford University.³³

However, even though Enron's board structure appeared to be at the height of good corporate governance practice, it was partly illusionary. The report of the Investigation Committee concludes that the independence of almost every board member was undermined by various side payments or by bonds of long service and familiarity.³⁴ If the Investigation Committee is accurate, it demonstrates that a monitoring board has to be independent in function, and not only in form, if it is going to be effective in its monitoring role.³⁵

29 Bratton, *ibid.*, p. 56, Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report), 1992, 4.33, accessed July 14 2003 at www.independentdirector.co.uk/cadbury.htm, Branson, *ibid.*, 31

30 Gillian and Martin, *ibid.*, p. 1f

31 Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", *ibid.*, p.11, Gillian and Martin, *ibid.*, p. 21

32 Gordon, *ibid.*

33 Gillian and Martin, *ibid.* p. 22, Bratton, *ibid.*, p. 56

34 Gordon, *ibid.*, p. 11

35 Gillian and Martin, *ibid.*, p. 3

Auditor Independence

Many commentators regard the failure of the “gatekeepers” as the main cause of the Enron collapse.³⁶ The watchdogs did not bark.³⁷ The focus has in particular been on one primary gatekeeper, the auditor.

John Coffee has defined gatekeepers as “reputational intermediaries who provide verification and certification services to investors.”³⁸ Corporate governance relies on gatekeepers to protect shareholders by monitoring “insiders” behaviour and by reporting financial results in a correct and unbiased way that allows for an objective valuation of a corporation.³⁹ Douglas Branson has pointed out that gatekeepers provide crucial verification and certification to corporations as well. Corporations can not survive without the support of some of the gatekeepers.⁴⁰

The mission of the gatekeeper to certify and verify for the corporations own statements is of great importance since the market regards the gatekeeper’s assurance as more reliable than the corporation. The gatekeeper is believed to have less incentive to lie.⁴¹

An audit is an examination of the corporation’s financial statements in order to give an opinion on whether the statements are reliable and in accordance with generally accepted accounting principles. The management of a corporation has in general incentive to present the corporation’s financial position in the best light possible. If the audit opinion is to give the desired level of assurance to shareholders and other stakeholders the auditor must be able to maintain independence from the corporation it is supervising. However, there are challenges to auditor independence.⁴²

John Coffee has put forward a gatekeeper model highlighting three elements that ought to be fulfilled for an effective gatekeeper. Firstly, the gatekeeper must provide a legally mandatory certification and the accuracy of this must be observable by the protected class. Secondly, the gatekeeper must be a repeat player with a reputational capital at stake on proper performance. Thirdly, the

36 See generally Coffee, “Understanding Enron: It’s About the Gatekeepers, Stupid”, *ibid.*

37 Hopt, *ibid.*, p. 23

38 Coffee, *ibid.*, p. 5

39 Coffee, “The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence”, *ibid.* p. 2

40 Branson, *ibid.*, p. 14

41 Coffee, “Understanding Enron: It’s About the Gatekeepers, Stupid”, *ibid.*, p. 5f

42 Bazerman and Morgan, “The Impossibility of Auditor Independence”, 38 *Sloan Management Review*, Summer 1997, 89,

gatekeeper must be expecting only a nominal fee from any individual client. As the elements weaken the more likely is it for an auditor to fail in its role.⁴³

A potential threat to auditor independence is the fact that the auditors are hired, paid and fired by the client that they audit and not the people whose interest they are supposed to protect. The risk of compromised independence is therefore inherent to the system itself.⁴⁴ Even so, auditors are theoretically said to be structurally independent of their clients. The major accounting firms have several thousands clients each, the firms all provide fundamentally similar services and the fee received from their clients is modest compared to the overall revenues of the firm. Subsequently, the auditors would not risk their reputation for a single client, a reputation they have invested years in building up.⁴⁵ This assumption was held to be true until recently.

The picture changed during the 1990s when the “Big Five” accounting firms, Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers, started selling consulting services to their auditing clients. The accounting firms’ revenues for non-audit services accounted for 50 percent of the firms’ revenues in 2000, an increase from 13 percent twenty years earlier.⁴⁶ Playing both consultant and watchdog further confuses the question of who the auditor is accountable to. Even a big accounting firm may have an incentive to disregard misconduct from a client if it makes significant revenues for consulting from the client. Factor number three in Coffee’s model has ceased to exist. The auditor may think that its conclusions are correct but only because its judgment is affected by self-serving bias. In addition, auditors may have an interest to maximise their own income in the firm and this may not always correspond with the interest of the firm as a whole, which is to protect its reputation.⁴⁷

However, it is not only that the auditor has more at stake in the relationship with the client and would lose more if fired, or that the auditor may have reason to please a client that might buy consultancy services, that threaten the auditor independence when cross-selling non-audit services. Moreover, it enables the client to threaten the auditor in a “low visibility way”. In the real world it is very difficult for a client to fire an auditor. The event must be disclosed and may result in an inquiry that causes more harm to the firing company than the auditor. Low

43 Coffee, “The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence”, *ibid.* p. 9f, Bratton, *ibid.*, p. 69

44 Bazerman and Morgan, *ibid.*

45 Coffee, “Understanding Enron: It’s About the Gatekeepers, Stupid”, *ibid.*, p. 6, “The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence”, *ibid.* p. 10, Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.* p. 13

46 Bratton, *ibid.*, p. 70

47 Bratton, *ibid.*, Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.* p. 13, Bazerman and Morgan, *ibid.*

visibility sanctions, such as withholding a contract if an auditor is resistant, on the other hand, offers a way to discipline auditors' behaviour without disclosure.⁴⁸

Arthur Andersen, Enron's external auditor, failed to fully inform the board about potential irregularities and aggressive accounting principles. During 2000, Enron paid US\$52 million to Anderson. Only US\$25 was directly linked to audit services. Anderson even performed audits on transactions the audit firm itself had advised. Although Enron was a relatively small client to Andersen the firm, it was one of the largest clients for the Houston office. Maybe the monitor failure of Andersen occurred because the firm was too close to Enron's management and influenced by consulting contracts.⁴⁹

Failure of Self Regulated Corporate Governance?

