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# Post-Enron: U.S. and German Corporate Governance

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# Post-Enron: U.S. and German Corporate Governance

Stefan W. Suchan (LL.M. Cornell, Ph.D. Heidelberg)\*

I. INTRODUCTION .....	2
II. CORPORATE GOVERNANCE BEFORE ENRON .....	4
1. The role of the auditors .....	4
a. U.S. – auditor as gatekeeper .....	4
b. Germany – auditor as gatekeeper and advisor .....	5
2. Management compensation .....	7
a. U.S. – Equity compensation “without limits” .....	7
b. Germany – Stock Options yes, but limited .....	9
III. REASONS FOR THE ENRON FAILURE .....	10
1. Failure of the gatekeepers, especially auditor .....	10
a. Loss of auditor independence .....	11
b. Reputation no longer key of business model .....	12
c. liability of the audit firms limited .....	13
d. Corporate Governance of Audit firms .....	14
2. Management compensation .....	16
IV. HOW DID LEGISLATION REACT?.....	19
1. U.S. legislation - Sarbanes Oxley Act .....	19
a. Rules with respect to auditors .....	19
i. Creation of Public Company Accounting Oversight Board .....	19
ii. Treatment of non-audit services .....	21
iii. Audit partner rotation .....	23
iv. No “revolving door” between audit firms and their clients .....	24
b. Management compensation .....	25
c. Post-Sarbanes-Oxley Act development.....	25
2. German and European legislation .....	26
a. Rules with respect to auditors .....	26
i. German legislation .....	27
(1) Treatment of non-audit services .....	27
(2) Audit partner rotation .....	29
(3) Implementation of new supervision body for financial disclosure .....	30
ii. German Corporate Governance Code.....	30
iii. European legislation .....	32
b. Management compensation .....	33
i. German Corporate Governance Code.....	33
ii. IAS-accounting rules .....	34
V. WHAT COULD BE DONE?.....	35
1. Auditor independence .....	36
a. Audit firm rotation .....	36
b. Corporate Governance within the audit firms, especially compensation .....	40
c. Other areas for improvement .....	42
2. Management compensation .....	43
VI. CONCLUSION.....	45

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## I. INTRODUCTION

Only five years after *Henry Hansmann* and *Reinier Kraakmann*<sup>1</sup> announced “the End of History of Corporate Law” – borrowing the words of *Francis Fukuyama*<sup>2</sup> –, this observation seems at least questionable. Following two major failures of the “American Model” with the bankruptcy of Enron and WorldCom, the question of the “right” Corporate Governance regime is again under discussion.

Legislators around the globe assume that further development of Corporate Governance is necessary. There is consent for the need of improvement, but no clear answer on how to improve. A first step to solving the arising problems might be to evaluate the reasons for collapse of the Corporate Governance regime in place. In the U.S., the fall of Enron has been understood primarily as a failure of the gatekeepers,<sup>3</sup> meaning the intermediaries who provide verification and certification services to the investors (e.g. securities analysts and especially the auditors).<sup>4</sup> U.S. legislation in the aftermaths of Enron reacted correspondingly: the Sarbanes-Oxley Act<sup>5</sup> further regulated the accounting profession by implementing a new administrative agency, the Public Company Accounting Oversight Board (PCAOB), to set new standards with respect to

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<sup>1</sup> *Henry Hansmann/Reinier Kraakmann*, The End of History for Corporate Law, Harvard Law School, John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 280, January 2000.

<sup>2</sup> *Francis Fukuyama*, The End of History?, The National Interest, Summer 1989.

<sup>3</sup> Cf. *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, Villanova Law Review, Vol. 48: p. 1023 (1024).

<sup>4</sup> For this definition of the term “gatekeepers” cf. *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (279).

<sup>5</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

the auditor's independence, especially with respect to compensation via consulting services provided for audit clients.

This first step of legislation has been criticized for dealing with only part of the relevant concerns. Questions relating to auditors have been largely left open. Instead of addressing the issue of rotation of audit firms<sup>6</sup> directly, the Sarbanes-Oxley Act orders a study on this topic.<sup>7</sup> Other problems connected to compensation of the persons involved have been ignored. Foremost to mention is the management compensation with equity instruments.<sup>8</sup> Remuneration with stock options rewards risk oriented management decision without penalizing for failure. Sarbanes-Oxley Act does not respond to this issue.

How do other jurisdictions cope with these problems? It might be worth examining the approach of the German labor- or stakeholder oriented model<sup>9</sup> of corporate governance. Under German law the auditor is not only understood as a gatekeeper, assuring the interest of the investing public (so called "Kontrollfunktion" or "Garantiefunktion"), but also acts as assistant for the supervisory board in its internal control of the

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<sup>6</sup> § 203 of the Act requires auditors only to rotate the lead audit partner, cf. *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.B.3.

<sup>7</sup> *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, *Villanova Law Review*, Vol. 48: p. 1023 (1027).

<sup>8</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (275).

<sup>9</sup> See *Henry Hansmann/Reinier Kraakmann*, The End of History for Corporate Law, Harvard Law School, John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 280, January 2000, at III.B. and D.

management (so called “Unterstützungsfunktion”).<sup>10</sup> This complementary role does not necessarily trigger different approaches with respect to Corporate Governance – under the German concept auditor’s independence is the key as well, as shown by new legislation after Enron.

Given similar approaches to similar problems in both jurisdictions, a convergence to the one “right” Corporate Governance model might take place. The paper will discuss the question of managerial and gatekeeper compensation<sup>11</sup>, focusing on compensation of auditors. Not only remuneration for consulting services, but also compensation schemes within the accounting firms might be an issue. Mandatory transparency reports of audit firms, proposed by the European Commission, could be a step in this direction. The paper will discuss and evaluate these topics.

## **II. CORPORATE GOVERNANCE BEFORE ENRON**

### ***1. The role of the auditors***

#### **a. U.S. – auditor as gatekeeper**

The independent auditor is commonly referred to as a “gatekeeper” of the investing public, i.e. as an intermediary who provides verification and certification services to the investors.<sup>12</sup> This common understanding of the auditor is based on the function

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<sup>10</sup> *Peter Hommelhoff/Daniela Mattheus*, Die Rolle des Abschlussprüfers bei der Corporate Governance, in *Handbuch Corporate Governance*, 2003: p. 639 (645).

<sup>11</sup> “Compensation” understood in the broad sense of *Coffee*, cf. *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (271).

<sup>12</sup> For this definition of the term “gatekeepers” cf. *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (279).

assigned to the auditor by the Securities Acts of 1933 and 1934. Under this model the auditor serves the investing public as well as his client. He allows the investing public to choose the right investment based on the firms certified financial statements and enables the client to achieve lower cost of capital by sending a signal of creditability.<sup>13</sup> The auditor is understood to be in a strong position and able to force the client to comply with all the accounting requirements specified by the auditor, otherwise risking to be “fired” by the auditor.<sup>14</sup> This strong position is solely based on the auditor’s reputation built up over the years of performing similar services for numerous clients.<sup>15</sup> Therefore, to stay in business requires to forego a short-term gain by participating in a client’s fraud and possibly risking the long-term loss of the accounting firm’s reputation.<sup>16</sup>

#### **b. Germany – auditor as gatekeeper and advisor**

As pointed out before,<sup>17</sup> the auditor under German law is not only understood as the gatekeeper, assuring the interest of the investing public, but also acts as assistant for the supervisory board in its internal control of the management.<sup>18</sup>

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<sup>13</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1168/1169); *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms’ audits of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 4/5.

<sup>14</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1168/1169).

<sup>15</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (280).

<sup>16</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1168, 1173); *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (280); *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms’ audits of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 5.

<sup>17</sup> See above, under I.

The function as a gatekeeper slightly differs from the understanding in the U.S. One characteristic of the German Corporate Governance model is the fact that large institutional investors, typically banks and insurance companies, hold large blocks of shares (5% or more).<sup>19</sup> These investors typically have more direct access to corporate information (e.g. as a corporate lender) and do not have to rely on the companies' financial statements.<sup>20</sup> On the other hand, if the auditor's failure results in financial loss for the blockholder, it might trigger negative reputational consequences more directly. Typically, blockholder can influence the outcome of the shareholder vote on the auditor appointment, especially banks allowed to exercise the voting rights of deposit shares.<sup>21</sup>

German corporate law endows the company's auditor with a second function. He has to support the supervisory board in its control of the management board.<sup>22</sup> German corporate law provides for special reporting obligations with respect to the financial accounting of the company.<sup>23</sup> By means of such auditor report the supervisory board shall

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<sup>18</sup> *Peter Hommelhoff/Daniela Mattheus*, Die Rolle des Abschlussprüfers bei der Corporate Governance, in *Handbuch Corporate Governance*, 2003: p. 639 (645/646).

<sup>19</sup> Cf. *Rafael La Porta/Florencio Lopez-de-Silanes/Andrei Shleifer*, Corporate ownership around the world, October 1998, Table II and III; *Henry Hansmann/Reinier Kraakmann*, The End of History for Corporate Law, Harvard Law School, John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 280, January 2000, at III.D.

<sup>20</sup> Cf. *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, *Villanova Law Review*, Vol. 48: p. 1023 (1054).

<sup>21</sup> Cf. *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, *Villanova Law Review*, Vol. 48: p. 1023 (1054).

<sup>22</sup> *Peter Hommelhoff/Daniela Mattheus*, Die Rolle des Abschlussprüfers bei der Corporate Governance, in *Handbuch Corporate Governance*, 2003: p. 639 (645).

