Spilt milk: Parmalat and Sarbanes–Oxley internal controls reporting

Richard Y. Roberts, Richard P. Swanson and Jill Dinneen

Received: (in revised form): 9th April, 2004

Thelen Reid & Priest LLP, 701 Pennsylvania Avenue NW, Suite 800, Washington, DC 20004, USA; Tel: +1 202 508 4148; Fax: +1 202 654 1852; E-mail: rroberts@thelenreid.com

Richard Y. Roberts is a partner with Thelen Reid & Priest LLP in Washington DC. He served as a Commissioner of the United States Securities and Exchange Commission from 1990–95.

Richard P. Swanson is a partner with Thelen Reid & Priest LLP in New York. He serves as the co-chair for the ALI-ABA annual conference on accountants’ liability.

Jill Dinneen is an associate with Thelen Reid & Priest LLP in New York.

ABSTRACT
KEYWORDS: European Commission, internal controls, international accounting standards, Parmalat, Public Company Accounting Oversight Board, Sarbanes–Oxley, Section 404

One of the more controversial provisions of Sarbanes–Oxley is Section 404 which requires management of a publicly held company, whether US or non-US, to attest to the quality of a corporation’s ‘internal controls’ in its annual report filed with the SEC. The international aspect of Section 404 has been hotly contested by foreign issuers in cross-border relationships as being unnecessary for non-US companies. This paper provides an overview of Section 404 and the associated US accounting rules with an international context in mind, particularly in light of the Parmalat scandal. Included in the paper is a discussion of the juxtaposition of, and the theme toward convergence in, Section 404, US accounting and auditing rules, international accounting standards, and the proposed EC corporate governance initiatives.

INTRODUCTION
The Sarbanes–Oxley Act 2002 (‘Sarbanes–Oxley’),¹ which became law on 30th July, 2002, is generally viewed as the largest single reform in corporate governance since the US securities laws were first enacted during the Great Depression. As it broadly applies to ‘all issuers’, both US and non-US companies, the corporate governance standards established by Sarbanes–Oxley are hotly disputed by foreign issuers in cross-border business relationships.

Foreign issuers have criticised Sarbanes–Oxley for attempting to impose US corporate governance and financial reporting standards on a global scale, and there is some validity to this criticism. Nevertheless, to tap US capital markets and have their securities traded in the USA, foreign issuers have little choice but to comply.

One of the more difficult and controversial provisions of Sarbanes–Oxley is Section 404 that requires management to attest to the quality of a corporation’s ‘internal controls’. Outside auditors need to test those controls. The associated design and audit expense is considerable, and foreign issuers resent being subjected to the requirement as a result.

The Parmalat case demonstrates that internal controls can be as important outside the USA as inside. As a practical matter, most
foreign private issuers who desire access to the US capital markets will have no choice but to adopt US internal control and audit committee standards in a substantially similar manner. In this fashion, there will be a continuing convergence in corporate governance and auditing standards around the developed world, just as there is a continuing convergence in financial reporting standards.

Auditing standards in the USA are now established by the Public Company Accounting Oversight Board (PCAOB). As a result of Sarbanes–Oxley Section 404, on 9th March, 2004, the PCAOB issued its auditing standards for the internal control reports that are subject to attestation by the management of the issuer and then to attestation by the issuer’s auditor. Whether they like it or not, foreign issuers accessing US capital will be subject to Sarbanes–Oxley Section 404 and their auditors will be subject to the related PCAOB rules. This paper provides an overview of Section 404 and the PCAOB rules with an international context in mind.

SARBANES–OXLEY SECTION 404, MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

Requirements
Sarbanes–Oxley Section 404 mandates an annual evaluation of internal controls and procedures for financial reporting. It requires management to assess and vouch for the effectiveness of these controls. Section 404(a) requires issuers, both US and non-US, to file with the Securities and Exchange Commission (SEC) an annual report assessing internal controls. Section 404(b) provides that the issuer’s auditor must attest to, and report on, the assessment made by management of the issuer of these internal controls. The focus of this paper is the management report on internal controls required by Section 404(a) and its effect on non-US issuers.