If one looks at the history of investor protection by company law and capital market law there are two particular elements that have influenced this history. The first factor is economic needs. The second factor is financial scandals. Legislators have had a tendency to respond more to financial scandals than economic needs. Instead of acting in a timely fashion, legislators react and then, very often overreact. The Bubble Act in 1720, US security regulation in 1933 and 1934, regulation on insider trading and rules on auditors are examples of legislation with roots in financial collapses.⁵⁰

During the 1990s systems of corporate self regulation had been widely thought to have reached a high level of standard due to increasing best practices and sophisticated institutional monitoring.⁵¹ Systems of self regulations are said to have many advantages. The following are said to be among them; the absence of detailed technical rules makes it a flexible system, the emphasis is on the spirit rather than the letter of rules, persons concerned with a self regulation system are experts in their field, the responsibility of a person operating in a system of self regulation produces greater professional integrity and discipline, sanctions of disapproval and damaged reputation are much stronger than legal sanctions in this field, legislation is concerned with minimum standards and operates at the

48 Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", *ibid.*, p. 6f, Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid", *ibid.*, p. 15f

49 Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", *ibid.*, p. 8, Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid", *ibid.*, p. 7, Branson, *ibid.*, p. 28, Gillian and Martin, *ibid.*, p. 39, Thorburn, *ibid.*, p. 14

50 Hopt, *ibid.*, p. 1f, Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.* p. 19

51 Bratton, *ibid.*, p. 7

margin while self regulation is said to operate from a higher threshold and finally the system is not expensive since costs are borne by the market.⁵²

The collapse of Enron has challenged some of the core beliefs in corporate governance and undermined the faith in self regulated corporate governance. The case represents a failed test for many institutions that self regulated systems rely on. As with most catastrophes, many separate systems failed at the same time. The collapse occurred although Enron adhered to many of the procedure that are considered good corporate governance. The story shows that the monitoring model is not an assurance against abuse. Neither are professional gatekeepers.⁵³ The loss of confidence in the system is summed up by financial writer Allan Sloan;

“The multilayered system of checks and balances that is supposed to keep a company from running amok completely broke down. Executives of public companies have a legal and moral responsibility to produce honest books and records – but at Enron they did not. Outside auditors are supposed to make sure that a company’s financial reports not only meet the letter of accounting rules but also give investors and lenders a fair and accurate picture of what is going on – but Arthur Andersen failed that test. To protect themselves, lenders are supposed to make sure borrowers are creditworthy – but Enron’s lenders were as clueless as everyone else. Wall Street analysts are suppose to dig through company numbers to divine what is really happening – but almost none of them managed to do that. Regulators did not regulate. Enron’s board of directors did not direct”.⁵⁴

Enron illustrates that the self regulatory governance system generates less powerful checks against abuse than many had believed. However, this point does not in itself validate regulation. The costs of any regulation can outweigh the benefits.⁵⁵

Further as pointed out by Douglas Branson, it should be remembered that the system of self regulation improved and worked tolerably well over a decade of economic growth unrivalled in US history. After all, Enron may just have been an aberration. Even if you count in other companies, such as WorldCom, Tyco, Xerox,

52 Farrar, *ibid.*, p. 331f

53 Gordon, “What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections”, *ibid.*, p. 5, “Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley”, *ibid.*, p. 4, Bratton, *ibid.*, p. 58

54 Sloan quoted in Blair, “Post-Enron Reflections on Comparative Corporate Governance”, Working Paper, 2002, p. 4, accessed July 1 2003 at http://papers.ssrn.com/abstract_id=316663

55 Bratton, *ibid.*, p. 13

Adelphia, where irregularities have been revealed it, only adds up to about twenty companies. Nearly 16 500 companies file periodic reports with the SEC as of June 2002. Thus, recent scandals have involved large companies, but their behaviour is not necessarily typical. They are not to be taken as a sign of a whole system meltdown.⁵⁶

The Regulatory Response – Sarbanes-Oxley Act of 2002

A lot of self-governance reforms took place after Enron by the NYSE and NASDAQ and other self-regulatory organisations. In the early summer of 2002 it looked as though post Enron reforms would be mainly limited to self-regulatory reform. However, after the collapse of WorldCom in June 2002, the Congress quickly passed the Sarbanes-Oxley Act with very little opposition.⁵⁷ President Bush has described the Sarbanes-Oxley Act as the most far-reaching reforms of American business practice since the Securities Act and Securities Exchange Act in the 1930s.⁵⁸ The Act is a package of reform measures aiming to improve corporate governance and thereby restore investor confidence and minimise the chances of future Enrons.⁵⁹

We will now first consider a few of Sarbanes-Oxley's reform measures and then some of the criticism that the Act has attracted.

Independent Directors - Requirements of Audit Committee

Requiring a greater degree of independence on boards has been a key theme in recent US corporate governance reform.⁶⁰ The Sarbanes-Oxley Act requires that the audit committees have to be staffed *exclusively* with independent directors.⁶¹ A director can not qualify as independent if he or she receives any compensation from the company other than compensation for audit committee services. Further, a director is not considered independent if he or she is so affiliated with the company that the person is unable to separate self interest from what is good for the company. However, this does not mean that a member of an audit committee is not allowed to own stock in the company.⁶²

56 Branson, *ibid.*, p. 2f, see also Holmstrom in Panel discussion "The future of Corporate Governance in Europe Post-Enron, accessed July 19 2003 at <http://www.ecgi.org/conferences/agm2003/index.htm>

57 *Ide, ibid.*, p. 830ff

58 *Ibid.*, p. 833, Branson, *ibid.*, p. 1 footnote 3

59 Branson, *ibid.*, p. 1, Aronson, *ibid.*, p. 128

60 Higgs Report, *ibid.*, p. 35, for example under the new NASDAQ listing rules and the new NYSE listing rules a majority of the board must be independent.