<sup>23</sup> See § 171 (1) Stock Corporation Act ("Aktengesetz" – AktG), § 321 German Commercial Code ("Handelsgesetzbuch" – HGB).

be entitled to decide if management board decision are (1) within German GAAP and (2) appropriate regarding the election of accounting methods (if not obligatory).<sup>24</sup> Consequently, the supervisory board acts on behalf of the company to agree with the auditor on his engagement.<sup>25</sup>

## **2. Management compensation**

### **a. U.S. – Equity compensation “without limits”**

The idea of compensating management and employees with equity instruments and especially stock options dates back to the 1950's. The manager is granted by the corporation a right to purchase a corporation's share within a designated time period at a set price (“strike price”). The option holder benefits if the market value of the underlying share is at or increases above the strike price.<sup>26</sup> The reasons for the rise of this type of compensation instruments were three-fold. First, tax law provided a favorable tax treatment for certain types of “incentive stock options”.<sup>27</sup> Second, the development of the capital markets in the 1980's, especially the takeover and Leveraged Buyouts (LBOs), brought a new focus on aligning management with shareholder interest.<sup>28</sup> In addition,

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<sup>24</sup> *Peter Hommelhoff/Daniela Mattheus*, Die Rolle des Abschlussprüfers bei der Corporate Governance, in *Handbuch Corporate Governance*, 2003: p. 639 (646).

<sup>25</sup> Cf. § 111 (2), sentence 3 AktG.

<sup>26</sup> See *Jesse H. Choper/John C. Coffee/Ronald J. Gilson*, *Cases and Materials on Corporations*, 5.E., p. 149/150.

<sup>27</sup> Cf. §§ 421, 422 IRC. These types of plans due to their requirements focus on employee compensation, not management compensation; cf. *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, *Gonzaga Law Review*, Volume 38: p. 535 (546/547).

<sup>28</sup> See *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (273/274).

accounting treatment for stock options was advantageous. Under APB No. 25<sup>29</sup> the corporation issuing stock options was able to avoid expensing the fair market value of these options in its financial statements.<sup>30</sup> Thereby the corporations were able to compensate their executives without reducing earnings. As the method of choice equity instruments, especially stock options, became common.<sup>31</sup>

Most States have statutory provisions specifically dealing with stock options.<sup>32</sup> Typically, the issue of rights or options to directors, officers, or employees requires an authorization by at least the majority of the votes at the shareholder meeting.<sup>33</sup> The adoption for such plan shall provide for the material terms and conditions upon which the options are to be issued. However, performance targets, holding requirements or similar limitations are not demanded by State corporate law.<sup>34</sup> From an accounting perspective,

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<sup>29</sup> Accounting Principles Board, American Institute of Certified Public Accountants., Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Issuing corporations may continue to account stock options under APB No. 25 provided they disclose the effect of expensing the fair market value of these stock options in a footnote; cf. Financial Accounting Standards Board, Statement No. 123, and Statement No. 148.

<sup>30</sup> So-called “fixed plans” under APB 25, which required a certain design of the stock option plan without any performance goals (other than the share price); see *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, *Gonzaga Law Review*, Volume 38: p. 535 (554/555).

<sup>31</sup> Between 1981 and 1984, the percentage of companies with stock option plans increased from 68% to 84% for manufacturing companies and from 43% to 77% for retail companies; cf. *Jesse H. Choper/John C. Coffee/Ronald J. Gilson*, *Cases and Materials on Corporations*, 5.E., p. 150, Fn. 96.

<sup>32</sup> For New York State cf. N.Y. Bus. Corp. Law, § 505.

<sup>33</sup> See N.Y. Bus. Corp. Law, § 505 (2)(d).

<sup>34</sup> Cf. N.Y. Bus. Corp. Law, § 505 (2)(e). The courts typically apply the business judgment rule with respect to the boards determination whether or not a corporation should compensate managers based on the market value of common stock; see *Lieberman v. Becker*, 38 Del. Ch. 540 (Supreme Court 1959). Only if the payments constitute “spoliation or waste”, the compensation might be excessive; cf. *Rogers v. Hill*, 289 U.S. 582 (1933). After Enron a more restrictive approach might be possible, see *In re Walt Disney*, 825 A.2d 275 (Court of Chancery 2003).

performance targets might even be negative, they typically<sup>35</sup> result in an obligation to expense in the financial statements the intrinsic value of the stock options at the date of exercise.<sup>36</sup>

#### **b. Germany – Stock Options yes, but limited**

In Germany, stock purchase plans for employees were popular starting in the 1970's. These plans allowed employees to purchase a very limited number of stock and provided for defined holding periods.<sup>37</sup> Due to the limited benefits management typically did not participate in these plans.

Stock option plans as means of management compensation became common in Germany starting in the mid 1990's. Equity compensation was understood as an important part of the "shareholder value concept" the importance of which grew to be popular in German business at that time. The early stock option plans were based on convertible bonds due to restrictive rules concerning the issue of share capital by management. In 1998, the German Stock Corporation Act ("Aktiengesetz" – AktG) was amended to enable all stock corporations to implement stock option plans. According to the new provisions in §§ 192 (2) No. 3, 193 (2) No. 4 AktG, a shareholder resolution can authorize the management board (or the supervisory board in case of options for members of the management board) to issue stock options. The shareholder resolution has to deter-

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<sup>35</sup> Otherwise in case of a so-called "premium priced" plan, providing for an strike price X % above the fair market value of the underlying stock at date of grant.

<sup>36</sup> So-called "variable plan": at the date of grant no measurement date because not both the number of shares and the exercise price with respect to those shares are known with certainty; for the criteria see *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, *Gonzaga Law Review*, Volume 38: p. 535 (554, 568).

<sup>37</sup> Cf. §§ 71 (1) No. 2, 203 (4) AktG, which resulted from legislation at this time.

mine the number of options available to members of the management board as well as performance targets which have to be met to exercise the options.<sup>38</sup> In addition, the Stock Corporation Act requires compensation of members of the management board to be appropriate.<sup>39</sup> If the supervisory board which is responsible for the compensation of the members of the management board<sup>40</sup> does not comply with these rules, the members are liable to the corporation.<sup>41</sup>

Notably, German GAAP – as U.S.-GAAP – does not require to expense stock options.<sup>42</sup> However, the accounting treatment does not change if the stock option plan provides for performance targets and therefore at least does not discourage defining performance goals.

### **III. REASONS FOR THE ENRON FAILURE**

#### ***1. Failure of the gatekeepers, especially auditor***

Arthur Andersen, Enron's auditor, provided a broad range of consulting services for Enron. This multi service involvement with the client might be the principal reason for Arthur Andersen's failure in forcing Enron to comply with U.S. GAAP. But there are several other issues worth mentioning.

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<sup>38</sup> § 193 (2) No. 4 AktG.

<sup>39</sup> See § 87 AktG.

<sup>40</sup> See § 84 AktG.

<sup>41</sup> Cf. §§ 93, 116 AktG.

<sup>42</sup> As of today there are no legal binding accounting rules with respect to the treatment of stock options in the P&L. According to the prevailing opinion no expenses are necessary.

### **a. Loss of auditor independence**

In the 1990's, the accounting profession became increasingly cartelized. This development was not initiated solely by business reasons, but by rather technical independence rules. An audit firm was treated as independent, if the revenue with a specific client did not exceed a certain percentage.<sup>43</sup> But audit firms did not only grow in size. They developed into “multi-service” firms which offered management and tax consulting work as well as legal and financial services. The audit services were utilized as a “portal of entry” into lucrative clients.<sup>44</sup> Low audit fees were agreed on (so-called “low balling”) which were cross financed by fees generated with consulting services.<sup>45</sup>

These consulting services created a new type of client-auditor relation for at least two reasons. First, it was no longer the auditor who could “fire” the client.<sup>46</sup> On the contrary, the client was able to punish the auditor by terminating consulting contracts without the public embarrassment associated with an auditor dismissal. “Cooperative” auditors could be rewarded with new consulting business.<sup>47</sup> The client was able to bribe

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<sup>43</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1176).

<sup>44</sup> *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms' audits of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 7; *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (291).

<sup>45</sup> *John C. Coffee, Jr.*, Understanding Enron: “It’s about the Gatekeepers, stupid”, *The Business Lawyer*, Vol. 57: 1403, Fn. 38 and accompanying text; *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (291).

<sup>46</sup> See above, at II.1.a.

<sup>47</sup> *John C. Coffee, Jr.*, Understanding Enron: “It’s about the Gatekeepers, stupid”, *The Business Lawyer*, Vol. 57: 1403, Fn. 40, 41 and accompanying text; *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1178/1179); *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (292); *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms' audits

or coerce the auditor in its core professional role using the disciplinary tool of consulting fees.<sup>48</sup> Second, by providing consulting services on management, tax, IT, or accounting related issues, auditors lost their function as an independent control of the systems and results implemented. As *William W. Bratton* states: “an auditor is hardly likely to question the effectiveness of a compliance system sold by his or her own firm.”<sup>49</sup>

### **b. Reputation no longer key of business model**

In the late 1990’s the capital markets grew to unknown heights. This changed the function of gatekeepers, especially the auditors. Their reputations was no longer required by the clients to achieve low costs of capital – the market “absorbed” new equity investment anyway. Consequently, management of the clients regarded the audit no longer as valuable or necessary, but rather as a formality.<sup>50</sup>

Realizing that reputation no longer was the key of doing business, audit firms focused on selling their services. The “certified audit” became a commodity understood as only one part of a variety of services offered to the client.<sup>51</sup> All of the big accounting

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of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 8.

<sup>48</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (292).

<sup>49</sup> *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, Villanova Law Review, Vol. 48: p. 1023 (1030).

<sup>50</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (293).

<sup>51</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, Villanova Law Review, Vol. 48: p. 1167 (1177).

firms followed this new approach.<sup>52</sup> Due to a concentrated market they were able to risk even a loss in reputation as long as all of the few competitors left in the market behaved similarly.<sup>53</sup> As a result, audit firms were increasingly willing to accept risky accounting policies in order to get lucrative consulting revenue.

### **c. liability of the audit firms limited**

The legal environment for audit firms changed in the 1990's. For several reasons the expected liability costs considered by auditors, deciding whether or not to accept aggressive accounting policies favored by the client, declined.<sup>54</sup> The Supreme Court in 1991 shortened the statute of limitations applicable to securities fraud to one year after discovery or three years after violation.<sup>55</sup> Private "aiding and abetting" liability in securities fraud cases was eliminated by a Supreme Court decision in 1994.<sup>56</sup> As a last step, the Private Securities Litigation Reform Act of 1995 (PSLRA) established new

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<sup>52</sup> See *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms' audits of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 2.