On 24th February, 2004, the SEC postponed the compliance dates for the rules adopted on 5th June, 2003 implementing the requirements of Section 404(a). A non-accelerated filer (non-US issuers generally fall within this category) must begin to comply with these requirements for its first fiscal year ending on or after 15th July, 2005. US-based issuers must comply as of 15th November, 2004. Thus, foreign issuers will have an ample basis of domestic precedent on which to rely when they prepare their initial filings.

The SEC’s final rules require management to acknowledge its responsibility for the adequacy of the company’s internal control framework and procedures for financial reporting. The rules added new Item 308 to Regulation S-K, which requires that, in the company’s annual report filed with the SEC, its management include a report on the company’s ‘internal control over financial reporting’ that contains, among other requirements:

- a statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;
- a statement identifying the framework used by management to evaluate the effectiveness of the registrant’s internal control over financial reporting;
- management’s assessment of the effectiveness of the registrant’s internal control over financial reporting as of the end of the registrant’s most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include the disclosure of any material weakness in the registrant’s internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant’s internal control over financial reporting is effective if there are one or more material weaknesses in the registrant’s internal control over financial reporting.
Framework
The SEC’s rules require that management base its evaluation of the effectiveness of the company’s internal controls over financial reporting on a suitable, recognised control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The rules do not mandate use of a particular framework, but the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (commonly referred to and known as ‘COSO’) is explicitly identified as satisfying the SEC’s criteria. The SEC recognises that other evaluation standards exist outside of the USA, and identifies the Guidance on Assessing Control, published by the Canadian Institute of Chartered Accountants, and the Turnbull Report, published by the Institute of Chartered Accountants in England and Wales, as additional examples of suitable criteria. Any foreign issuer is well-advised to consult these sources. Management’s report must identify the evaluation framework utilised to assess the effectiveness of internal controls.

If a non-US company prefers, it may apply home country internal control standards (if any). Before doing so, it should determine whether the home country standards for an internal control framework are:

- free from bias;
- structured to permit reasonably consistent qualitative and quantitative measurements of the company’s internal controls;
- sufficiently complete; and
- relevant to an evaluation of internal control over financial reporting.

Auditor independence
In designing and making an initial assessment of internal control, management may be tempted to rely upon the company’s outside auditors to ensure that the system of control will pass muster with the auditor, and that the auditor will be able to issue its own report on management’s controls. Obviously, some level of consultation with the auditor is necessary and appropriate. Many audit firms are cross-selling their expertise in the design of internal controls, which they are using to offset the decline in revenue in other business segments due to tightened independence rules. But management needs to be wary of relying too much on its outside auditor for control of design work. Too much reliance on the auditor’s design work may itself impair the auditor’s independence if the auditor delivering a report on the effectiveness of management’s controls is deemed to be auditing its own work, having designed the system of controls in the first place. Where the auditor ‘crosses the line’ is not at all clear.

As a result, if management believes it necessary to look for outside consulting expertise in designing and implementing a system of internal control, a firm other than the company’s existing outside auditors should be considered. A whole cottage advisory industry has developed in this regard. One benefit from retaining such a consultant is to facilitate the company’s outside auditor becoming sufficiently comfortable so that the auditor may issue its own report later.

US issuers are investing considerable sums in designing and preliminarily testing control systems. Auditors are already conducting ‘test audits’ or ‘dry runs’ (sometimes referred to as ‘walkthroughs’) for the control testing they must later perform, and it is not too early for foreign issuers to begin this process.