61 Sarbanes-Oxley Act Section 301

62 Grunfeld, *ibid.*

It should be noted that NYSE and NASDAQ have proposed rules that raise the barrier of what qualifies as independent for members of the audit committee. The requirements under these rules are stricter than those under the Sarbanes-Oxley Act and companies listed on the NYSE and NASDAQ must comply with their definitions of independence. For example the NYSE rule goes back five years to see whether a person has received any compensation before becoming an audit committee member, whereas Sarbanes-Oxley only looks at the present situation.⁶³

In order to provide the audit committee with competence to scrutinize financial statements the Act requires that at least one member of the committee is a "financial expert". A financial expert is defined as someone "having experience as a public accountant or an auditor or financial officer, controller or principal accounting officer of an issuer".⁶⁴ The Securities and Exchange Commission (SEC) has confirmed that the financial expert does not have a higher degree of responsibility than other members of the audit committee.⁶⁵

The role of the audit committee has expanded substantially under the Sarbanes-Oxley Act. As a matter of federal law the audit committee is "directly responsible for the appointment, compensation, and oversight of the work of the outside director and the auditing firm will report to the audit committee rather than the full board".⁶⁶ Every year the auditors must make a formal report to the committee on critical accounting policies and practices that are being used.⁶⁷ The audit committee also has the power by federal law to engage independent accountants and other consultants. According to Douglas Branson the audit committee, and not the management and board of directors, has become the client of the auditing firm.⁶⁸

The audit committee must monitor and ensure that external auditors do not provide prohibited non-audit services and must also approve in advance all auditing and permitted non-audit services.⁶⁹ Another function of the audit committee is to ensure that complaints regarding questionable accounting and auditing matters from employees are fully investigated. Moreover, the committee must set up internal complaint hotlines for whistleblowers.⁷⁰

The Sarbanes-Oxley Act imposes increasing duties on the audit committee. The enhanced responsibility and exposure of risk under the Act has led many members of audit committees to hand in their resignation. The risk of being subject to legal

63 Grunfeld, *ibid.*

64 Ferrarini in panel discussion, *ibid.*, Branson, *ibid.*, p. 31

65 Grunfeld, *ibid.*

66 Sarbanes-Oxley Act Section 301, Branson, *ibid.*

67 Sarbanes-Oxley Act Section 204

68 Branson, *ibid.*, p. 31f

69 Sarbanes-Oxley Act Section 202, Branson, *ibid.*, p. 32, Grunfeld, *ibid.*

70 Branson, *ibid.*, Grunfeld, *ibid.*

action is considered to be higher under the Sarbanes-Oxley Act than before. However, even if it may be more difficult to get people to serve on the audit committee, it is clear that a company must have a committee. It seems like the audit committee mitigate the exposure of the board of directors as a whole.⁷¹

Certification of Financial Statements

Enron and other recent corporate scandals emphasises the key importance of trust in financial statements. It is essential for shareholders, creditors and financial markets that financial statements correctly show the financial position of a company.⁷² The Sarbanes-Oxley Act is concerned with the issue of ensuring the probity of financial statements.

Section 302 of the Act, requires the chief executive officer and financial officers to certify in every annual and quarterly report that they have read the report, that the report, based on their knowledge, does not contain any material misstatements or omissions and that the financial statements fairly present the financial condition and results of the company. They must further certify within 90 days prior to the report that they have evaluated the company's internal controls and presented in the report their conclusions about the effectiveness of the internal controls.⁷³

Hence, the Sarbanes-Oxley Act puts emphasis on chief executives' and financial officers' responsibilities for financial reporting and internal control. The requirement of certification of financial statements corresponds with liability, and the Sarbanes-Oxley subsequently imposes a direct accountability on the part of the chief executive officer and the chief financial officer. There are severe penalties for non-compliance, up to ten years in prison and US\$1 million fine for "knowing violations". The penalties increase for "wilful violations up to twenty years in prison and US\$5 fine."⁷⁴

Auditing

Enron and other recent scandals also pointed out weaknesses in the auditing process. The Sarbanes-Oxley Act contains several provisions aiming to increase auditor independence.

Section 201 of the Act bars auditors from performing certain non audit services for an audit client. The section lists nine types of services that are no longer permitted. These include bookkeeping, financial information system design, valuation services, actuarial services, internal audit outsourcing, management

71 Grunfeld, *ibid.*

72 Report from the High Level Group, *ibid.*, p. 67

73 Branson, *ibid.*, p. 27, Aronson, *ibid.*, p. 143

74 Branson, *ibid.*, p. 44, Ide, *ibid.*, p. 849, Higgs Report, *ibid.*, p. 16

functions or human resources, broker/dealer services or investment adviser and legal services.⁷⁵

The Act also restricts audit services to any company whose chief executive officer or senior accounting officer were employed by the auditor during the past year.⁷⁶ This may result in one year celibacy for a leading auditor before he or she can pass through the revolving door leading in to the executive office of an audit client.⁷⁷ Further, the Act requires rotation of lead audit partners after five years.⁷⁸

Part of the problem regarding the negligent behaviour shown by auditors in recent scandals has to do with board oversight of the auditors work. As mentioned above, this issue is addressed by the audit committee requirements.⁷⁹ Sarbanes-Oxley also requires more detailed reports by the auditor to the audit committee regarding for example critical accounting policies and practices.⁸⁰

Sarbanes-Oxley has further established a *Public Company Accounting Oversight Board* (PCAOB). The PCAOB task is to oversee, inspect and investigate accounting firms. Section 102 states that only firms registered with the PCAOB may perform audit work for companies publicly trading in the US.⁸¹ US audit firms are required to register with the PCAOB by October 2003 and foreign audit firms by May 2004. If this is not done, it will be unlawful for audit firms to provide audit service to companies in the US. This includes about 280 companies from the European Union with dual listing in the US as well as major subsidiaries of US listed groups located in the European Union.⁸²