<sup>53</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (300).

<sup>54</sup> See *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (288).

<sup>55</sup> *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991); see *John C. Coffee, Jr./Joel Seligman*, Securities Regulation – Cases and Materials, 9.E., p. 1293; *John C. Coffee, Jr.*, Understanding Enron: "It's about the Gatekeepers, stupid", The Business Lawyer, Vol. 57: 1403, Fn. 29 and accompanying text; *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (288).

<sup>56</sup> See *Central Bank of Denver, N.A. v. First Interstate of Denver, N.A.*, 511 U.S. 164 (1994); *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms' audits of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 6; *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (288); cf. also *John C. Coffee, Jr./Joel Seligman*, Securities Regulation – Cases and Materials, 9.E., p. 1289, addressing the enactment of § 20 (e) of the Securities Act of 1934, as well as *In re Enron Corp. Securities, Derivatives & ERISA Litigation*, 235 F.Supp 2d 549 (United States District Court, S.D. Texas), 2002, adopting the "maker" theory of primary liability.

pleading standards for securities fraud actions and limited the liability to the proportion of the victims' losses corresponding to the auditor's responsibility.<sup>57</sup> These changes of the legal environment were accompanied by less strict enforcement by the SEC.<sup>58</sup>

As a result of these legal and enforcement changes, expected liability costs declined.<sup>59</sup> Consequently, auditors more often chose to accept and certify the client's accounting even if they recognized a risk that the accounting treatment might not be in accordance with U.S. GAAP.

#### **d. Corporate Governance of Audit firms**

The changing business and legal environment did not only alter the audit firm's approach towards the client. The Corporate Governance of the audit firms themselves was also subject to change.

Due to the high-risk character of their business audit firms have elaborate internal control and monitoring systems.<sup>60</sup> These monitoring systems rely on the influence of the

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<sup>57</sup> § 21D (b), and (f) of Securities Act of 1934; cf. *Theodore Eisenberg/Jonathan R. Macey*, Was Arthur Andersen Different? An Empirical Examination of major Accounting Firms' audits of large clients, Yale Law School, Center for Law, Economics and Public Policy Research Paper No. 287, p. 6; *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (288/289); *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, Villanova Law Review, Vol. 48: p. 1023 (1029).

<sup>58</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (290).

<sup>59</sup> Cf. U.S. Securities and Exchange Commission, Office of the General Counsel, April 1997: Report to the President and the Congress on the first year of practice under the Private Securities Litigation Reform Act of 1995 (available at <http://www.sec.gov/news/studies.shtml>), under II.A., stating the decline of class actions against "secondary" defendants (i.e. auditors).

<sup>60</sup> *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, Villanova Law Review, Vol. 48: p. 1023 (1030).

internal monitoring staff. In the late 1990's those internal monitoring functions were no longer understood as an essential part of doing business by all members of the audit firms.<sup>61</sup> The focus of doing business had shifted from a reputation- to a sale-based approach.<sup>62</sup> In addition, the risk of liability had declined. Not only the audit firms' expected liability costs,<sup>63</sup> but also – due to the emergence of the LLP – the individual partners' liability for the wrongdoing of other firm members.<sup>64</sup> Thus, the internal control system developed to assure compliance with auditing standards set by the firms no longer guaranteed best practice.

This problem was amplified by the engagement structure within the big accounting firms. In the case of important or multinational clients, generally, one partner (so-called “lead partner”) is responsible for overlooking all transactions with the client. Typically, due to the client's size, this creates a situation similar to a “one-client” practice,<sup>65</sup> leading the individual partner to be more receptive to his audit client's interest.<sup>66</sup> The lead partner's compensation and career within his firm depend on the

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<sup>61</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (301).

<sup>62</sup> See above, under III.1.b.

<sup>63</sup> See above, under III.1.c.

<sup>64</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1171/1172). – It should be mentioned that German audit firms typically are incorporated. Therefore personal liability of members of the firm is no issue at all.

<sup>65</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (292); *John F. Olson*, Looking beyond the Efficient Markets Hypothesis: A comment on Professor Macey's Post-Enron Analysis, *Cornell Law Review*, Vol. 89: 527 (528/529).

<sup>66</sup> *Jonathan R. Macey*, Efficient Capital Markets, Corporate Disclosure, and Enron, *Cornell Law Review*, Vol. 89: p. 394 (409).

revenue generated with this one client. As a result the lead partner might choose to risk the own firm's reputation for the benefit of consulting and audit fees with the client.<sup>67</sup> Since the internal monitoring systems of the big audit firms in the late 1990's relied for the most part on the cooperation of the partners,<sup>68</sup> the lead partner were able to pursue their own interest without being constrained by the firm.<sup>69</sup>

## **2. Management compensation**

Equity-based compensation for members of the management is aimed to strengthen the management's focus on shareholder interests.<sup>70</sup> Nevertheless, Enron exemplifies the weaknesses of compensating manager by means of stock options.

Management compensation by means of equity instruments is intended to make managers more sensitive to their firm's market price.<sup>71</sup> During the late 1990's the strong growth of the Capital Markets and the accompanying media attention reinforced this impact of equity-based compensation. As a result, the management's focus shifted from

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<sup>67</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1172); *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (301).

<sup>68</sup> *Jonathan R. Macey*, Efficient Capital Markets, Corporate Disclosure, and Enron, *Cornell Law Review*, Vol. 89: p. 394 (410).

<sup>69</sup> Cf. the colorful description of Enron auditor Arthur Andersen and its lead partner by *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1179-1181), showing the weakness of Arthur Andersen's control system. In the Enron case Arthur Andersen's quality control officer was overruled and replaced after warning of Enron's accounting practices; see *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (302).

<sup>70</sup> See above, under II.2.

<sup>71</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, *Cornell Law Review*, Vol. 89: p. 269 (275); *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, *Gonzaga Law Review*, Volume 38: p. 535 (537/538).

the relationship between the firm's market price and break-up value as a measure of "fair value" to the likely future performance of their firm's stock in the short run.<sup>72</sup> This is especially true with respect to stock options. These instruments allow taking advantage of a rising stock price without any financial risk even if the stock price should drop (again). The structure of stock options therefore encourages managers to take greater risk to inflate the company's stock price.<sup>73</sup> In addition, due to relaxed holding requirements for the stock received on exercise of the stock options,<sup>74</sup> most executives were free to sell the underlying stock on the same day. Thus, they were able to exploit even daily gains in the firm's share price.<sup>75</sup>

The accounting treatment of stock options amplified this development. Most companies, limited to pay a fixed salary of max. \$ 1 million p.a. to the top executives by tax law,<sup>76</sup> decided to compensate their executives by granting stock options.<sup>77</sup> Since such

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<sup>72</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (275/276).

<sup>73</sup> *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (275).

<sup>74</sup> In 1991, the SEC relaxed the holding period requirement under § 16 (b) of Securities Act of 1934 - executives could tack holding period of the stock option to holding period of the underlying shares; see SEC Exchange Act Release No. 34-28869, Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 56 Fed. Reg. 7242, amending Rule 16b-3 (amendment explained under IV.B.2.); *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (276).

<sup>75</sup> Cf. *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (276).

<sup>76</sup> § 162 (m) IRC allows max. \$ 1 million p.a. for CEO or one of the four highest paid executives as deductible expenses; see *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (274); for details *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, Gonzaga Law Review, Volume 38: p. 535 (543/544).

<sup>77</sup> See *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, Gonzaga Law Review, Volume 38: p. 535 (539).

type of performance-based remuneration does not guarantee any benefits, typically, the number of stock options granted included additional options for the inherent risk in performance-based compensation not to get anything at all. There was no market force stopping the companies from doing so. The additional stock options did not show up in the financial statements,<sup>78</sup> and therefore were a kind of remuneration without a payee.<sup>79</sup> This might explain the excessive compensation some executives received during the late 1990's.<sup>80</sup> Being paid in such amounts, executives were encouraged to inflate the stock price (e.g. by means of questionable accounting) and then leave.<sup>81</sup> Two or three years worth of compensation enabled them to live "comfortable" for the rest of their life.

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<sup>78</sup> See above, under II.2.a. A change in the accounting treatment proposed by the Financial Accounting Standards Board (FASB) in 1993 failed due to lobbying of the industry; cf. *Matthew A. Melone, Art Compensatory Stock Options worth reforming?*, *Gonzaga Law Review*, Volume 38: p. 535 (555/556).

<sup>79</sup> This for sure is not true. The current shareholders get diluted by distributing new or treasury shares below fair market value – they are paying the price for compensating with stock options.

<sup>80</sup> Top five for 1999: Robert Annunziata (Global Crossing Ltd.) \$ 193,784,118; Joseph Nacchio (Qwest Communication Intl., Inc.) \$ 172,205,151; Dennis Kozlowski (Tyco International) \$ 138,331,617; Thomas Siebel (Siebel Systems) \$ 134,437,170; and Michael Jeffries (Abercrombie & Fitch) \$ 124,513,616. Top five for 2000: Steven Jobs (Apple Computer) \$ 690,347,363; Thomas Siebel (Siebel Systems) \$ 293,097,323; Rowland Landon (Kansas City Southern Inds.) \$ 245,016,942; Sanford Weill (Citigroup Inc.) \$ 230,033,668; and Dennis Kozlowski (Tyco International) \$ 139,494,530. For more detailed numbers on total compensation received cf. *Rajesh Aggarwal, Executive Compensation and Corporate Controversy*, *Vermont Law Review*, Vol. 27: p. 849 (859, 866); *Michael B. Dorff, Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, *Buffalo Law Review*, Vol. 51: 811 (821-826).

<sup>81</sup> *John C. Coffee, Jr., What caused Enron? A capsule social and economic history of the 1990s*, *Cornell Law Review*, Vol. 89: p. 269 (276/277).

