Spilt Milk: Parmalat and Sarbanes-Oxley Internal Controls Reporting

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

Foreign issuers have criticized Sarbanes-Oxley for attempting to impose U.S. corporate governance and financial reporting standards on a global scale, and there is some validity to this criticism. Nevertheless, to tap U.S. capital markets and have their securities traded in the United States, 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 are critical of being subjected to the requirement as a result.

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¹ H.R. 3763 (Jul. 30, 2002).
Recent disclosures concerning Parmalat demonstrate that internal controls can be as important outside the United States as inside. As a practical matter, most foreign private issuers who desire access to the U.S. capital markets will have no choice but to adopt U.S. 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 U.S. are established by the Public Company Accounting Oversight Board (“PCAOB”). As a result of Sarbanes-Oxley Section 404, on March 9, 2004, the PCAOB issued its auditing standard 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 U.S. capital will be subject to Sarbanes-Oxley Section 404 and their auditors will be subject to the related PCAOB rules. This article provides an overview of Section 404 and the PCAOB rules with an international context in mind.

I. Sarbanes-Oxley Section 404, Management Assessment of Internal Controls

A. 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 U.S. and non-U.S., 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 article

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