Registered firms have to pay annual fees to the PCAOB, which together with payments from their clients, will fund the board. Firms must also, among other things submit several reports to the PCAOB and they are further subject to inspections from the PCAOB.⁸³

75 Branson, *ibid.*, p. 39

76 Sarbanes-Oxley Act Section 206

77 Branson, *ibid.*, p. 38

78 Sarbanes-Oxley Act Section 202

79 Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.* p. 14

80 Sarbanes-Oxley Act Section 204

81 Ribstein, "International Implications of Sarbanes-Oxley: Raising the Rent on US Law", *ibid.*, p. 6

82 Press Release from the European Union, April 24 2003, accessed June 28 2003 at http://europa.eu.int/comm/internal_market/en/company/audit/news/index.htm

83 Branson., *ibid.*, p. 38, Sarbanes-Oxley Act Section 102-109

Criticism of Sarbanes-Oxley Act

Independent directors

The Sarbanes-Oxley Act put a lot of emphasis and faith in making monitors more independent. However, the concept of monitoring boards and independent directors is not embraced by everyone. It is argued that monitoring boards suffer from inherent limitations regarding independent directors' effectiveness. Independent outside directors lack time, information and inclination to participate effectively in the management of a company. With respect to the time factor, independent directors normally just have time to review business decisions rather than make them. There are also constraints on information as independent directors must depend on insiders for critical information. Further, independent directors lack the inclination to take over management. Independent directors are generally nominated by insiders and selected from the same business community. They are therefore usually unwilling to second guess management. Independent directors' on boards have done little to prevent frauds in the past. Existing data on monitoring boards do not offer much basis for relying on regulation of board composition to solve corporate fraud.⁸⁴

Another concern regards the substantially expanded role of the audit committee. It has been overloaded with responsibilities. By adding tasks such as ensuring that complaints regarding questionable accounting and auditing matters from employees are fully investigated and setting up internal complaint hotlines for whistleblowers, may cause the committee to lose its focus, which should be on the integrity of financial reporting. There are limits to what even the best audit committee can do. To serve on an audit committee has become a full time job.⁸⁵

Financial statements

The responsibility of chief executives and financial officers to certify in every annual and quarterly report has been criticised for being an "overkill". Companies have to develop an internal corporate process that will lead up to them. Further, the regulatory scheme will pressure and stress 998 capable chief executives and financial officers just to get the one or two bad ones.⁸⁶

It is also doubtful whether the liability that goes with the responsibility can stop future frauds. Recent corporate frauds have demonstrated that corporate insiders are driven by strong impulses of loyalty, greed and failed ability to realistically

84 Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002", *ibid.*, p. 26ff, Ribstein and Letsou, *ibid.*, p. 388ff

85 *Ibid.*, p. 28, Branson., *ibid.*, p. 32

86 Branson, *ibid.*, p. 28

assess the risks of their conduct. It is uncertain how more liability can prevent such people.⁸⁷

Further, these certifications will bring a feeling of false accuracy to the public. Leading the public to believe that they can completely trust the certified statements.⁸⁸

Auditing

Even if self-regulation has not been sufficient in deterring an auditor from compromising his independence, it is doubtful whether restricting sale of non-audit services can solve the problem. The Act forbids sale of non-audit services “in the moment”, but clients may still have some power over auditors that hope to sell such services to them in the future.

Federal legislation

As mentioned the efficiency of many of the Sarbanes-Oxley provisions has been questioned. Moreover, there are concerns that the costs outweigh the benefits. The potential costs include deterring of informed risk taking of managers, increasing distrust and bureaucracy in firms and impeding information flows.⁸⁹

Even if regulation is appropriate it must be considered on which level the regulation should be imposed. The governance of US corporations is to a great extent established by the law of the state in which the corporation has chosen to incorporate. State legislation governs for example questions of boards and committees and state courts can impose standards of conduct. Sarbanes-Oxley Act brings these questions up to federal level. Federalizing corporate governance should be approached with caution. There is significant data supporting the view that companies' incorporation decisions are efficient. It is important that corporate governance rules should be designed to fit the particular circumstances of the company. The effect of many of the rules in Sarbanes-Oxley depends on a firm's size, business needs and governance structure. This implies that regulation should be governed at state and not federal level.⁹⁰

87 Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.*, p. 34f

88 Branson, *ibid.*, p. 29

89 Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.*, p. 3, 35ff, Branson, *ibid.*, p. 44

90 Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: a Critique of the Sarbanes-Oxley Act of 2002”, *ibid.*, p. 45, 57f

International consequences

Sarbanes-Oxley imposes problems not only for companies based in the US but also for foreign companies who become subject to the law because of cross-listing in the US. Almost a sixth of the listings on the NYSE are foreign based companies. Some of the requirements in the Sarbanes-Oxley Act may conflict with the national law of the company. Companies might choose to leave the US to avoid being affected by the Act.⁹¹ Porsche has for example stressed that the Sarbanes-Oxley Act was the key factor behind its decision to cancel its listing on the New York Stock Exchange.⁹²

Improving Corporate Governance in the European Union

A common response among European politicians, as well as auditors and other professionals, to the corporate scandals in the US was that these were American phenomena with no direct relevance for Europe. According to them, the US suffered uniquely from a lethal combination of greedy executives, conflicted auditors, reliance on accounting rules not principles and an obsession with quarterly earnings.⁹³ However, the claim of immunity was never justified. On February 24 2003, Royal Ahold, the world's third biggest food retailer, with its base in the Netherlands disclosed that it had overstated its 2001 and 2002 earnings by as much as US\$500 million.⁹⁴

The need for company and capital market law reforms regarding corporate governance was recognised by the European Union before the scandals in the US. However, in the light of these scandals the efforts to improve corporate governance have been intensified. Company law and corporate governance are now issues that matter in the European Union. This has not always been the case.⁹⁵ As a politician expressed it in the early 1980s; "Negotiations in Europe are a question of give and take. You have to be prepared to make concessions on something unimportant and technical, such as a company directive, so that you can keep something in reserve. You need to save the big guns for topics that really matter: sheep-meat or UHT milk."⁹⁶