## **IV. HOW DID LEGISLATION REACT?**

### **1. U.S. legislation - Sarbanes-Oxley Act**

The “Public Company Accounting Reform and Investors Protection Act of 2002” (“Sarbanes-Oxley Act”)<sup>82</sup> passed Congress by nearly unanimous votes and was signed into law by the President on July 30, 2002. The Sarbanes Oxley Act has to be understood as the immediate response to the corporate accounting scandals of Enron and WorldCom in 2001 and 2002. To address the problems legislation, besides addressing special issues which had become evident in these corporate failures, focused on regulating the accounting profession.<sup>83</sup>

#### **a. Rules with respect to auditors**

##### **i. Creation of Public Company Accounting Oversight Board**

In a decisive first step, the Sarbanes Oxley Act created a self-regulatory body, the “Public Company Accounting Oversight Board” (PCAOB), to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.<sup>84</sup> Although the PCAOB is a private body, established as a non-profit corporation, it is subject to SEC oversight.<sup>85</sup> The five members

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<sup>82</sup> Pub. L. No. 107-204, 116 Stat. 745.

<sup>83</sup> See *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002.; *John C. Coffee, Jr.*, What caused Enron? A capsule social and economic history of the 1990s, Cornell Law Review, Vol. 89: p. 269 (303/304).

<sup>84</sup> Cf. § 101 (a) of Sarbanes-Oxley Act.

<sup>85</sup> § 107 of Sarbanes-Oxley Act.

of the PCAOB are appointed by the SEC for five-year terms.<sup>86</sup> Only two certified public accountants are allowed to serve as members of the board;<sup>87</sup> this limitation shall prevent the “capture” of the PCAOB by the accounting profession.<sup>88</sup> The PCAOB is funded by a so-called Annual Accounting Support Fee paid by the issuers as well as registration and annual fees charged to accounting firms.<sup>89</sup>

The Sarbanes-Oxley Act “transfers” the auditor profession into a new world of regulation and interference.<sup>90</sup> All accounting firms that prepare audit reports for an issuer, the securities of which are registered under Securities Act of 1934 or which has filed a Registration under Securities Act 1933,<sup>91</sup> must register with the PCAOB,<sup>92</sup> and are subject to inspections by the PCAOB.<sup>93</sup> As a standard setter the PCAOP shall establish or adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports.<sup>94</sup>

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<sup>86</sup> See § 101 (e)(1), (e)(4)(A) and (e)(5) of Sarbanes-Oxley Act.

<sup>87</sup> § 101 (e)(2) of Sarbanes-Oxley Act.

<sup>88</sup> *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.A.

<sup>89</sup> Cf. §§ 102 (f), 109 (c)(1), (d) of Sarbanes-Oxley Act.

<sup>90</sup> *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1183).

<sup>91</sup> See definition of “issuer” for details, § 2 (a)(7) of Sarbanes-Oxley Act.

<sup>92</sup> §§ 101 (c)(1), 102 (a) of Sarbanes-Oxley Act.

<sup>93</sup> §§ 101 (c)(3), 104 (a) of Sarbanes-Oxley Act.

<sup>94</sup> §§ 101 (c)(2), 103 (a) of Sarbanes-Oxley Act.

Under this power, delegated by the Congress to the PCAOB,<sup>95</sup> the board shall set auditing standards providing for<sup>96</sup> the preparation and maintenance of audit work papers, second partner review and approval within the audit firms, as well as detailed description in the audit report of the auditor's testing of the internal control structure of the issuer.<sup>97</sup> Quality control standards with respect to registered public accounting firms shall for example, relate to the monitoring of professional ethics and independence from issuers.<sup>98</sup>

## **ii. Treatment of non-audit services**

Enron demonstrated that consulting relationships can contribute to audit failures.<sup>99</sup> Consequently, the Sarbanes-Oxley Act prohibits auditors from providing consulting services. Several types of non-audit services defined in a list in § 201 (a) of the Act (e.g. bookkeeping, financial information systems design and implementation, appraisal or valuation services, management functions, legal services and expert services unrelated to the audit) are impermissible.<sup>100</sup>

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<sup>95</sup> Critical regarding this approach: *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, *Villanova Law Review*, Vol. 48: p. 1023 (1026), "The Delegation Gamble".

<sup>96</sup> For details see § 103 (a)(2)(A) of Sarbanes-Oxley Act; *Jonathan R. Macey/Hillary A. Sale*, Observations on the role of commodification, independence, and governance in the accounting industry, *Villanova Law Review*, Vol. 48: p. 1167 (1184).

<sup>97</sup> According to § 404 of the Sarbanes-Oxley Act the issuers have to implement internal control structure and procedures for financial reporting. *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, *Villanova Law Review*, Vol. 48: p. 1023 (1028), points out that Sarbanes-Oxley Act does not provide for new rules with respect to the audit practice itself (i.e. what should be tolerated by audit partners and what are sanctions for departures from GAAP). This might be a next step for the PCAOB in exercising its power to establish or adopt other standards under § 103 (a)(2)(B)(vii), (3)(A)(i) of Sarbanes-Oxley Act.

<sup>98</sup> For details cf. § 103 (a)(2)(B) of Sarbanes-Oxley Act.

<sup>99</sup> See above, under III.1.a.

<sup>100</sup> The list basically carries over SEC regulations instead of barring all non-audit services; see *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, *Villanova Law Review*, Vol. 48: p. 1023 (1031).

All other non-audit services require a “preapproval”.<sup>101</sup> The activity must be approved in advance by the audit committee of the issuer,<sup>102</sup> in accordance with the preapproval requirements defined in § 202 of the Sarbanes-Oxley Act. In effect, this might prevent audit clients to contract their auditor for non-audit services. The pre-approval process is time consuming. Since the non-audit services provided by the remaining big accounting firms are substitutable, the management might choose to get the services from one of the competitors. In addition, new shareholder activism by institutional investors might pressure audit committees not to approve non-audit services by the auditor.<sup>103</sup>

Tax services are explicitly allowed as long as approved in advance.<sup>104</sup> This provision might be a result of the lobbying power of the audit firms<sup>105</sup> to secure an important source of revenue,<sup>106</sup> but still seems justified due to the close link of tax issues

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<sup>101</sup> Please note the “de minimus” exception in new § 10A (i) of Securities Act of 1934, as amended by § 202 of Sarbanes-Oxley Act.

<sup>102</sup> The audit committee must be composed entirely of independent board members, cf. § 301 of Sarbanes-Oxley Act. For more details see *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.C.1.

<sup>103</sup> Cf. *Deborah Brewster*, Calpers to oppose Citigroup’s Prince, Financial Times, 04/12/2004: the U.S. pension fund Calpers will vote against Citigroup’s CEO Prince and Chairman Weill (as well as Coca-Cola’s Warren Buffet), because of being members of the audit committee that had authorized the auditor to perform non-audit services.

<sup>104</sup> See new § 10A (h) of Securities Act of 1934 as amended by § 201 of Sarbanes-Oxley Act.

<sup>105</sup> See *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, Villanova Law Review, Vol. 48: p. 1023 (1033/1034), describing the industry’s lobbying efforts and power with respect to the nomination of PCAOB chair.

<sup>106</sup> *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.B.2.

and financial accounting. However, the fact that audit firms can continue to provide tax services to their audit clients might prove wrong in the future. With respect to tax structures provided by the auditor's accounting firm, the auditor might face the same independence issues as with respect to IT-implementations or other services no longer allowed.<sup>107</sup> Furthermore, it seems questionable whether the PCAOB has the power to include tax services in the list of prohibited services.<sup>108</sup> The explicit referral to tax services in the new § 10A (h) of Securities Act of 1934<sup>109</sup> can be understood as a congressional override of the Board's power. Even if the PCAOB still holds the power to prohibit tax services, an actual attempt might fail due to the audit firms' lobbying power.<sup>110</sup>

### **iii. Audit partner rotation**

Enron's failure demonstrated that the client-auditor relationship in case of big national or multinational clients is similar to a "one-client" practice. In response to this problem, the Sarbanes-Oxley Act requires auditors to rotate the lead audit partner at least every five years.<sup>111</sup>

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<sup>107</sup> The SEC's final rule 33-8183: Strengthening the Commission's Requirements Regarding Auditor Independence, under II.B.11., tries to respond to this by banning tax services focused on tax avoidance.

<sup>108</sup> Cf. new § 10A (g)(9) of the Securities Act of 1934 ("any other service that the Board determines").

<sup>109</sup> As amended by § 201 of Sarbanes-Oxley Act.

<sup>110</sup> See *William W. Bratton*, *Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents*, *Villanova Law Review*, Vol. 48: p. 1023 (1033/1034).

<sup>111</sup> § 203 of Sarbanes-Oxley Act.

Congress stopped short of mandating audit firm rotation.<sup>112</sup> Under this alternative approach a particular accounting firm may be auditor for a particular issuer only for a limited time period.<sup>113</sup> Nevertheless, the Sarbanes-Oxley Act calls for a study and a report by the Comptroller General on the potential effects of requiring a mandatory rotation of public accounting firms.<sup>114</sup> This might lead to new legislation in the future. It should be noted, however, that in 2002 the time for implementation of these rules might have been better. Today, the accounting industry is gaining influence in Washington again.<sup>115</sup>

#### **iv. No “revolving door” between audit firms and their clients**

The Sarbanes-Oxley Act seeks to close the “revolving door”<sup>116</sup> between audit firms and their clients. Many of the employees of Enron had been employees of Arthur Andersen before. This personal connection which might jeopardize the independence of the audit firm shall no longer be allowed at least on top executive level. Accordingly, audit firms are banned from auditing if the CEO, CFO, Chief accounting officer or an equivalent person was in the past year employee of the accounting firm.<sup>117</sup>

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<sup>112</sup> *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.B.3.

<sup>113</sup> See definition in § 207 (c) of Sarbanes-Oxley Act.

<sup>114</sup> § 207 (a), (b) of Sarbanes-Oxley Act.

<sup>115</sup> Cf. *William W. Bratton*, Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents, Villanova Law Review, Vol. 48: p. 1023 (1033/1034).

<sup>116</sup> *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.B.3.