Management assessment of ‘significant deficiencies’ and ‘material weaknesses’ in internal control
Item 308 of Regulation S-K, which implements Sarbanes–Oxley Section 404(a), requires management to assess and report
‘significant deficiencies’ in controls. In accounting standards, the term ‘reportable condition’ has been used to describe the level of deficiency in internal control that had to be communicated to the audit committee. Reportable conditions are matters coming to an auditor’s attention that, in the auditor’s judgment, represent significant deficiencies in the design or operation of internal control that could adversely affect the entity’s ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements. A ‘material weakness’ in internal control is a reportable condition in which the design or operation of a component or components of internal control does not reduce to a relatively low level the risk that a material misstatement may be contained in the issuer’s financial statements.

Sarbanes–Oxley used the term ‘significant deficiency’ and established certain communication requirements concerning this term. The term ‘significant deficiency’ is currently understood as substantially the same as ‘reportable condition’. The existence of a significant deficiency must be communicated by management to the auditor and to the audit committee; and likewise, the auditor will report such a condition to management if one is identified in the course of the audit.

The phrases ‘material weakness’ and ‘significant deficiency’ are inherently ambiguous. Troublesome issues concerning their application can be affected. Some commentators have suggested that a poorly functioning audit committee is itself a reportable weakness or condition in internal control. Since under Sarbanes–Oxley the audit committee hires the auditor and the auditor reports to the audit committee, a contentious and adversarial relationship between the auditor and the audit committee is possible. Additionally, since Sarbanes–Oxley requires that significant deficiencies are reported to the audit committee, as a practical matter, foreign issuers may have no choice but to create an audit committee as part of their corporate governance structure, whether their local jurisdiction requires it or not.

Application to non-US issuers
In general, the requirements of Sarbanes–Oxley Section 404(a) apply to non-US issuers; however, non-US issuers, who do not report quarterly, need only file annually on their Form 20-F or 40-F, as applicable. Non-US issuers may be required by home country regulations to file periodic or quarterly reports in their home jurisdictions.

EU objections: Enron, Worldcom ‘It can’t happen here’

EU objections to Sarbanes–Oxley in general
Sarbanes–Oxley was drafted for the US regulatory environment; most of the implementing regulations are promulgated under the Securities Act 1933 or the Securities Exchange Act 1934. However, Sarbanes–Oxley also regulates non-US companies doing business in the US capital markets, despite the fact that foreign jurisdictions may already have their own corporate governance regulatory schemes in place. Although the precedent for applying US securities laws to non-US companies is of long standing, many in the European Union (EU), and elsewhere, have objected to the unilateral application of Sarbanes–Oxley to non-US companies.

Some in the EU support the position that Sarbanes–Oxley was prompted by scandals in US corporations such as Enron and WorldCom and that the existing corporate governance regimes in Europe are more than sufficient to prevent such scandals, frauds and mismanagements from happening there. Objections notwithstanding, the SEC intends to apply Sarbanes–Oxley both to US and non-US companies, although it has left the door open to accommodate home country requirements and the regulatory approaches.
of the home jurisdiction of non-US companies.\(^7\)

**Parmalat: It did happen there**

The December 2003 demise of Parmalat tended to show that European doubters, who said ‘it can’t happen here’, were misguided. From all outside appearances, in the Parmalat matter, there were egregious failings of basic controls involving items as fundamental as cash reporting. Parmalat will certainly convince the SEC not to alleviate the internal control reporting requirements on foreign issuers, if they were ever inclined to consider such a prospect.

Parmalat, which had food operations in 30 countries, faces a multibillion-euro accounting scandal after the company acknowledged that it failed to actually have US$85bn (€3.95bn) claimed to be in a Bank of America account. Soon after, Parmalat filed for bankruptcy protection in Italy. Investigators are examining how Parmalat concealed debt through shell companies, and what it did with a US$1.5bn (€1.19bn) debt raised through bond issues.

