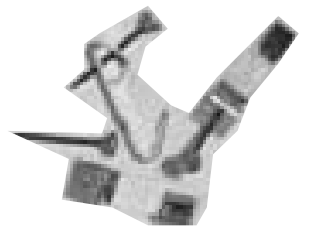




Why these folk mean business



THE US SARBANES-OXLEY ACT 2002 – OR SOX – IS SEEN AS A GOOD, IF SLIGHTLY LATE ADDITION TO THE CANON OF CORPORATE GOVERNANCE. HOWEVER, LIKE ALL THINGS AMERICAN, ITS REACH IS FAR AND WIDE – AND THERE LIES A PROBLEM. **ADRIAN HOLLIDAY** REPORTS

MENTION ENRON and WorldCom to most people involved in financial services in Europe and the UK and they'll have some idea of what you're talking about. Mention Sarbanes-Oxley, however, and the response is less clear-cut. Corporate governance? Something to do with accounting standards?

Both are right. However, what's harder to digest this side of the Atlantic is the impact that Sarbanes-Oxley (Sox) – named after US senator Paul Sarbanes and congressman Michael Oxley who pushed the legislation through – will have on our own corporate reforms. The new Combined Code, as well as the UK financial services industry in general, will be affected.

Sox is the most important piece of accounting and corporate governance to have come out of the US since the Great Depression. Born out of the disastrous financial accounting conflagrations of WorldCom and Enron – where fraud and clever off-balance sheet reporting tools were used to disguise the real level of debt some companies carried – it aims, in part, to jack up US accounting transparency by several notches. It also seeks to rid the US corporate world of potential conflict-of-interest issues between a broad spread of parties, including auditors and their clients. Confidence – both institutional and private – has hit rock bottom. Sox aims to help ease its return.

Sarbanes-Oxley is significant for the UK financial

At a glance...

- > The Sarbanes-Oxley Act – or Sox – was brought in by the Bush administration, anxious to restore confidence in the markets after the collapse of Enron and WorldCom.
- > The Act has repercussions for all UK financial services institutions that are listed – or that want to list – on the New York Stock Exchange.
- > Its extraterritorial reach has brought it into conflict with the UK's own corporate governance standards.
- > Many UK financial institutions see the cost and complexity of abiding by the US regulations difficult to justify.

services industry because it has extraterritorial reach. Any UK company wanting to list on the New York Stock Exchange has to abide by the new Sox standards (see box, p29). These can mean criminal sanctions – including lengthy prison terms – for senior management for misleading financial reporting. It also forces chief executives and their chief financial officers to personally sign off company accounts. Barclays, HSBC, Lloyds TSB and Prudential are among the big UK names affected, as are more than half of the UK's FTSE 100 companies that may be dual-listed.

“[Sox] does have an impact on the UK because we have so many US connections,” says David Chopping, technical partner at accountants Moore Stephens.

“However, there are large differences within our approaches to corporate governance – board structures being a classic example: the UK having a unitary board system and Germany with its two-tier system.”

The Sox rules have been seen as coming somewhat late in the day, at least compared to the UK's own corporate governance standards, according to David Illingworth, president of the Institute of Chartered Accountants in England and Wales. “Certainly the UK had its problems with BCCI and Maxwell, of which the Cadbury Code [see p32] was a direct result,” he says. “After Enron and WorldCom many people thought we would have to comply with Sox, but we already have a lot of safeguards in place.”

Sarbanes-Oxley does not overlap with the Higgs reforms, although it does come close to complimenting the new Combined Code – which comes into affect from

SARBANES-OXLEY THREE MAIN ESSENTIALS

1 **Rigorous new financial reporting requirements**
Any New York Stock Exchange-listed company will need to meet Sox's legal requirements, including chief executive and chief financial officer sign-off on company accounts. If the accounts are fudged or misleading, criminal sanctions – possibly up to 20 years in prison – could apply. A full audit trail must also be attached to every single annual report where management acknowledge responsibility for their internal financial controls, stating the model they use, as well as providing a quarterly assessment of the effectiveness of these controls. This full-on audit trail should cascade from the chief executive, via the chief financial officer, to various management levels. The requirements are effective for non-US companies from 2005.

2 **Agreement over accounting standards**
The EU has agreed to recognize International Accounting Standards (IAS) from 2005. However, the US Securities and Exchange Commission (SEC) also says it will require non-US companies to either produce accounts that comply with US accounting standards or allow companies to use IAS. However, those who opt for the second route will have to prepare a report on how the results would have been different had US standards been used instead of IAS.