91 Ribstein, "International Implications of Sarbanes-Oxley: Raising the Rent on US Law", *ibid.*, p. 8ff

92 Copp, "A Winters Tale", *Financial Management (UK)*, April 2003

93 Hopt, *ibid.*, p. 2, *The Economist*, "The Ahold scandal shows that Europe is not immune from America's corporate ills", March 1 2003

94 Ball, Lublin, Karnitschnig, "Directors Face Fire in Wake of Ahold", *Wall Street Journal*, February 27 2003

95 Hopt., *ibid.*, p. 3, Copp, *ibid.*, p. 30

96 Copp, *ibid.*

In September 2001 the Commission appointed the High Level Group of Company Law Experts. The High Level Group was composed of leading European experts on company law. Its original mandate in the area of corporate governance was to review of whether and, if so, how the European Union should actively co-ordinate and strengthen efforts undertaken by member states to improve corporate governance. In a direct reaction to Enron the mandate was extended to cover “issues related to best practice in corporate governance and auditing, in particular concerning the role of the non-executive directors and supervisory board, management remuneration, management responsibility for financial information and auditing practices”.⁹⁷ The High Level Group published its report in November 2002. Before the report was published it had been subject to extensive consultation with investors, companies and other interested parties.⁹⁸

The report resulted in a Communication, Action Plan, from the Commission to the Council and the European Parliament in May 2003, on how to modernise company law and enhance corporate governance in the European Union. The Action Plan outlines the approach that the Commission intends to undertake in the area of company law and corporate governance. It sets out necessary actions and defines priorities, i.e. whether the action ought to be taken in short term (2003-2005), medium term (2006-2008), or long term (2009 -). The Action Plan does not contain any legislative proposal from the Commission. The Plan is open for consultation until August 31 2003.⁹⁹

The report from the High Level Group and the Action Plan from the Commission are focused on internal corporate governance. As we have seen auditing is also a fundamentally important part of corporate governance.

With regard to auditing and auditors independence, the collapse of Enron resulted in the European Union issuing a Recommendation on auditors’ independence in May 2002.¹⁰⁰ The Recommendation follows a principle based approach. However, the Commission has in its Communication on Statutory Audit, put forth that the principles on auditors’ independence will become subject to legislation, through a directive.

97 Report of the High Level Group, *ibid.*, p. 43

98 Hopt, *ibid.*, p. 3

99 Action Plan, *ibid.*, p. 3ff

100 Commission Recommendation of 16 May 2002 – Statutory Auditors’ Independence in the EU, accessed 12 July 2003 at http://www.europa.eu.int/comm/internal_market/en/company/audit/news/index.htm>

General Policies

Objectives and guiding political criteria

The objectives of the Action Plan from the Commission are to foster efficiency and competitiveness in the European Union and strengthen shareholder rights and third party protection. The European Union approach to company law harmonisation has primarily focused on the protection of members and third parties. The High Level Group boldly stated in its report that the European Union should shift its approach and concentrate primarily on the efficiency and competitiveness of business. However, the Action Plan emphasises that protection of shareholders and third parties must be at the core of any company law policy.¹⁰¹

In developing a regulatory response under the Action Plan the Commission have observed certain guiding criteria. Firstly, any regulatory response should respect the subsidiarity and proportionality principles of the Treaty¹⁰², while at the same time strengthen the internal market and enhance the rights of shareholders and third parties. Secondly, the approach should be firm on the principles but flexible in application. Thirdly, the regulatory response should assist international regulatory developments. It is emphasised that the European Union must define its own approach to corporate governance constructed after its own traditions. The approach developed should earn the right to be recognised as least as equivalent to other national and international rules.¹⁰³

No European corporate governance code

Community law has until now been almost silent on the subject of corporate governance. Member states within the European Union have different systems of corporate governance that reflect their different cultures and views about the roles of corporations. During the last ten years more than forty corporate governance codes relevant to the European Union have been adopted, at national level or international level, all aiming at protecting the interests of shareholders and other stakeholders. The diversity has increased further as ten new member countries have entered in to the Union.¹⁰⁴

Differences in national corporate governance may cause uncertainty and costs for companies as well as investors. However, a recent comparative study of corporate governance codes, prepared for the Commission, concludes that the European

101 Ibid., p. 8f, Report of the High Level Group, *ibid.*, p. 29f

102 Article 5 (3b) Treaty by the Maastrich Agreement (Treaty on European Union)

103 Action Plan, *ibid.*, p. 4f

104 Ibid., p. 7,10, Speech by Internal Market Commissioner Fritz Bolkestein January 30 2003, accessed June 26 2003 at http://www.europa.eu.int/comm/internal_market/en/company/company/news/index.htm

Union should not spend time and effort to develop a European corporate governance code.¹⁰⁵ The study observed that the main differences between member states are found in the area of company law and securities regulation, rather than in corporate governance codes. The latter show a fairly high degree on convergence. Further, the existence of many codes is generally not looked upon as an obstacle by companies. Companies primarily operate on their domestic market and when they operate on other markets, the codes are similar.¹⁰⁶

The High Level Group pointed out that the adoption of a corporate governance code would fail to deliver full information to investors about key corporate governance rules applicable to European companies, since these would still be based on national company laws that are divergent. Moreover, such a code would not improve corporate governance in Europe as it either has to allow for many alternative rules or confine itself to abstract principles. Effective harmonisation is not achievable without affecting company law.¹⁰⁷

In its Action Plan the Commission also reached the conclusion that a European corporate governance code would not add much value to international principles and national codes. OECD is currently revising its corporate governance principles and the Commission is taking an active part in this work. Further, a one-size-fits-all solution is not feasible or desirable in Europe because of the many different national models. Hence, the Commission is not aiming for total harmonisation. Nevertheless, the European Union is considered to have an active role to play in the area of corporate governance. The growing integration of European capital markets justifies a certain common approach on European Union level. The Commission therefore intends to implement a few essential principles and rules as well as co-ordinate efforts of member states to improve corporate governance in order to facilitate convergence between the member states.¹⁰⁸