On 29th January, 2004, Pricewaterhouse-Coopers (PwC), the accountancy firm appointed to replace former accountants Grant Thornton, reported that the company’s debts stood at US$18bn (€14.3bn) and that the company’s assets were ‘negligible’. Cash on hand, which one ordinarily thinks of as the most easily controllable, and auditable, item, was misstated by billions of euros. The revised estimate of Parmalat’s debt is nearly eight times the US$2.3bn (€1.82bn) former directors had reported as the company’s debts in September. Apparently, Parmalat was reporting debt as having been retired when it was not (had the debt in fact been retired, there should have been an associated cash outflow).

According to PwC, Parmalat had also overstated its earnings for 2002 and the first nine months of 2003. Parmalat’s operating units suffered a pre-tax loss of at least US$435m (€351m) during the first nine months of last year, in contrast to the pre-tax profit of US$384m (€304m) previously reported by management. The loss, detailed in a preliminary review by PwC, could rise if investigators discover that Parmalat executives further padded sales and failed to account for numerous expenses and losses.\(^8\)

Indeed, according to a report prepared by an independent auditor for prosecutors in Milan, Parmalat had only one profitable year from 1990 to 2002, the period covered by the report, which gives the most comprehensive look yet at Parmalat’s finances and reveals that the company’s deception was carried out over more than a decade. Parmalat, which had reported that it was profitable every year since 1990, probably began fabricating its earnings statements even before then, the independent auditor’s report stated.\(^9\)

The report describes dozens of instances where investigators believe Deloitte’s Italian office, in particular, failed to apply basic accounting principles and verify ‘irregular’ and ‘suspect’ accounting entries. The report details how Deloitte Italy, which coordinated the audit of Parmalat’s worldwide operations, repeatedly ignored and buried evidence of accounting irregularities uncovered by sister offices in Brazil, Argentina, Mexico, Portugal, the USA and Canada. These episodes highlight the need for better internal controls.\(^10\)

Parmalat’s former chairman, Calisto Tanzi, two former finance directors and two employees of the former Grant Thornton SpA are among the 29 people who have been charged in connection with the fraud allegations thus far.\(^11\) Mr Tanzi is suspected of misappropriating at least US$600m from the business over the years.\(^12\)

As reported, Parmalat apparently started out as a fairly standard accounting fraud. Managers allegedly used various accounting tricks to avoid disclosing sizeable losses, possibly with the collusion of at least some
auditors and lawyers. In other words, the Parmalat problem expanded from ‘mere’ accounting fraud into a classic example of the corporate governance problems associated with large publicly held corporations.

Dominated by the Tanzis, Parmalat demonstrates how easy it is for one powerful group of managers and shareholders to perpetrate a fraud, absent a strong system of internal controls. That is why internal controls are important for the protection of outside investors.

Because some European commentators derisively chided US capitalism after Enron, it is tempting to make much of the Parmalat scandal. The problem of majority shareholder US abuse, however, can be found by looking no further than the Adelphia accounting scandal. There are no easy solutions. Transparent accounting rules are important, but enforcement appears to be a problem everywhere.

**How internal controls could have prevented Parmalat**

Although internal controls are not a cure-all, Parmalat illustrates that having no methodology of control systems in place is disastrous. As mandated first by the Foreign Corrupt Practices Act 1977, companies must devise and maintain a system of internal accounting controls to ensure that financial transactions are properly authorised and recorded (so financial statements can be prepared in accordance with generally accepted accounting principles (GAAP)), that only authorised personnel have access to corporate assets, and that the company can reconcile its books to a documented physical inventory. In response to the Enron crisis, which was perceived to originate in internal control failure, Sarbanes–Oxley required auditors to audit those internal controls. In this cycle of control mandates followed by audit mandates, pressure builds on auditors to create controls that can be audited. But since controls do not automatically reduce audit risk, audits of controls cannot assure the effectiveness of the underlying substance over which controls offer no reliable assurance — if management is dishonest, they may find a way around any internal controls. Legislative enthusiasm for controls as crisis-response mechanisms pretends controls can do more than they can and when controls consequently proliferate they can do even less — it becomes hard to assess which controls are effective.