3 **Auditors and the services they sell to clients**
Audit teams would rotate after five to seven years of consecutive partner involvement. Accountants would not be deemed independent from an audit client if any of the audit partners had received fees for non-audit services they had sold to a client.

SOX THE VIEW FROM THE DTI

The Department of Trade and Industry (DTI) says it supports the broad aims of Sarbanes-Oxley. However, it admits that conflicts between Sox and UK legislation are a worry.

"In some places there are conflicts between the Sarbanes-Oxley Act and domestic legislation," says a DTI spokesperson. "And in others it risks creating extra red tape, confusion and costs to business by introducing double regulatory oversight. The registration of audit firms with US regulators is a case in point and we have been lobbying the US hard for mutual recognition and equivalence between Europe and the US.

"This has led to some significant improvements in rules on registration of foreign audit firms – an extra six months to register – but we are disappointed that the Public Companies Accounting Oversight Board (PCAOB) is not proposing to grant exemption from the recognition requirement for non-US audit and accounting firms."

However, the long-term objective – to persuade the US administration, and specifically the SEC and PCAOB, to acknowledge the UK's existing corporate governance and accountancy standards – remains the DTI's ultimate objective.



US congressman Michael Oxley: on the anniversary of the passing of the Sarbanes-Oxley Act he said: "The lesson we've learned is a lasting one – that there's never a substitute for honesty"

next month – in some areas. The Financial Services Authority (FSA), however, admits that Higgs' explorations were certainly given a stir by the US accounting scandals. "They did give stimulus to the debate," a spokesperson says. "But Higgs was generally a feeling that it was time to look at corporate governance anew anyway. The remit of Higgs was the role of non-executive directors, not accounting standards."

However, tensions exist between the two sets of law. UK corporate governance is based on best practice and a comply or explain to shareholders approach. "But in the US," says Colin Melvin, director of corporate governance at Hermes pension fund management, which manages over half the UK's biggest pension funds, "they have a more legalistic approach – Sox is an example of this." Melvin says this difference – largely a cultural one – is also down to shareholders' rights – or lack of them – in the US. "They have little option when things go wrong, apart from seeking redress in the courts. In contrast, UK shareholders can vote directors off the board and put resolutions to the board, which are absent in Sox."

So is Sarbanes-Oxley simply an overreaction by US authorities to unpalatable truths about their financial reporting standards? "You can understand why they've

reacted in this way when you think of what they've experienced," says David Chitty, a technical partner at accountants Chantrey Vellacott DFK. "Sox is very much rules-based and there's an issue of how it will work outside the US. However, the US Financial Accounting Standards Board is moving towards principles-based accounting on developing standards."

Principles-based accounting methods are widely used in Europe, placing the emphasis on the "spirit", not just the legal letter of an action. Potential loopholes are therefore (in theory) filled and voluminous rule minutiae, which may or may not be open to legal interpretation as with the US system, is done away with. The Securities and Exchange Commission (SEC), the US financial services watchdog, says it is looking to investigate taking a more principles-led approach further.

Although Sarbanes-Oxley has been welcomed in the US, the speed with which it was assembled has caused consternation, particularly in the UK and Europe. The legislation was first mooted in September 2001 and was on the US statute books by the following July. Frits Bolkestein, the EU's internal markets commissioner, has been particularly angry about the way he feels the US has attempted to

CHECKS AND BALANCES

Desperate to be seen taking robust action to restore investor confidence after the collapse of Enron and WorldCom, the Bush administration was keen to overhaul the relationship between big-name auditors and their clients. Audit companies are banned under Sarbanes-Oxley from selling certain services to their clients that in the past could encourage unhealthy close relationships between the two parties.

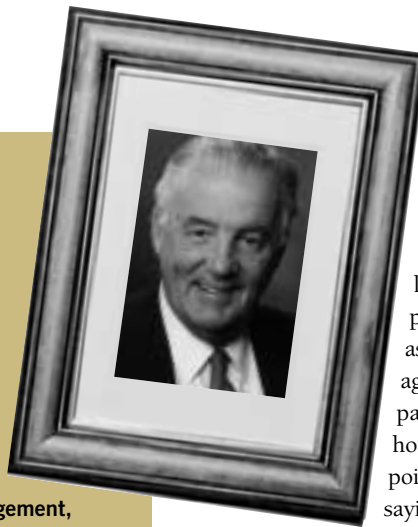
However, Mark Hutchinson, chief executive of Parson Consulting, a firm specializing in financial and operational management, says the conflict between audit and non-audit services offered by accounting firms, particularly the Big Four, remains. "Both the SEC and the UK Government have avoided tackling the real issue – the separation of audit and non-audit services. How can the final four accounting firms claim independence when they still provide business advisory, tax, corporate recovery, forensic accounting and corporate finance?"

