European Corporate Governance after the Sarbanes-Oxley Act

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I. Introduction

Sarbanes-Oxley Act of July 30, 2002 (SOA) as a benchmark for ECG

The SOA

- **"federalizes" US (and international) corporate governance standards**
- **is likely to influence the reshaping of European and national corporate laws and practices**
- **is applicable to many European companies having their shares listed in the US.**

II. Audit Committee

A. Independence

SOA: all audit committee members must be independent

Winter Report: committee members should be in the majority independent

<u>1st Thesis</u>: the SOA's provision is preferable also in concentrated ownership systems as

- independence from both the controlling shareholders and the managers is important
- the controlling shareholders do not lose out in terms of monitoring

B. Expertise

SOA: at least one audit committee member must be a *financial expert*

= experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer

Winter Report: all board members should possess basic financial understanding

(implicitly rejects the American requirement)

2nd Thesis:

- the SOA's requirement is acceptable and justified by the audit committee's responsibilities as to financial reporting

- possible mitigation of this requirement's rigidity

C. Powers

SOA: the audit committe is directly responsible for the appointment, compensation, and oversight of the outside auditors

Winter Report: the audit committee selects the external auditor for appointment by the shareholders meeting or the full board

3rd Thesis:

the SOA's approach has substantial value, particularly with respect to companies with concentrated ownership (as is the case of many European companies)

II. Financial Reporting

A. Responsibility

SOA: **CEOs and CFOs must certify in each annual or quarterly report that the report does not contain any untrue statement of a material fact or omit to state a material fact**

The Winter Report recommends that EU law confirms the collective responsibility of the board

4th Thesis: contrasting collective responsibility to individual responsibility may be misleading as

- collective responsibility for the accounts does not mean that all directors are equally liable

- the SOA makes the executives and officers well aware of their individual responsibilities for financial reporting, without excluding collective responsibility of the board

B. Internal Controls

SOA: CEOs and CFOs must certify internal controls

Winter Report: the audit committee’s competences include monitoring the company’s internal controls

Turnbull Report (1999): the primary responsibility of the internal control system is of the board, while the executive managers should implement the board’s policy as to internal controls

5th Thesis: **substantial convergence in the area of internal controls, even though**

- **the SOA emphasizes the responsibility of managers**

- **European best practices emphasize the board's responsibility**

IV. Auditor Independence

SOA:

- approval by the audit committee of all audit and non-audit services,
- prohibition of a variety of non-audit services

Commission Recommendation of 16 May 2002:

- principles-based approach
- “safeguards” to mitigate or eliminate threats to statutory auditors’ independence
- Non-audit services are allowed if general and specific safeguards are complied with.

6th thesis: the prohibition foreseen by the SOA is, to a large extent, justified by the conflicts of interest inherent to the provision of non-audit services to an issuer;

- **this is confirmed by the Commission Recommendation's analysis of non-audit services;**

- **a prohibition of non-audit services is foreseen by national best practices (see e.g. the French Bouton Report)**

V. Conclusions

The SOA might become a benchmark for corporate governance also in Europe

Possible areas of influence:

1. **independence of audit committee members**
2. **financial expert in the audit committee**
3. **appointment, compensation, and oversight of the outside auditors by the audit committee**

4. **emphasis on executives and officers' responsibilities for financial reporting**
5. **emphasis on executives and officers' responsibilities for internal controls**
6. **prohibition of a variety of non-audit services**