With regards to the co-ordination process, both the High Level Group and the Commission notes the importance of member states designating one particular code of corporate governance for use at national levels. This code should be a reference code with which companies in the jurisdiction should comply with or explain in which way they diverge. It is acknowledged that even if the comparative study of codes shows a high degree of convergence within the Union this is a situation that can change fast. Many member states are undertaking reform in this area and ten new members have entered the Union.¹⁰⁹ A European

105 See Comparative Study of the Corporate Governance Codes relevant to the European Union and its Member States, March 2002 by Weil, Gotshal & Manges, available at <http://europa.eu.int/comm/internal_market/en/company/company/news/corp-gov-codes-rpt_en.htm>

106 Ibid.

107 Report of the High Level Group, *ibid.*, p. 72

108 Action Plan, *ibid.*, p. 11f

109 Report of the High Level Group, *ibid.*, p. 73, Action Plan, *ibid.*, p. 16f

Corporate Governance Forum should be introduced to encourage the co-ordination and convergence of national codes. It will be an informal structure and will compound representatives from member states, European regulators, companies, investors and academics.¹¹⁰

Directives or recommendations

Community regulation can take five different forms; regulations, directives, decisions, recommendations and opinions. The ones of concern to corporate governance are directives and recommendations. Directives may be addressed only to member states. They are binding only as to the result to be achieved and leave it up to the member states to choose method and form. Recommendations are not binding at all.¹¹¹

Fritz Bolkenstein, member of the Commission and in charge of the Internal Market, have expressed that a self regulatory approach should be the guiding principle within the area of corporate governance. However, he also acknowledged that such an approach, based on non-binding recommendations, may not always be enough to guarantee sound corporate governance. In some limited cases there is need for legislation.¹¹²

Legislation efforts made by the European Union in the area of company law have so far been done through directives. The High Level Group concluded that this has resulted in a certain “petrification”. Once a directive has been implemented it becomes very difficult to change and modify. At the same time there is a growing need for the ability to rapidly adapt existing rules to changed circumstances. Therefore in cases where there is a need for directives it is preferable that they should be based on principles and general rules. Details should be left to secondary legislation by member states. The High Level Group argues that secondary legislation together with co-ordinated standard settings would be a well chosen method to encourage development of best practice in the area of corporate governance.¹¹³

What ever form of regulation that may be adapted, the High Level Group emphasise the importance of consultation with industry, commerce, services and profession that are affected by the rules.¹¹⁴

The approach taken by the Commission is to use as far as possible alternatives to legislation. This has resulted in a mix of binding and non-binding regulation.

110 Action Plan, *ibid.*, p. 17

111 Hartley, *The Foundations of European Community Law*, Oxford, 5th edition, 2003, p. 103

112 Speech by Bolkestein, January 30 2003 and June 13 2003, *ibid.*

113 Report of High Level Group, *ibid.*, p. 31f

114 Report of High Level Group, *ibid.*, p. 32f

Modernising the Board of Directors

Board structure

As in the US, board reform is high up on the agenda in Europe. There is an ongoing debate in Europe regarding the advantages and the disadvantages of the one-tier and the two-tier board system. Earlier attempts have shown that it is hard to make either one of the two systems mandatory. The High Level Group therefore recommended that listed companies should be offered to choose the system best suited for them.¹¹⁵ Although positively reacting to the idea, the Commission wants to be able to study such an approach carefully and therefore proposes that this recommendation should be followed up in a medium term.

The Commission does not wish to control the composition of the board and to what extent independent non-executive or supervisory directors should be members of it. However, in key areas where executive directors have conflicts of interest, decisions should be made by a *majority of independent directors*. Supervision of the company's audit is considered an area where executive directors clearly have conflicts of interest.¹¹⁶ Thus, the responsibility of auditing should lie with directors who are at least in majority independent. This can be done by creating an audit committee composed of a majority of independent directors. Audit committees are common in the UK and other countries with one-tier boards. Such committees are also common in large German companies but much less common than in other member states.¹¹⁷ If no audit committee is set up its role should be exercised by the non-executive directors in the one-tier board or by the supervisory board, in which the majority should be independent.¹¹⁸

Compared to the US, the audit committee does not need to consist exclusively of independent directors. This was considered by the High Level Group, but finally rejected. The presence of controlling shareholders and employees on European boards make such a criterion inappropriate. Controlling shareholders and employees would generally not be considered to be independent and it would go too far to exclude them entirely. It is sufficient that the majority is independent.¹¹⁹

The requirement of independence in relation to auditing is considered a key element in restoring confidence in the market and the Commission intends to issue a Recommendation to this effect in short term. The High Level Group

115 Report of High Level Group, *ibid.*, p. 59, Hopt, *ibid.*, p. 7

116 Example of other area is remuneration of directors. The High Level Group also included nomination of directors. The Commission, however, considered that the responsibility for nomination ought to be entrusted to a group of mainly executive directors since they have deep knowledge of the company

117 Hopt., *ibid.*, p. 9

118 Action Plan, *ibid.*, p. 15, Report of High Level Group, *ibid.*, p. 71

119 Report of High Level Group, *ibid.*, p. 61

advocated the use of Recommendation over Directive in this area. To issue a directive regarding board structure is a lengthy process and it is important to get substantial result in the short term.¹²⁰

The requirement should be enforced on a “comply or explain basis”, requiring companies who do not comply to explain in their annual corporate governance statement why and to what extent they derived from it. It is up to the Member States how they choose to implement it. The Recommendation will define minimum standards as to the creation, composition and role of the audit committee or any equivalent. Further, minimum standards of what cannot constitute independence will be established.¹²¹

The High Level Group considered the question of independence. They offered a list of relationships that would disqualify a director as independent. The list included; employees or former employees that have worked for the company during the last five years, consultants, controlling shareholders, related parties and family relations, people whose payment is depended on the performance of the company and interlocking relationships.¹²²