<sup>117</sup> § 206 of Sarbanes-Oxley Act.

## **b. Management compensation**

Despite the fact that management compensation can be understood as one of the reasons for the corporate failures in 2001/2002,<sup>118</sup> the Sarbanes-Oxley Act does not address the issue of equity or other types of management compensation directly. Only in the context of financial accounting and disclosure rules management compensation is targeted: if a company is required to prepare an accounting restatement due to the material noncompliance with any financial reporting requirement under the securities laws the CEO and CFO of the issuer shall reimburse the company for any incentive- or equity based compensation received during the 12 months following the filing.<sup>119</sup> Changes of stock ownership of officers and directors (e.g. sales of stock received after exercise of stock options) have to be reported within two business days.<sup>120</sup> Furthermore, § 402 (a) of Sarbanes-Oxley Act bars companies from directly or indirectly taking out loans to executives. As a consequence, companies are no longer able to lend executives funds needed to tender the exercise price of stock options to the issuing corporation.<sup>121</sup>

## **c. Post-Sarbanes-Oxley Act development**

On March 31, 2004 the Financial Accounting Standards Board (FASB) published a Proposal on Equity-Based Compensation (Exposure Draft) as an amendment of FASB Statements No. 123 and 95.<sup>122</sup> Under the proposal all forms of share-based payments to

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<sup>118</sup> See above, under III.2.

<sup>119</sup> § 304 of Sarbanes-Oxley Act. For further information see *John C. Coffee, Jr.*, A brief tour of the major reforms in the Sarbanes-Oxley Act, ALI – American Bar Association Continuing Legal Education, Dec. 5, 2002, under II.C.3.

<sup>120</sup> § 403 of Sarbanes-Oxley Act.

<sup>121</sup> See *Matthew A. Melone*, Art Compensatory Stock Options worth reforming?, *Gonzaga Law Review*, Volume 38: p. 535 (540).

<sup>122</sup> Download available at <http://www.fasb.org>.

employees (including stock options) would be treated the same, triggering compensation expenses in the income statement over vesting period measured at fair value<sup>123</sup> at grant date.<sup>124</sup> The proposal resulted from the FASB's approach to achieve substantial convergence in this area between the U.S. GAAP and International Accounting Standards (IAS).<sup>125</sup>

## **2. German and European legislation**

### **a. Rules with respect to auditors**

The auditor under German law is understood as gatekeeper assuring the interest of the investing public as well as assistant for the supervisory board in its internal control of the management.<sup>126</sup> These two functions require the same independence of the auditor crucial under the U.S. approach.<sup>127</sup> Under German corporate law it is the supervisory board which acts on behalf of the corporation with respect to the auditor. This relationship could be undermined by the management board employing the audit firm to provide consulting services.<sup>128</sup> Accordingly, German legislation after Enron focused on this issue.

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<sup>123</sup> Exposure Draft, paragraph 6 and Appendix B, favor a mathematical model (Binomial Lattice) over the alternative Black-Scholes-Merton formula. This immediately drew criticism for two reasons: first, the binominal approach would be unworkable because too complex, and second, the all companies which already expense options apply the Black-Scholes-Merton formula; see *Dan Roberts/Joshua Chaffin*, FASB unveils options proposal, *Financial Times*, 03/31/2004; more detailed with respect to valuation: *Roberto Medoza/Robert Merton/Peter Hancock*, A simple way to value stock options, *Financial Times*, 04/01/2004.

<sup>124</sup> Exposure Draft, paragraph 1, 5. The proposed statement eliminates the alternative of continuing to account for share-based payment arrangements with employees under APB No. 25.

<sup>125</sup> Exposure Draft, paragraph 2. See also *Adrian Michaels/Andrew Parker*, Lobbyist stick to their guns over options plan, *Financial Times*, 03/31/2004.

<sup>126</sup> See above, under II.1.b.

<sup>127</sup> *Peter Hommelhoff/Daniela Mattheus*, Die Rolle des Abschlussprüfers bei der Corporate Governance, in *Handbuch Corporate Governance*, 2003: p. 639 (652/553).

<sup>128</sup> See above, under III.1.a.

## **i. German legislation**

### *(1) Treatment of non-audit services*

German rules of auditor independence are based on the understanding that no auditor shall be allowed to audit its own services provided to the issuer (so-called “Selbstpruefungsverbot”).<sup>129</sup> However, consulting services at present are permissible as long as the final decision over several alternatives presented to the client by the audit firm is up to the client.<sup>130</sup> Of decisive influence is if there are reasons for the concern that the auditor is biased.<sup>131</sup>

Looking back at Enron, WorldCom and similar failures in Germany (e.g. Flowtex), this general approach no longer seems appropriate. Thus, new legislation has been proposed incorporating a list of prohibited services into the German Commercial Code (“Handelsgesetzbuch” – HGB).<sup>132</sup> The services disqualified recall § 201 of Sarbanes-Oxley Act. Internal audit outsourcing services, management or financial services, actuarial and valuation services<sup>133</sup> as well as financial information system

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<sup>129</sup> Besides this persons having a financial interest in the issuer or a personal relationship (e.g. board member or employee of the issuer or an affiliate) are banned from providing audit services, cf. § 319 (2) No. 1-4 HGB.

<sup>130</sup> Cf. § 319 (2) No. 5 HGB; Federal High Court (“Bundesgerichtshof” – BGH), 04/21/1997, BGHZ 135, 260; BGH 11/25/2002, DB 2003, 383. See also *Karl Ernst Knorr/Christoph Huelsmann, Zur Staerkung der Rolle des Abschlusspruefers*, NZG 2003, 567 (569); *Kurt Kiethel, Der Befangene Abschlusspruefer – Schadenersatz bei Interessenkollision?*, NZG 2003, 937.

<sup>131</sup> See § 318 (3) HGB.

<sup>132</sup> Proposed Accounting Law Reform Act (“Bilanzrechtsreformgesetz” – BilRegG), 12/15/2003, with reasons for Government proposal, available at <http://www.bmj.bund.de>. The proposed BilRegG has been amended by German Cabinet decision, dated 04/21/2004 – the new version is available at <http://www.bmj.bund.de>.

<sup>133</sup> See new § 319 (3) No. 3 b-d) HGB, as amended by proposed BilReG, 12/15/2003.

design and implementation<sup>134</sup> are no longer allowed. Furthermore, the proposed law prohibits legal and tax services if these services go further than merely present alternatives, and inevitably<sup>135</sup> generate a different presentation of the financial statement in question which is not insignificant.<sup>136</sup> In addition, § 319 (2) HGB provides for the general rule that an auditor is prohibited from providing audit services if concerns exist that the auditor due to her business, financial or personal relationship might be biased. This might be the case if the fees of consulting services exceed the audit fees or executives of the issuer are former employees of the audit firm.<sup>137</sup>

These changes resemble the rules implemented by the Sarbanes-Oxley Act. The German government proposed these changes and determined the prohibited services with the U.S. rules in mind.<sup>138</sup> Nevertheless, there are some differences. Legal services are only prohibited if the services provided result in a different presentation of the financial statement. This leaves room for legal services which German accounting firms are

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<sup>134</sup> § 319a (1) No. 3 HGB, as amended by proposed BilReG, 12/15/2003, and German Cabinet decision, date 04/21/2004.

<sup>135</sup> New § 319a (1) No. 2 HGB as amended by proposed BilReG, 12/15/2003, and German Cabinet decision, date 04/21/2004, uses the word “unmittelbar” (directly). However, Reasons of German Cabinet decision, 04/21/2004, p. 89, state that the effect of the proposed tax structure on the financial statements has to be inevitable.

<sup>136</sup> § 319a (1) No. 2 HGB, as amended by proposed BilReG, 12/15/2003, and German Cabinet decision, date 04/21/2004, reads as follows: “Ein Wirtschaftsprüfer ist ... von der Abschlussprüfung eines Unternehmens ... ausgeschlossen, wenn er ... 2. in dem zu prüfenden Geschäftsjahr über die Prüfungstätigkeit hinaus Rechts- oder Steuerberatungsleistungen erbracht hat, die über das Aufzeigen von Gestaltungsalternativen hinausgehen und die sich auf die Darstellung der Vermögens-, Finanz- und Ertragslage in dem zu prüfenden Jahresabschluss unmittelbar und nicht nur unwesentlich auswirken.”

<sup>137</sup> Cf. Reasons, Government proposal of BilReG, 12/15/2003, p. 44. See also proposed § 285 No. 17 HGB requiring disclosure of the ratio of consulting fees to audit fees. The proposed BilReG does not provide for a “revolving door” rule (see above, under IV.1.a.iv.); according to Reasons, Government proposal of BilReG, 12/15/2003, p. 48, this issue might be addressed in the German Corporate Governance Codex.

<sup>138</sup> See Reasons, Government proposal of BilReG, 12/15/2003, p. 16/17.

generally allowed to provide if in connection with tax or similar services. On the other hand, the same restrictions apply to tax services. The more restrictive approach with respect to tax services<sup>139</sup> seems reasonable given the fact that tax services are strongly related to accounting issues and therefore tax structures might determine the accounting treatment by the client.<sup>140</sup>

The proposed legislation does not require a preapproval of an audit committee or the supervisory board for non-audit services provided by the auditor. It is the Government's understanding that German corporate law provides for sufficient instruments to deal with this issue.<sup>141</sup> The supervisory board itself under § 111 (4) AktG can define certain transactions to require the approval of the supervisory board. Since the supervisory board relies on the auditors support in its control of the management board, it might be in the supervisory board's best interest to establish this approval requirement for non-audit services.<sup>142</sup>

## *(2) Audit partner rotation*

Already part of German law is § 319 (3) No. 6 HGB which disqualifies an auditor who certified the financial statement of the issuer more than six times in the last ten

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<sup>139</sup> This approach seems in line with the SEC's final rule 33-8183: Strengthening the Commission's Requirements Regarding Auditor Independence, under II.B.11.; cf. Reasons, Government proposal of BilReG, 12/15/2003, p. 51.