The issue is highly pertinent. Accounting firm Andersen certainly made a significant – and regular – income from its relationship with Enron on non-audit work. However, Peter Wyman, management infrastructure partner at PricewaterhouseCoopers, rebuts Hutchinson's accusation. "The SEC and UK Government have not 'avoided tackling the real issue'. They have looked carefully at the issue and concluded that what is needed is the highest possible quality audit. This is more likely to be obtained if the audit firm has a wider remit. Of course there are potential conflicts, but there is a well-established and well-understood framework for dealing with any threats to objectivity that might result from such a conflict."

UK trade and industry secretary Patricia Hewitt recently announced plans to boost auditor powers to avoid an Enron-style debacle. Hewitt launched an investigation into UK accounting and auditing relationships shortly after the US accounting company disasters. Auditors will be allowed to question company directors and probe them on whether they have withdrawn company information from auditors. Businesses in the UK accountancy industry are certainly wary of an overly legalistic approach. And unlike the US, the Blair administration – exercising a light touch – does not intend to force accounting firms to follow regular client rotation. This is down to the confidence in the UK's own corporate governance standards and the revised Combined Code, incorporating recommendations from the Higgs' review.

impose its regulations beyond its borders. "I do not accept the imposition of US standards on our firms – the EU will regulate its own businesses," Bolkestein said in May.

Plans to reinforce European corporate and governance standards are already under way to counteract any US "intrusion", says Bolkestein. The EU – and this is where things begin to get fearsomely complex – is in the throes of creating a new audit regulatory committee as well as ensuring that all EU members adopt international accounting standards (IAS), drawn up by the International Accounting Standards Board (IASB) and due to come into force by 2005. "The key issue," says the FSA spokesperson, "is between the EU as a whole and the US and how the IASB standards will operate alongside US standards operated by the Federal Accounting Standards Board."



The EU and the US signed an agreement on this area in October of last year. However, progress remains slow, as Peter Wyman, management infrastructure partner at PricewaterhouseCoopers (PwC), points out. "The SEC is saying non-US companies can either produce

US Senator Paul Sarbanes: in June 2003, he was awarded the Paul H Douglas Ethics in Government Award from the University of Illinois. The award is designed to honour those who have made a substantial contribution to promoting ethics

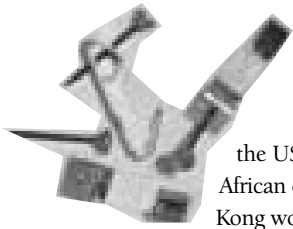
accounts that comply to US accounting standards or use IASB standards. But they will need to prepare a report on how the results will differ. The consequence is a massive amount of double work. Taken together with the additional burdens of Sarbanes-Oxley, we're talking about millions of pounds per case, or tens of millions, taken collectively. You have to ask: where's the benefit?"

The big auditing firms face a further tussle with US authorities as many of their clients are registered on both sides of the Atlantic and will be subject to double audit standards, which may dramatically increase costs. All UK and EU accountancy and auditing firms that work for US companies will have to register with the new US Public Companies Accounting Oversight Board (PCAOB). This PCAOB edict has caused massive resentment. Unless the US backs down and accepts some form of mutual recognition, Peter Montagnon, head of investment affairs at the Association of British Insurers, believes it's only a matter of time before there's a showdown. "The EU has threatened to retaliate by starting to regulate US accountants whose work relates to European companies. A major confrontation would be deplorable," he says.

Pinned against the backdrop of slow progress in the world trade round, a spat would further sour relations between the US and EU, and possibly lead towards more trade protectionism, Montagnon warns. "One of the issues thrown up by Sarbanes-Oxley is that it seems to be driving the thinking of the European Commission," he says.

"The EU has been seeking to develop a regime that can match the provisions in the Sox legislation as well as some of the other initiatives in corporate governance taken by the SEC." Certainly from the US perspective, a good 20 per cent of New York stock market capitalizations are from foreign companies – about 1,400 non-US firms – from about 60 countries worldwide. That's a great deal of overseas business that Sox wants to rein in.