The High Level Group further considered the responsibilities of the audit committee, including both external and internal aspects. The audit committee should be responsible for selection of the external auditor, monitoring auditor’s independence, monitoring of non audit services supplied by the auditor firm, meeting with the auditor on a regular basis, and ensuring that the auditor has access to all relevant information. The Committee should also be responsible for the accounting policies of the company, monitor the internal audit process and consider whether findings of risk management should be included in the company’s financial statements.¹²³

Both the European Union and the US embraces the concept of the monitoring board and independent directors as an effective weapon to control management. Although the Sarbanes-Oxley pushes the concept further by demanding that the audit committee should consist exclusively of independent directors. The role of the audit committee is extensive under the Sarbanes-Oxley Act. Even though the audit committee has a wide role under the European approach it does seems a bit more restricted than in the US. Moreover, the responsibilities of the audit committee in US is a matter of federal law, while the approach from the European Union is to issue a recommendation leaving the appropriate course of action up to the member states.

120 Action Plan, *ibid.*, p. 15, Report of High Level Group, *ibid.*, p. 61

121 Action Plan, *ibid.*, p. 15

122 Report of High Level Group, *ibid.*, p. 62f

123 Report of High Level Group, *ibid.*, p. 71

Further, the Sarbanes-Oxley Act requires that at least one member of the audit committee is a “financial expert”. The High Level Group recommends that all board members should possess basic financial understanding. Thus, it seems like the Group implicitly rejected the US requirement.¹²⁴

Responsibility of directors

The Commission considers it is of great importance to enhance the responsibility of directors.¹²⁵

The responsibility for trustworthy financial statements is, under company laws of Member States, primarily a collective responsibility of the whole board. In the one tier board it is the responsibility of both executives and non-executives and in the two tier board it is the collective responsibility of the managing directors and supervisory directors. A collective responsibility is considered an appropriate approach to avoid excessive individual influence from, in particular, executive directors whose performance is reflected in the statements.¹²⁶

The Commission embraces this view and requires a collective responsibility of all board members for financial statements. The collective responsibility should also extend to key non-financial data.¹²⁷ The view taken by the Commission differs from the US, which emphasise responsibilities for financial reporting on certain individuals, executives and financial officers. The European approach is on the board as a whole.

Both the High Level Group and the Commission consider the responsibility of directors for financial statements and key non-financial data an area where only self regulation is insufficient. It should be a matter of European Union law. The Commission therefore intends to confirm the collective responsibility of directors through a directive. This will be done in short-term.¹²⁸

Traditionally, member states have had the exclusive competence to impose sanctions for corporate malpractice. The Commission has no intention to alter that general principle. However, the Commission is considering imposing one particular sanction for misleading financing and non-financial statements and other forms of misconduct at European Union level. It is undesirable that a director disqualified to serve as director in one member state can be able to start up a company in another member state. Such a step will require careful consideration. The principle of subsidiarity has to be balanced against the need of

124 Ferrarini in panel discussion, *ibid.*

125 Action Plan, *ibid.*, p. 16

126 Report of High Level Group, *ibid.*, p. 67

127 Action Plan, *ibid.*, p. 16

128 Action Plan, *ibid.*, p. 16, Report of High Level Group, *ibid.*, p. 68

investors and the internal market. The Commission intends to investigate this issue and present any potential proposal in the medium term.¹²⁹

Auditor independence

The question of whether, and how far, an auditor should be allowed to provide non-auditing services has been a controversial question for a long time. In the US, Harvey Pitt, chief of the SEC, still maintained shortly before Enron collapsed that a rule separating the two should not be adopted. Sarbanes-Oxley has now decided the question in the US, auditors are now prohibited from performing certain non audit services for an audit client. This approach is probably going to be followed in many member states.¹³⁰ However, the Smith Report in the UK puts forth the opinion that it would not be right to impose a prescriptive approach since there are no universal answers. Whether there is a threat to auditor independence will depend on the circumstances in each case.¹³¹

The question is considered at EU level as well. EU's Eighth Company Law Directive¹³² establishes the principle that auditors should not handle audits if they are not independent. However, the Directive does not define what is supposed to be understood by independence. European Union confronted this problem shortly after the collapse of Enron by issuing a Recommendation on auditor independence. The objective was to improve harmonisation of auditor independence within the European Union.¹³³

The Recommendation follows a principle-based approach. The fundamental principle governing the approach is that "a statutory auditor should not carry out a statutory audit if there are any financial, business, employment or other relationships between the statutory auditor and his client that a reasonable and informed third party would conclude compromise the statutory auditors' independence."¹³⁴ The responsibility is on the auditor to consider possible threats to his independence and to apply safeguards. The Recommendation addresses certain circumstances where auditor independence may be compromised. The following situations are mentioned; financial interests, business relationships, employment with the audit client and the audit firm, managerial or supervisory

129 Action Plan, *ibid.*, p. 16, Press release frequently asked questions on Commission' Action Plan, accessed at June 21 2003 at http://www.europa.eu.int/comm/internal_market/en/company/company/news/index.htm

130 Hopt, *ibid.*, p. 24

131 Smith Report on *Combined Code Guidance for Audit Committees*, accessed July 1 2003 at www.frc.org.uk/publications

132 Eighth Company Law Directive (84/253/EEC)

133 Commission Recommendation of 16 May 2002 – Statutory Auditors' Independence in the EU, *ibid.*

134 *Ibid.*

role in the audit client and family and personal relationships. It also describes what safeguards the auditor should consider to mitigate any threat. As a result of the principle based approach the Recommendation does not prohibit non-audit services to clients unless the auditor compromises his independence while doing it.

The Recommendation also addresses the issue of rotation of key audit partners. It is recommended that such rotation occur within seven years. A cooling period of two years for a key audit partner who want to take up key management position at the audit client is also recommended.