<sup>140</sup> This is especially true under German tax law. Under so-called "Massgeblichkeitsprinzip" tax accounting generally follows financial accounting (cf. § 5 (1) German Income Tax Act). To receive certain benefits under tax law the taxpayer has to account for the transactions in the financial statement correspondingly.

<sup>141</sup> Reasons, Government proposal of BilReG, 12/15/2003, p. 17, mentioning 7.2.1 of the German Corporate Governance Codex as well as § 111 (4) AktG.

<sup>142</sup> Reasons, Government proposal of BilReG, 12/15/2003, p. 17.

years. The proposed § 319a (1) No. 5 HGB clarifies this provision by banning lead partners (and not audit firms) who have taken part in the audit in the last five years.<sup>143</sup>

### *(3) Implementation of new supervision body for financial disclosure*

According to a bill proposed by the German government, a two step supervision of the financial disclosure of listed companies shall be implemented.<sup>144</sup> First, a private body, the so-called German Audit-organization for Accounting (“Deutsche Pruefstelle fuer Rechnungslegung”) established in accordance with proposed § 342b HGB, will independently audit financial statements of publicly listed companies. In a second step, the Federal Institute of Control of Financial Services (“Bundesanstalt fuer Finanzdienstleistungsaufsicht”) might enforce the applicable accounting standards if the issuer does not comply. By means of this two-step approach, an enforcement body similar to the SEC shall be implemented.<sup>145</sup>

## **ii. German Corporate Governance Code**

The German Corporate Governance Code (Code) presents essential statutory regulations for the management and supervision of German listed companies.<sup>146</sup> First issued in 2002<sup>147</sup>, it is reviewed annually; the current version dates 05/21/2003. It

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<sup>143</sup> The Government proposal of BilReG, 12/15/2003, provided for a seven year period, cf. Reasons, Government proposal of BilReG, 12/15/2003, p. 53. The German Cabinet decision, 04/21/2004, amended this proposed § 319a (1) No. 5 HGB, requiring audit partner rotation after five years. This is in line with European legislation; cf. Reasons of German Cabinet decision, 04/21/2004, p. 91, and IV.2.a.iii.

<sup>144</sup> Proposed Financial Statement Control Act (“Bilanzkontrollgesetz” – BilKoG), 12/08/2003, with reasons for Government proposal, available at <http://www.bmj.bund.de>.

<sup>145</sup> Reasons, Government proposal of BilKoG, 12/08/2003, under A.I. (p. 18).

<sup>146</sup> See <http://www.corporate-governance-code.de> for English version of the Code.

<sup>147</sup> The Code was developed based on a decision of the German government, dated 09/06/2001, to meet international standards of Corporate Governance. The governmental decision resulted out of the findings of the Governmental Commission Corporate Governance, which in 2000/2001 recommended the development of a Corporate Governance Code. The Code has to be understood as an attempt to achieve international

contains recommendations marked in the text by use of the word “shall” and suggestions for which the Code uses terms such as “should” or “can”. According to § 161 AktG companies are obliged to disclose annually whether they comply with or deviate from the recommendations of the Code (“comply or explain”).<sup>148</sup>

According to 5.3.2 of the Code, the supervisory board shall set up an Audit Committee which handles issues of accounting and risk management, the necessary independence required of the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement.<sup>149</sup> However, this Audit Committee differs from an Audit Committee under the Sarbanes Oxley Act in one important matter: the members of the Audit Committee do not have to be independent board members. The Code only states, that the Chairman of the Audit Committee “should” not be a former member of the Management Board of the Company.<sup>150</sup> With respect to the Audit Committee’s control of the auditor’s independence, the Code requires the Committee to obtain a statement from the proposed auditor stating whether any professional, financial and other relationship (e.g. consulting services provided)

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convergence to attract international investors. However, the failure of Enron has contributed to some of the provisions of the Code. See for more details of the Code’s history *Axel von Werder/Henrik-Michael Ringleb*, in Ringleb/Kremer/Lutter/von Werder, Deutscher Corporate Governance Kodex, Foreword, para. 1-33.

<sup>148</sup> German Corporate Governance Code, Foreword; see also *Henrik-Michael Ringleb*, in Ringleb/Kremer/Lutter/von Werder, Deutscher Corporate Governance Kodex, Foreword, para. 39.

<sup>149</sup> If no Audit Committee is set up these obligations are within the power of the supervisory board, cf. § 111 (2) AktG.

<sup>150</sup> Current members of the management board cannot be members of the supervisory board, cf. § 100 (2) AktG.

exists between auditor and enterprise.<sup>151</sup> This shall entitle the Audit Committee to make an informed decision whether or not to mandate the auditor.

### **iii. European legislation**

A new Directive on statutory audit in the EU has been proposed by the European Commission.<sup>152</sup> The statutory auditors are understood as the major defense against fraud. Accordingly, the proposed Directive is intended to clarify the duties of the auditors and to set out certain ethical principles to ensure the auditors' objectivity and independence.<sup>153</sup>

The proposed Directive deals with a broad variety of measures. It requires an Audit Committee<sup>154</sup>, the disclosure of fees paid to the statutory auditor or audit firm for the statutory audit and the fees for other assurance services, tax advisory services and other non-audit services,<sup>155</sup> and to implement a "revolving door" rule.<sup>156</sup> Besides this, the proposed Directive focuses on audit rotation and Corporate Governance of the audit firms. Art. 40 (c) of the proposed Directive obliges the Member States to ensure that the statutory auditor/key audit partner shall rotate within max. five years, or alternatively, the audit firm shall rotate within a maximum period of seven years. The Directive stops short

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<sup>151</sup> See 7.2.1 of the Code. Cf. *Thomas Kremer*, in Ringleb/Kremer/Lutter/von Werder, *Deutscher Corporate Governance Kodex*, 7.2.1 of the Code, para. 942-944.

<sup>152</sup> Proposed "Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts" (proposed Directive), dated 03/16/04., text under [http://europa.eu.int/comm/internal\\_market/auditing/officialdocs\\_en.htm](http://europa.eu.int/comm/internal_market/auditing/officialdocs_en.htm).

<sup>153</sup> European Commission, Press Release IP/04/340, 04/16/2004.

<sup>154</sup> See Art. 39 of proposed Directive, requiring at least one independent member with competence in accounting and/or auditing.

<sup>155</sup> Cf. Art. 50 of proposed Directive.

<sup>156</sup> See Art. 40 (d) of proposed Directive, disallowing the key audit partner to take up a key management position with the audit client within two years of resigning from the audit engagement.

of requiring mandatory audit firm rotation. According to Art. 38 (1) of the proposed Directive, the Member States shall ensure that auditors of “public interest entities” (e.g. listed companies)<sup>157</sup> publish on their website an annual transparency report including (1) the legal structure and ownership, description of network, (2) the governance structure of the audit firm, (3) the internal quality control system, (4) a statement about the audit firm’s independence practices, and (5) information on the basis of the partner remuneration. This focus on transparency of the audit firms appears to be the right approach to establish independent auditors. The disclosure requirements allow the investing public to assess the business model of the audit firm. This might lead to competition between the audit firms based on “good” Corporate Governance justifying higher audit fees.

## **b. Management compensation**

Equity-based management compensation in Germany is subject to restrictions.<sup>158</sup> The Stock Corporation Act requires performance criteria for stock options as well as an “appropriate” overall compensation of the members of the management board. However, new limitations have been implemented.

## **i. German Corporate Governance Code**

According to 4.2.3 of the German Corporate Governance Code,<sup>159</sup> as amended by the revision of May 21, 2003, the overall compensation of members of the management board shall comprise fixed and variable components. The new wording of the provision

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<sup>157</sup> See Art. 2 (11) of the proposed Directive.

<sup>158</sup> See above, under II.2.b.

<sup>159</sup> The Code’s approach is a “comply or explain” one, see under IV.2.a.ii.

explicitly states that the compensation components must be appropriate, both individually and in total. A new focus is noticeable by identifying company stock with multi-year block period as the first of several examples for variable compensation components with long-term incentive effect and risk elements.<sup>160</sup> This new recommendation is in line with the observations of the past corporate failures. Compensating with stock will not create the same problem as stock options which allow taking advantage of a rising stock price without any financial risk if the stock price should drop, thereby encouraging risky behavior.<sup>161</sup> Furthermore, stock options and comparable instruments shall be related to “demanding, relevant comparison parameters”. For extraordinary, unforeseen developments a cap (limitation of the max. benefit) shall be agreed for by the supervisory board.<sup>162</sup> These new recommendations are not mandatory. Nevertheless, companies which do not comply with these rules have to disclose the non-compliance to the market.

## **ii. IAS-accounting rules**

The International Accounting Standards Board (IASB) on February 19, 2004 issued International Financial Reporting Standard 2 “Share-based Payment” (IFRS 2) on accounting for share-based payment transactions, including the grant of stock options to employees.<sup>163</sup> The IASB, explicitly mentioning the past major corporate failures, with this new standard wants to address the fact that investors might be misled by the

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<sup>160</sup> The first version of the Code named stock options first and did not mention stock with block periods at all.

<sup>161</sup> See above, under III.2.

<sup>162</sup> Para. 4.2.3 of the Code.

<sup>163</sup> See IASB Press Release, 02/19/2004, available at <http://www.iasb.org>.

understatement of expenses in case of equity remuneration.<sup>164</sup> No matter what form of compensation is paid, companies' financial statements shall reflect the same effects on profit or loss. Accordingly, IFRS 2 requires the company to expense for stock option transactions in its financial statements based on the fair value of the stock options measured at grant date. These rules are applicable for consolidated financial statements of German companies starting in 2005.<sup>165</sup>

## **V. WHAT COULD BE DONE?**

After Enron, U.S. and German legislation reacted similarly, focusing on auditors' independence by enacting new rules such as rotation of partners within the audit firm and limitation of non-audit services. With respect to management compensation there was less activity. From a German perspective that might be understandable since limitations were already in place. However, regarding the accounting treatment an initiative by the international standard setters (IASB and FASB) was necessary to solve the problem of inadequate recognition in the financial statements.