PwC's Peter Wyman says everyone – including >> (continued on page 38)



the US – needs to focus on the big picture. “A South African company listed in the UK, New York and Hong Kong would have to do everything four times and then explain to its shareholders that the four different answers are one and the same. Although, in theory, investors would be clearer over what is happening, it would be hugely expensive and impossible to justify the cost.”

Even if the US gets much of its way with the changes, not all believe it will result in ironclad improvements. Janet Tavakoli, president of Tavakoli Structured Finance, a Chicago firm specializing in securities and derivatives for institutional investors, says: “Some of the provisions of the Act [Sox] merely seem to ask corporate officers to behave in a responsible manner. Sarbanes-Oxley may help regulatory bodies and the SEC cut some baby teeth, but it remains to be seen. So far it seems that those responsible have much less downside than the financial institutions that do business with them.”

In the UK there seems a resigned attitude to compliance. One financial FTSE-100 blue-chip company is clear that the Sox requirements are financially onerous but see no way of getting around them. Lloyds TSB says the regulations were broadly a formalizing of its existing procedures. No large financial company will give wholehearted endorsement to the Sox changes, although Paul Chisnall, an executive director at the British Bankers’ Association, welcomes the fact that the SEC recognized the need for foreign companies to be given more time to formalize reporting structures to enable them to meet SEC certification obligations.

The EU is hardly enthusiastic either, although it does seem rather anxious – perhaps too anxious, say some – to engage with the US on an equal footing. “There is a risk of the US setting the agenda here for Europe,” says one banking source. “But Europe should set its own agenda and, where appropriate, do things better than the US.”

One element where the UK is setting the standard is the inclusion of a whistleblowing clause in the Combined Code. The key difference between the two countries is that the Higgs Code favours open and confidential audit whistleblowing, while Sarbanes-Oxley features anonymous reporting. This is good news for UK shareholders, says Public Concern at Work’s director Guy Dehn. “This practical approach provides effective board oversight, without undermining proper management.”

If a settlement between the US PCAOB and the UK and Europe on accounting standards can be agreed, audit firms will breathe a massive sigh of relief. As will their clients, including large UK financial services players, who are ever-conscious of spiralling fees. However, this fight has several rounds to go yet.

The UK’s own corporate governance regulatory framework has so far proved robust in engaging with the hydra-headed US laws, particularly after the new Higgs and Combined Code improvements and despite the gaping transatlantic cultural differences. In this sense, Europe

VIVE LA DIFFÉRENCE

WHY SARBANES OXLEY HAS CREATED AN INTERNATIONAL STINK

In June, 2003, Lawrence Cunningham, law and business professor at Boston College, Massachusetts, addressed a meeting of the Federation of European Securities Exchanges at Guildhall, London, as to why Sox had managed to put so many noses out of joint across the world.

Much of it was down to very different business cultures, he said. “UK and US companies share the goal of maximizing shareholder profits, which Sox embraces. In Japan, the goal is expanding power, size and market share – goals that Sox-type provisions may or may not advance. In Germany the focus is survival, a feat threatened by imposing non-German corporate norms. In France, the corporate orientation supports sovereignty enhancement, of boosting the French state, also a conception threatened by US-style norms.” No surprise, then, that Sox has angered so many.

“Sox’s thrust is audit and control,” Cunningham said. “But audit and control address, test and verify different underlying accounting data, that is, in turn, driven by finance and governance peculiarities. They confront different pressure points. Changes in audit and control can drive changes in corporate purpose and governance. Maybe this is what Sox’s foreign foes fear...”

THE CADBURY REPORT

The Cadbury Report was the work of the Committee on Financial Aspects of Corporate Governance, appointed by the Financial Reporting Council, the London Stock Exchange and the accountancy profession. Chaired by Sir Adrian Cadbury, head of the Cadbury Schweppes empire, the committee recommended the adoption of a voluntary code of best practice on financial reporting and accountability in a bid to restore confidence in the industry following the BCCI and Maxwell scandals. The committee was appointed in May 1991 and reported in December 1992.

and the UK may be able to show the US a clean pair of heels – provided that no Enron-style collapse is waiting in the wings. “Think about the reforms since the Cadbury Report in 1992,” says Colin Melvin, of Hermes. “There has been a steady rise of investor activity in this area. Investors are exercising their rights more frequently and taking a more intelligent approach to voting. People will always defraud. It’s always better to tackle it by way of best practice. I can’t see how legislation can work.” **FW**

See *Legal issues*, p62.



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