Nonetheless, even if these are imperfect tools, strong systems of internal control can help to detect, and deter, accounting fraud and misstatement. Plainly, there were massive failures of internal control at Parmalat. If the company had strong controls, which were regularly tested by the outside auditors, and which operated as a check on family dominance of the company, it is possible that the demise of Parmalat would not have occurred. That possibility validates the Sarbanes–Oxley approach to internal controls, even if many foreign commentators have criticised such an approach.

**THE PCAOB’S AUDITING STANDARDS FOR INTERNAL CONTROLS**

As noted above, on 9th March, 2004, the PCAOB issued its Auditing Standard No. 2, ‘An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements’ (‘Audit Standard No. 2’). In this lengthy release, the PCAOB enunciated its standards for the outside auditor’s own testing of controls, which are designed to lead to the auditor’s own report on management’s attestation of controls.

The most significant provision of the PCAOB’s Audit Standard No. 2 is its requirement that the outside auditor perform ‘walkthroughs’ of control processes. It is anticipated that these ‘walkthroughs’ will add considerably to the expense of an audit. While the PCAOB’s Audit Standard No. 2 sets forth a uniform standard for the
conduct of an audit of internal controls, it is an auditing and not a financial reporting standard. In the USA, the PCAOB has the authority to prescribe generally accepted auditing standards, or GAAS. GAAP, however, are the province of the Financial Accounting Standards Board (FASB). Although the impact of the internal control requirements of Section 404 on financial reporting standards is unclear, there undoubtedly will be some impact since the implementation of the internal control requirements, and the audit thereof conducted in accordance with the PCAOB rules, if effective, should catch the misapplication of financial reporting standards. Going forward, the juxtaposition of Section 404, the related PCAOB rules, and the financial reporting standards issued by the FASB will be interesting to observe.

INTERNATIONAL ACCOUNTING STANDARDS
In the international arena, on the other hand, the authority to make definitive pronouncements concerning financial reporting standards is less clear. However, standards set by the International Accounting Standards Board (IASB), the international counterpart to the FASB, are generally becoming more widely accepted. The IASB, headed by Sir David Tweedie, is actively examining financial reporting rules and principles.

One significant difference between the FASB and the IASB is their basic approach to financial reporting. The FASB utilises a ‘rules-based’ approach, with detailed, comprehensive pronouncements. The FASB approach has been criticised as leading to what might be termed pejoratively as a ‘loophole-based approach’, under which accountants scour the rules for ways around them, utilising the argument that if a financial reporting policy is not expressly prohibited by a definitive FASB or SEC pronouncement, then it is permissible.

The IASB, on the other hand, utilises a ‘principles-based’ approach, under which an accountant is supposed to take a more judgmental or ‘holistic’ approach as to the fairness of the overall financial presentation. This approach can be criticised as allowing too much leeway in the modern financial world, where complex structures and issues arguably require more definitive guidance. Such a ‘judgmental’ approach can produce chicanery just as much as a ‘loophole’ approach, and it may render comparisons among companies in the same industry more difficult if the companies reach different judgments on the accounting principles to be employed. In addition, issuers and auditors are rightly concerned about exposure to litigators second-guessing, with the benefit of hindsight, decisions taken under a relatively more amorphous ‘principles-based’ approach.

While GAAP and GAAS are supposed to be conceptually different, the use of different accounting principles may lead to somewhat different audit approaches. The use of different accounting principles might logically lead to somewhat different internal control environments for a foreign issuer utilising international accounting standards approved by the IASB than for one using a FASB-promulgated GAAP approach. Yet, the PCAOB’s internal control Audit Standard No. 2 does not appear even to consider, let alone make any provision for, these differences. Again, this circumstance leaves the USA open to criticism for having one of its standard setters or regulators making rules applicable to the rest of the world.