Considering the reasons of Enron's failure the results already achieved might not be sufficient. A first step towards auditor independence could be stricter enforcement of the existing rules by the regulators.<sup>166</sup> Since the Enron-debacle there is evidence of

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<sup>164</sup> Cf. IASB Press Release, 02/19/2004, citing IASB Chairman Sir David Tweedie.

<sup>165</sup> See new § 315a HGB, as proposed by BilReG, requiring listed companies to prepare their consolidated financial statements in accordance with international accounting standards; cf. also Reasons, Government proposal of BilReG, 12/15/2003, p. 3.

<sup>166</sup> The implementation of a new two-step supervision by German legislation ("Bilanzkontrollgesetz" – BilKoG), 12/08/2003, is based on this approach; see above, under IV.2.a.i.(3).

tougher action by the SEC.<sup>167</sup> The following part will consider other possible improvements.

## **1. Auditor independence**

### **a. Audit firm rotation**

Both U.S. and German law provide for a mandatory rotation of the audit partner responsible for the client within the audit firm.<sup>168</sup> However, neither the Sarbanes-Oxley Act nor the current German legislation take the next step to require mandatory audit firm rotation. The U.S. legislator mandated the PCAOB present a report on this issue,<sup>169</sup> thereby enabling the accounting firms and their lobby to block such future development.<sup>170</sup> The same can be stated with respect to the proposed EU-Directive. Audit firm rotation is offered as an alternative to audit partner rotation, not as a mandatory rule.<sup>171</sup>

The decision by the U.S. legislation to defer audit firm rotation need not necessarily be wrong. Even if at first glance securing auditor independence by mandatory audit firm rotation seems convincing, the real goal of improving audit quality should be kept in

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<sup>167</sup> See for example *In the Matter of ERNST & YOUNG LLP*, 04/16/2004, download of the full text of the decision available at [www.ft.com](http://www.ft.com). The involvement of Ernst & Young with Peoplesoft, being the auditor of Peoplesoft and at the same time having a business agreement over software and consultancy, violated SEC independence rules for auditors. According to the decision Ernst & Young is banned from taking on new public audit clients in the U.S. for six months; Ernst & Young is not going to appeal the decision. For further information cf. *Adrian Michaels*, E&Y banned from taking new clients, *Financial Times*, 04/16/2004; *Adrian Michaels*, E&Y pays for past indiscretions, *Financial Times*, 04/17/2004.

<sup>168</sup> See above, under IV.1.a.iii. and IV.2.a.i.(2).

<sup>169</sup> Cf. § 207 of Sarbanes-Oxley Act.

<sup>170</sup> As noted above, the time for implementation of such rules has never been better than in 2002 – the accounting industry is gaining influence in Washington again; cf. *William W. Bratton*, *Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents*, *Villanova Law Review*, Vol. 48: p. 1023 (1033/1034).

<sup>171</sup> See Art. 40 (c) of proposed Directive.

mind. With respect to audit quality audit firm rotation is not automatically the best solution. Certainly, there are valuable arguments for audit firm rotation: an effective peer review by the incoming audit firm might discourage aggressive accounting practices; the limited audit period could prevent conflicts of interest arising from long-standing relationship; and the ongoing change might promote a more competitive market for audit firms.<sup>172</sup> Yet, the downsides have to be taken into account. There are significant start-up costs for both the auditor as well as the client (estimated at circa 20% by the accounting industry).<sup>173</sup> More important, the impact on audit quality might be negative. As indicated by recent research, mandatory audit firm rotation may lead to lower audit quality.<sup>174</sup> According to these research results the advantages of audit firm rotation are outweighed by the downsides of auditor change.<sup>175</sup> Changing audit firms increases the risk of an audit failure in the early years – the cumulative knowledge of the existing audit team is lost and the new auditors need to go up the learning curve.<sup>176</sup> Furthermore, the new auditor might

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<sup>172</sup> See *Thomas Healey*, The best safeguard against financial scandal, *Financial Times*, 03/12/2004.

<sup>173</sup> See *United States General Accounting Office*, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services: Public Accounting Firms – Required Study on the Potential Effects of Mandatory Audit Firm Rotation (GAO-report), November 2003, p. 6. However, it should be noted that the average audit fees represent approximately 0.04% of company operating expenses; cf. GAO-report, p. 7. A significant gain in reputation, lowering the costs of capital, therefore might more than outweigh the additional auditing costs.

<sup>174</sup> *James Myers/Linda A. Meyers/Thomas C. Omer*, Exploring the Term of Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?, June 2002, download available at <http://www.ssrn.com>. *James Myers/Linda A. Myers/Zoe-Vonna Palmrose/Susan Scholz*, Mandatory Auditor Rotation: Evidence from Restatements, July 8, 2003, download available at <http://www.ssrn.com>.

<sup>175</sup> *James Myers/Linda A. Meyers/Thomas C. Omer*, Exploring the Term of Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?, June 2002, p. 21/22. According to *James Myers/Linda A. Myers/Zoe-Vonna Palmrose/Susan Scholz*, Mandatory Auditor Rotation: Evidence from Restatements, July 8, 2003, p. 22, a greater percentage of companies misstate during the first five years of an auditor-client relationship than over longer auditor tenure (leaving open whether this result is triggered by the fact that young companies typically show a higher percentage of misstatements).

<sup>176</sup> GAO-report, p. 6; *Co-ordinating Group on Audit and Accounting Issues (CGAA)*, Final Report to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer, January 29, 2003, p. 26.

be less aggressive in the oversight of management early in an auditor-client relationship and might invest less time in the audit to recoup losses from the competitive practice of low-balling.<sup>177</sup> This is especially true, if the audit firms can no longer cross-finance the audit division with consulting fees generated with the new client.

The failure of Parmalat might add some new information to the discussion. Italy is the only country having long time experience with mandatory audit firm rotation.<sup>178</sup> Despite this fact, Parmalat's auditor Deloitte & Touche failed to assure proper accounting by the company. As has been pointed out before, Parmalat's Cayman Islands-based division, Bonlat Financing continued to be audited by Grant Thornton (the former auditor of the Parmalat group). Therefore, the new auditor is not to blame with the failure to detect the false documentation regarding the Bonlat accounts, which actually triggered the collapse of Parmalat.<sup>179</sup> However, according to a report prepared for Italian prosecutors, Deloitte's Italian office failed to apply basic accounting principles and verify "irregular" and "suspect" accounting entries.<sup>180</sup> In the case of arising problems, Deloitte Italy lobbied within the audit firm to assure certification by the non-Italian units of

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<sup>177</sup> See *James Myers/Linda A. Meyers/Thomas C. Omer*, Exploring the Term of Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?, June 2002, p. 5/6.

<sup>178</sup> Italy has required mandatory audit firm rotation of listed companies since 1975. Brazil enacted similar law in 1999, Austria in 2004; Spain has abandoned such rules for listed companies in 1995; cf. GAO-report, Appendix V.

<sup>179</sup> *Thomas Healey*, The best safeguard against financial scandal, *Financial Times*, 03/12/2004.

<sup>180</sup> Cf. *Fred Kapner*, Eight billion reasons to destroy Parmalat 'Account 999', *Financial Times* (print version), 04/12/04, p. 17.

Deloitte.<sup>181</sup> Audit firm rotation therefore might not necessarily secure an independent high quality audit. These observations are in line with Italian research on the impact of mandatory audit firm rotation.<sup>182</sup> This states that mandatory firm rotation shall have a negative effect on the quality of audit work during the first year of engagement as well as during the last three years of audit tenure.<sup>183</sup>

Another problem is worth mentioning. Any audit firm rotation rule might be in conflict with other independent requirements. Multinational clients in fact have only the choice between the four global accounting firms.<sup>184</sup> In case of a mandatory rotation they would be required to choose one of the other three firms remaining. If non-audit services are provided to the client by these audit firms, the audit firms might have to decide whether to take up the position as an auditor or to stick to their position as a provider of more lucrative consulting services. The obvious solution to this problem would be to

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<sup>181</sup> *Fred Kapner*, Parmalat investigators believe Italian branch of Deloitte ignored evidence, *Financial Times* (print version), 04/10/2004, p. 1; *Fred Kapner*, Eight billion reasons to destroy Parmalat 'Account 999', *Financial Times* (print version), 04/12/2004, p. 17.

<sup>182</sup> *Dalocchio/Vigano*, The Impact Of Mandatory Audit Rotation On Audit Quality And On Audit Pricing: The Case of Italy, SDA Università Bocconi, 2003 (Bocconi-study), cited after SEC's final rule 33-8183: Strengthening the Commission's Requirements Regarding Auditor Independence, Fn. 121. The study is not publicly available on the internet. GAO experienced difficulties to receive information about this study, too; cf. GAO-report, Appendix V "Italy".

<sup>183</sup> Cf. *Chew Ng*, Rotation of Auditors: History and Recent Developments, available at [www.unisi.it/eventi/3AHIC/programme.htm](http://www.unisi.it/eventi/3AHIC/programme.htm). The GAO-report points out that concerns have been raised by the Commissione Nazionale per le Società e la Borsa (CONSOB) about the study's methodology, accuracy, data used, and appropriateness of the conclusions: the GAO-report shares at least part of these concerns; cf. GAO-report, Appendix V "Italy".

<sup>184</sup> Cf. GAO-report, p. 7.

disallow audit firms to provide any non-audit services.<sup>185</sup> However, this would be a ban to do business, a measure questionable at least under German constitutional law.

In conclusion, the decision by the U.S. and German legislation to focus on audit partner rotation seems correct. Audit partner rotation might provide the same advantages as audit firm rotation (a “fresh look”) without the significant downsides of losing all of the audit firm’s knowledge of the client.