The Commission chose to issue a Recommendation as it considered it the quickest and most efficient way to improve rules about auditors' independence. However, the Commission also made clear that the Recommendation would be reviewed three years after its adoption. The Commission should review how the Recommendation has been applied in practice and consider whether binding legislation would be necessary. The Commission should also take into account international developments, in particular on the question of non-audit services.¹³⁵

The Commission acted earlier than within three years. At the same time as the Commission introduced its Action Plan it also presented a Communication on Statutory Audit.¹³⁶ The Commission sets out ten priorities for improving and harmonising the quality of statutory audit in the European Union. Once the proposals are adopted there will exist comprehensive legislation on how to conduct audit and on audit supervision within the European Union. Among other things the Commission is proposing a modernisation of the Eighth Directive. The Directive will include principles on auditor independence in accordance with the existing Recommendation on auditor independence. The Commission is also going to perform a study on the impact of a more restrictive approach on non-audit services to an audit client.¹³⁷

The Recommendation on auditors' independence is under implementation within member states why, does the Commission overhaul the Recommendation and opt for binding legislation? The reason can be found in recent accounting scandals in Europe and lost investor confidence in the capital markets during the recent year. Non-binding regulation is not longer considered enough. The main driver for the whole package on auditing is the development of the single European capital market by 2005. However, there is also an international aspect to why the Commission wants to progress quickly with the proposed rules and that it is the question of mutual recognition in regards to Sarbanes-Oxley Act. There is a growing irritation in the European Union over the unnecessary outreaching effect of Sarbanes-Oxley for European Union companies and auditors. The European

135 Ibid.

136 *Communication from the Commission to the Council and the European Parliament, Reinforcing the Statutory Audit in the EU*, *ibid.*

137 *Ibid.*, p. 8ff

view is that European approach to corporate governance issues should be recognised as equivalent to the US approach. There are certain areas that are of particular concern. They are; the registration of audit firms with the PCAOB, the direct US access to EU audit working papers, the audit committee requirements, the rules on auditors' independence and the certification of financial reports and internal controls.¹³⁸

There have been a lot of negotiations between the countries and some issues have been solved, but there is no wide exemption for the European Union from the Sarbanes-Oxley rules.

The European Union is particular concerned by the required registration with the PCAOB. The European Union does not accept having its audit firms regulated by the US. Such registration is unnecessary and burdensome for the European audit firms. Equivalent systems of registration and oversight already exist in member states. Further, if European audit firms will have to register with the PCAOB the audit firms has to give access to audit working paper and client document. This creates major conflicts of law both with European Union law and member states national laws on data protection and professional secrecy.¹³⁹

In case the European Union does not get exemption and no mutual recognition of equivalent systems is reach with the US, the European Union are considering using the same method as the US, i.e. US audit firms will have to register in the European Union.

Conclusion

Enron and other recent scandals have resulted in major corporate governance reforms in many countries in order to restore investor confidence. The collapse of Enron has undermined the faith in self regulated corporate governance. It has been questioned whether the system offers adequate protection to shareholders and other stakeholders. Enron had first class gatekeepers and a model board but all failed in their monitoring role.

The European Union and the US have responded in a different way to the challenge of improving corporate governance and restoring public and investor confidence after Enron. The Sarbanes-Oxley Act in the US has chosen a heavy regulated approach. The approach from the European Union has so far been a mix of binding directives and non-binding recommendations.

138 Ibid., p. 3, 14

139 Ibid. Speech by Internal Market Commissioner Fritz Bolkestein April 24 2003, accessed June 28 2003 at http://www.europa.eu.int/comm/internal_market/en/company/audit/news/index.htm

The Sarbanes-Oxley Act has been highly criticised for federalising corporate governance. Corporate governance issues are to great extent a matter of State law in the US. This has given companies opportunity to choose between states with different approaches to corporate governance in order to find a system that suits the company. Federalisation is a very sensitive question in Europe as well. The Commission has made clear that it is not aiming at total harmonisation. That is a sensible approach given the diversity among member states in company law and other legislation. It is further recognised that when “federal legislation” in form of directives is considered necessary, the directive should be principle based leaving the details to the member states. In general, the principle of subsidiarity seems to have prevailed over harmonisation in the area of corporate governance within the European Union. Such an approach provides flexibility with the potential to adapt over time.

Both the US and the European Union highlight the same key elements for enhancing corporate governance; monitoring of management, trustworthy financial statements and the importance of a proper audit.

Even if the concept is questioned by some, both the US and European Union embrace the idea of the monitoring board and the concept of independent directors. The responsibilities of audit committees have been enhanced by both. Though, it seems like the US has expanded the role of the audit committee further than the European Union intends to do. More importantly while the US has made the responsibilities of the audit committee a matter of federal law, the European Union stops at issuing a non-binding Recommendation.

In regards to responsibility for financial statements the view differs between the US and the European Union. The US emphasises responsibility of financial reports on executives and financial officers, while the European Union requires a collective responsibility of the board. The latter seems like a more sensible approach as it avoids too much influence from executive directors. Moreover, it is questionable whether increased responsibility and liability on an individual basis can stop corporate fraud. The approach from the US is very punitive. The European Union has chosen to make the collective responsibility a matter of European law. However, even if self regulation is considered not enough in this area, it must be questionable whether directive on collective responsibility is needed since it exists in member states legislation. This probably has to be linked with the potential proposal to impose a European Union sanction regarding directors’ disqualification in a later stage. It makes sense to have the same grounds disqualification if such a sanction is imposed.

In relation to recent accounting scandals in Europe and the development of a single capital market, the European Union has reconsidered the Recommendation on auditors’ independence. Self regulation is no longer considered sufficient. The Communication on auditing should be linked to ongoing negotiations with the US

about mutual recognition of equivalent system. By making the audit issues subject to binding legislation the European Union gets better bargaining power when negotiating. Hopefully this is not the major reason from the shift from recommendation to directive. If so the US has indirect influence over European policy.

It is most understandable that the European Union does not accept having its companies and audit firms regulated by the US. If the US does not exempt European companies and audit firms from the outreaching effect of Sarbanes-Oxley the situation can develop into a “sand box war” and that is no good for anyone.

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