Significantly, the SEC recently pronounced that a foreign issuer may rely in its US securities law filings on international accounting standards set by the IASB.14 Thus, the SEC appears to be moving in the direction of acceptance of the IASB’s work.15 Yet, neither the SEC nor the PCAOB at this time appears to have considered the impact of the difference in
accounting standards on internal control reporting or auditing.

PROPOSED CORPORATE GOVERNANCE INITIATIVES IN THE EU

The European Commission Action Plan


Unlike Sarbanes–Oxley, the corporate governance initiatives proposed in the EC Action Plan are not intended to be mandatory. The EC stated it does not believe that a European Corporate Governance Code would offer significant added value but would simply add an additional layer between international principles and national codes. Nevertheless, the EC concedes that a self-regulatory market approach, based on non-binding recommendations, is not sufficient to guarantee sound corporate governance. In view of the growing integration of European capital markets, the EC Action Plan proposes that the EU adopts a common approach covering certain essential rules:

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

EU initiatives compared to Sarbanes–Oxley

The EU and the USA have identified broadly the same problems and broadly share the same goals. Both recognise the importance of good corporate governance for investors and for the economy as a whole.

On the US side, approval of the Sarbanes–Oxley Act is not the end of the story. The SEC and other regulators are assessing how to implement the Act, and the SEC is engaged in a dialogue with a view to negotiating acceptable solutions with non-US authorities, in order to avoid imposing double regulation on businesses already adequately regulated in the EU.

As noted above, the SEC has also identified certain foreign sources of internal control standards to be utilised in establishing the foreign issuer’s own control standards. This was obviously designed to ameliorate to some extent the criticism of the SEC
for imposing worldwide financial reporting standards. But again, the PCAOB’s Audit Standard No. 2 does not account for the possible differences in country accounting standards.

The EC’s High Level Group of Company Law Experts believes that a one-size-fits-all solution is not feasible or desirable given the many different national models within the EU. Therefore, the EC Action Plan proposes combining a few essential rules with closer coordination between national codes. It should also be noted that some EU member states already have or are in the process of preparing tougher corporate governance rules than are suggested by the EC Action Plan. Moreover, some of the proposals in the EC Action Plan stop short of formal legislation and aim instead to create strong moral and market pressure on companies to improve their corporate governance and on EU member states and regulators to enforce that improvement.

There is a fundamental difference in the approach of the US securities regulatory scheme as compared to the European model. In the USA, the protection of shareholders, the investing public, is paramount. The US capital markets are a major source for corporate financing, but federal securities law necessarily developed in counterpoint to sometimes more liberal state corporation laws. The result is that, to protect shareholders, the US federal securities laws have disclosure and transparency at their core. In addition, the US stock exchanges, as self-regulated organisations, impose another level of rules for companies listing on national exchanges. Post–Enron, in the wake of financial and accounting scandals and monumental corporate bankruptcies, the corresponding huge loss of capital has prompted US regulators to develop a more strict approach to corporate governance, an integral part of which is a highly regimented stream of information to board members, regulators and the public.

The European model has a more multi-dimensional approach, placing shareholder interest as one of a group of protected interests. As European corporate finance focuses more on obtaining capital from outside sources, the domestic equity markets become less significant. The European regulatory scheme balances the interests of shareholders with the protection of creditors, stakeholder interests (particularly employees) and the public interest. The Parmalat scandal suggests that the European markets need more aggressive corporate governance reforms, and that the provisions of Sarbanes–Oxley that were forced upon foreign issuers by US policy makers could be more welcome than first thought.