#### **b. Corporate Governance within the audit firms, especially compensation**

In the U.S. and in Germany, audit firms are understood as gatekeeper for the investing public ensuring full disclosure by the issuers. However, the audit firms themselves typically<sup>186</sup> are not required to fully disclose details of their financial results. The proposed EU-Directive might change this. The Member States shall ensure that auditors of “public interest entities” publish an annual transparency report including the legal structure and ownership, description of network, the governance structure of the audit firm, the internal quality control system, a statement about the audit firm’s independence practices, and information of the basis of the partner remuneration.<sup>187</sup> This might allow the audit firms to compete based on “better internal control”, or “better governance structure”. Hopefully, this will lead to a “race to the top” – thereby justifying higher audit fees necessary to refinance this investments by the audit firms.

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<sup>185</sup> Such a rule would be favorable for law firms and other consulting business. Lobbying therefore might be driven by economic interests on both sides of the discussion.

<sup>186</sup> The German divisions of the final four audit firms are incorporated. Therefore the general disclosure rules for corporations (i.e. §§ 264-289 HGB) apply to these firms.

<sup>187</sup> See above, under IV.2.a.ii.

The requirement to disclose the basis for partner remuneration within the audit firms seems of special importance.<sup>188</sup> Remuneration is understood as a primary means of monitoring and directing behavior. This is common understanding with respect to executive compensation<sup>189</sup> and should be equally true regarding remuneration of partners within accounting firms. As far as variable compensation is concerned, a shift in determining of the amount as well as the form of compensation could help to re-focus on the reputation of the audit firms.<sup>190</sup> Annual bonus payments, based on revenue with clients, permit partners to focus on their individual revenue and enable them to immediately “bail-out”. This adds to the pressure to create revenue to ensure a continuing career with the audit firm. Long-term incentives, providing for holding periods or deferral of payout of the compensation earned, might – at least partly – shift the focus towards securing and strengthening the reputation of the audit firm. Typical instruments for such a shift could be cash-based compensation plans.<sup>191</sup> Compensation is based on a combination of individual (e.g. revenue of the cost center) and collective goals (e.g. annual net profit of the firm) which is payable only after a defined period of participation in the plan (e.g. five years). An audit firm compensating its partners by means of such remuneration schemes might be able to compete with its peers based on better reputation. This is

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<sup>188</sup> Art. 38 (1)(j) of the proposed Directive.

<sup>189</sup> See above, under II.2.

<sup>190</sup> Cf. above, under III.1.b. and d., for the lost focus on the firm’s reputation.

<sup>191</sup> Equity-based compensation does not seem as favorable for two reasons: (1) the partners typically own the audit firm anyway, even if the firm is incorporated, and (2) audit firms, at least today, are not publicly listed, therefore capital markets are no able to immediately punish or reward the firms’ performance – one of the key features of equity compensation.

especially true if new disclosure requirements oblige the audit firms to disclose the basis for partner remuneration.

### **c. Other areas for improvement**

The Parmalat failure, besides the effects of audit firm rotation, might teach another lesson. It is not sufficient to have strict rules in place for the audit of a group's parent company (i.e. Italy), but rather for all the companies, including the subsidiaries, contributing to the financial statement (i.e. Cayman Islands). International auditing standards, applicable to all audit firms participating in a group audit are therefore necessary.<sup>192</sup> Furthermore, the audit firm of the parent company must take full responsibility for the consolidated financial statements without being able to rely on the work of the subsidiaries' auditors.<sup>193</sup> The proposed EU-Directive provides for such full responsibility.<sup>194</sup> It should be mentioned that such global auditing standards may be based on new legislation or on the big accounting firms applying internal auditing standards globally. The latter approach would allow competition between the audit firms on who provides the most valuable audit (i.e. competing with reputation). However, such competition is only possible if the markets are willing to pay the price of increased auditing fees.

Another approach is worth mentioning. In some countries (e.g. France) all companies with an obligation to publish consolidated financial statements must have at

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<sup>192</sup> *Andrew Parker*, Big firms must obey global audit rules, *Financial Times*, 04/12/2004; Editorial comment: The lessons of a scandal, *Financial Times*, 04/12/2004.

<sup>193</sup> *John Plenders*, Schooled by scandal: what auditors and investors still have to learn from Europe's accounting debacles, *Financial Times* (print version), 01/22/2004, p. 11; *Andrew Parker*, Big firms must obey global audit rules, *Financial Times*, 04/12/2004.

<sup>194</sup> Cf. Art. 27 (a) of proposed Directive.

least two auditors who jointly sign the audit opinion on financial statements (so-called “joint audit”).<sup>195</sup> Even one step further, two auditors could audit the financial statements issuing separate opinions (“combined audit”).<sup>196</sup> Such a “double-check” might increase the creditability of the financial statements, resulting in lower costs of capital for the issuer. However, there are some down-sides First, two audits trigger additional costs.<sup>197</sup> Second, the audit is much more time consuming for the client and its audit committee having to deal with two audit teams.<sup>198</sup> At this stage, it seems too early to require mandatory joint or combined audit. Nevertheless, for some issuers it might be worth opting for a joint audit on a voluntary basis – possibly lower costs of capital might justify the additional fees and management input.

## **2. Management compensation**

The change of the accounting treatment of equity-based compensation under IAS and the (proposed) change under U.S. GAAP are important steps towards a more controlled use of equity compensation.<sup>199</sup>

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<sup>195</sup> *John Mellows*, The Debate: Joint audits..., AccountancyAge.com, 08/29/2002; *Andre O. Westhoff*, Glaubwuerdigkeit des Jahresabschlusses: Brauchen wir eine Kontrolle der Kontrolleure bezogen auf die Abschlusspruefer und wenn ja, welche? (part II), DStR 2003: 2132 (2135).

<sup>196</sup> *Andre O. Westhoff*, Glaubwuerdigkeit des Jahresabschlusses: Brauchen wir eine Kontrolle der Kontrolleure bezogen auf die Abschlusspruefer und wenn ja, welche? (part II), DStR 2003: 2132 (2135).

<sup>197</sup> According to *Andre O. Westhoff*, Glaubwuerdigkeit des Jahresabschlusses: Brauchen wir eine Kontrolle der Kontrolleure bezogen auf die Abschlusspruefer und wenn ja, welche? (part II), DStR 2003: 2132 (2135), this did not happen in France due to fierce competition. However, assuming that the margins in audit business are not high (which is the case), a lower price means less scrutiny of the audit team in the audit means lower audit quality.

<sup>198</sup> *Ted Awty*, The Debate: Joint audits..., AccountancyAge.com, 08/29/2002.

<sup>199</sup> See above, under IV.1.c. and IV.2.b.ii.

However, this does not necessarily mean that there is a substantial cut back on executive compensation.<sup>200</sup> There is still plenty of opportunity for improvement which holds especially true to the U.S. The State corporate law does not provide for performance goals which have to be met or limitations on the maximum amount of total compensation. In Germany, these restrictions are part of the legal requirements to issue stock options (in the case of performance targets) or – at least – best practice under § 87 AktG and the German Corporate Governance Code (in the case of a cap on the total benefit allowed).<sup>201</sup> Furthermore, holding requirements for the stock received on the exercise of stock options are necessary to prevent immediate “bail-out” after exercising the options in the moment of a share-price peak.

It seems problematic to implement these rules by means of the Model Business Corporation Act or Federal Securities law (as in the case of the Sarbanes-Oxley Act). An amendment of the Internal Revenue Code (IRC) might be more promising. This approach works with respect to employee stock options (§§ 421, 422 IRC) as well as fixed executive compensation (§ 162 (m) IRC). Besides action by the legislator, it is up to the shareholders to implement rules improving executive compensation. Amendments of the

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<sup>200</sup> According to recent surveys nearly 50% of the companies will cut back the eligibility and/or size of grants for employees below management levels. Even so, very few companies have any intention of reducing eligibility or the size of awards at the senior executive level; cf. *Corey Rosen*, Will Broad-Based Equity Survive Expensing?, 11/11/2003, text available at <http://www.nceo.org>. See also *Dan Roberts*, Executive bonuses set to match boom levels, *Financial Times* (print version), 03/22/2004, p. 1, showing top U.S. executive pay packages of up to \$ 45.5 million.

<sup>201</sup> Para. 4.2.3 of the Code; cf. II.2.b. and IV.2.b.i.

bylaws or at least non-binding recommendations by shareholder vote might increase the pressure on the board.<sup>202</sup>

## VI. CONCLUSION

The U.S. and the German Corporate Governance regime share the understanding that independence of auditors is vital for the auditor's function within the system.

Accordingly, auditors are banned from certain non-audit services. The supervisory board or an Audit Committee without members of the management is dealing with the auditors.

Further, partners within the audit firms have to rotate to allow a "fresh-look". An independent control institution regarding financial disclosure has been proposed in Germany as a counterpart to the SEC. A development towards convergence can be observed, even though both countries have a slightly different understanding of the function of auditors. Independence of auditors is the key in both systems, regardless of their function as a gatekeeper or an assistant to internal management control.

Regarding management compensation, both systems have a different approach. U.S. corporate law does not provide for mandatory limitations, i.e. performance targets. It is up to the shareholder to demand these changes.<sup>203</sup> The proposed mandatory expense treatment of stock options might accelerate this development. However, convergence

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<sup>202</sup> Cf. the majority vote on PeopleSoft's annual meeting in favor of expensing stock options, see *Adrian Michaels*, EDS switches camps over expensing options, *Financial Times*, 03/25/2004.

<sup>203</sup> Cf. new stock option program of IBM providing for "premium-priced" options with a 10% hurdle, see *Elizabeth Wine/Stephen Schurr*, Shift in option accounting rules could hit bottom line, *Financial Times*, 03/02/2004.

with respect to this issue requires more time. The German model seems more shareholder-value oriented.

What are the reasons for this different “speed” of convergence? The main reason might be more pressure for convergence towards U.S. ideas than implementing structures of any other country. Access to the U.S. capital market is the key for nearly all businesses worldwide. Accordingly, U.S. investors decide which rules should be implemented. These investors expect a Corporate Governance regime similar to the U.S. one. For foreign countries to enable their companies to comply with these rules, they need to implement similar ones. Otherwise, the foreign companies would not be able to compete, since they would have to obey both sets of rules. Simply said: if you want someone’s money you have to stick to their rules – right now the rules are set by the U.S. investors.

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