In Italy, events at recent shareholders’ meetings bear this out. Shareholders at these meetings have been provided extensive information about directors, auditing rules and shareholder rights that until recently were hard to obtain. According to Assonime, the association of Italian quoted companies, all 30 companies within Italy’s Mib30 stock market index, which tracks the 30 largest companies in Italy, will this year, for the first time, give biographical detail of their directors and, in some cases, their boardroom attendance record. This comes as an Italian parliamentary commission, spurred into action by the massive fraud at Parmalat, struggles to piece together governance legislation that often mirrors the two-year-old Sarbanes–Oxley Act in the USA. A crucial part of the Italian bill involves reorganising the country’s archaic and opaque regulatory agencies, notably stock market regular Consob and the Bank of Italy. The framework for improvements in corporate governance originated in 1998, when the government passed the so-called ‘Draghi law’ that required more transparent corporate reporting and greater protection for minority shareholders. One year later, companies were asked to apply a list of corporate governance rules, dubbed the ‘Preda code’. 
The Preda code, however, is voluntary. Until 2002 and the passage of Sarbanes–Oxley, it was also inconsistently followed.

ENFORCEMENT AND LIABILITY
An oft-mentioned criticism of Sarbanes–Oxley in general, and of Section 404 in particular, is the private litigation and government enforcement that will be spawned therefrom. It is difficult to assess the validity of these criticisms at this time, but the concerns may be well placed.

Because acceptable and effective internal control frameworks are still developing, foreseeability analysis in tort is hard to predict. If controls are applied only in particular settings with defined functions, they could indicate that related risk realisation was foreseeable. When every aspect of corporate governance is layered with elaborate controls, however, such inferences are less certain.

Another factor is that, as frameworks and structures for compliance with the obligations of Sarbanes–Oxley Section 404 develop, companies will weigh the cost of compliance against the prospect of government enforcement threats and penalty levels. Assuming Section 404 is enforced adequately, some government enforcement actions with resulting penalties are bound to occur. Until actual experience is had, how many and how much is difficult to guess.

CONCLUSION: NO CONCLUSION YET
Convergence of corporate governance and financial reporting standards throughout the developed world is a reality, but it is a slow and evolutionary process, and significant differences remain. The USA has justifiably been criticised for attempting to impose its standards on the rest of the world. Sarbanes–Oxley’s Section 404 requirement that management and the auditor attest to internal controls, and the associated PCAOB internal controls auditing standards, together force foreign issuers to adopt a US-style system of controls, and controls auditing, whether they like it or not, and whether their own jurisdiction requires it or not. It will be interesting to watch how, between now and 2005, foreign issuers react to these US-imposed rules, and conversely, how the USA reacts to this reaction by foreign issuers. No doubt, there is more to this saga yet to come.

REFERENCES
1 H.R. 3763 (30th July, 2002).
5 As defined in Rule 13a-15(f) or Rule 15d–15(f) under the Exchange Act.
7 See, for example, remarks of the then SEC Chairman, Harvey Pitt, to the Financial Times’s ‘Conference on Regulation and Integration of the International Capital Markets’, 8th October, 2002, London.
11 ‘First charges brought in Parmalat case’, Financial Times, 18th March, 2004. ‘Prosecutors investigating the €14.8bn ($18bn) collapse of Parmalat on Thursday hauled a trolley-load of evidence before a pre-trial judge in Milan and filed market-rigging charges against 29 people and against the Italian units of Bank of America and
auditors Deloitte and Grant Thornton. Calisto Tanzi, Parmalat founder, Fausto Tonna, former chief financial officer, Gian Paolo Zini, legal adviser, and Italian executives of the bank and accounting firms are accused of conspiring to issue false statements to buoy the Italian dairy group’s share price.

15 Moreover, in July 2003, the SEC Offices of the Chief Accountant and Economic Analysis submitted to the Senate Banking and House Financial Services Committees a study on the adoption of a principles-based accounting system in the USA: entitled ‘Study Pursuant to Section 108(d) of the Sarbanes–Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System’.
16 ‘Corporate Italy grapples with the Parmalat effect: Telecom Italia chairman leads the way towards more effective in-house governance’, Financial Times, 7th May, 2004; ‘Shareholders In Italy Begin To Accept Role Of Inquisitor’, New York Times, 12th May, 2004.