

## STRENGTHENING CORPORATE GOVERNANCE

*Written by Sharad Kumar*

*Faculty, Unicaf Federal University, Cyprus*

---

The present lack of public confidence in Corporate Sector has two major root problems. First the Public has come to believe that corporate executives are more interested in their bank accounts than the interest of their stakeholder's especially independent stock owners, retirees, employees and women. The Sarbanes Oxley Act 2002 addresses the problem through tougher penalties for white collar criminals and requirements that hold CEOs and CFOs primarily and personally responsible for disclosure in financial statements.

Secondly the Public has come to believe that first problem is a norm. This false public perception that everyone does it in corporate world cannot be eliminated by tougher laws and regulations. This can only be achieved through tradition of ethical standards in Corporate Sector and greater transparency in disclosure norms in financial statements and other public documents.

Though we must punish the wrongdoers but more important is to recognize and reward the majority of honest corporate executives, board members and auditors who are known for their integrity and hard work. No one can argue the fact that there is no dearth of ethical individuals in Corporate Sector. Unless we debunk the myth of every one does in Corporate Sector we may write the obituary of Corporate world.

Thus having set the problem in motion we seek to get the answer to moot question how the public confidence in corporate sector can be restored. We must remember the sleaze of measures taken subsequent to Enron and World Tel Scams have not stopped the scandals in Corporate America. The answer lies in Corporate Governance where accountability is fixed by corporate world, professional bodies and regulating bodies on Board level officials for their conduct in running the affairs of a corporate entity. The Purpose of Corporate Governance is to promote accountability among corporate participants and to enhance corporate performance.

The Board of director's responsibility is to ensure that management is working in the best interest of its stakeholders. The major professional bodies of Auditors world over have recommended the setting up of independent audit committees whose role flows from Board oversight function. Though there has not been adequate discussion on how the audit committees should carry out their job and who should serve on the audit committees' .Though significant literature has been evolved on the subject in last two decades in the West we have failed to bring a uniform policy at the global level.

The good corporate governance is dependent upon integrity, honesty and transparency of independent directors who serve as members in such audit committees. The Corporate Legislations of major countries give this power entirely in the hands of promoters and Board of directors of the company thus ensuring complete dependency of such independent directors on them. They often resort to the practice of appointing each other as independent directors in their companies thus throwing away the very objective of impartiality.

The First two recommendations of Blue Ribbon Committee set up BY SEC, NYSE and NASDAQ in US on improving the effectiveness of Corporate Audit Committees are aimed at strengthening the independence of Audit Committees, Members of the committee shall be considered independent if they have no relationship to the corporation without financial, family or other material personal ties to the management that may interfere with the exercise of their independence from management.

The effectiveness of an audit committee depends largely upon the backgrounds and abilities of its members. Choosing right candidate for the Chairmanship of audit committees is crucial as his approach that drives the committee towards an active examining body which ensures investor confidence in that particular company.

How do we ensure that members are totally independent, ensuring transparency protecting the interest of all stakeholders? The board of directors should encourage selection and retention of diligent and knowledgeable members who are dedicated to the industry and interested in the job and willing to devote substantial commitment of time and energy to the responsibility of

audit committee. The job of appointment of independent directors should be left to regulatory agencies, Professional bodies, investor's protection group and chamber of commerce.

The Blue Ribbon Committee also recommended that the audit committees should receive a formal written statement from the statutory auditors delineating all relationship between auditors and the company, consistent with independent standards besides actively engaging in dialogue with statutory auditors with respect to any disclosed relationship or services which may impact his objectivity and independence.

Though Statutory Auditors are appointed by the shareholders at a company AGM they are in fact nominees of the promoter management. In real practice no statutory auditors can ever hope to be appointed without the active support and agreement of the promoters which makes them comply with their demands with financial reports more hiding than what is being revealed. According to recent news accounts of 226 blue chip companies failed in CRISP test though no norms were violated.

The audit committee should require the statutory auditors to report reportable conditions which are deficiencies that could adversely affect company's ability to produce financial statements beside Reporting illegal acts detected during audit.

Beside statutory auditor should be asked to discuss his judgment about the quality and just not the acceptability of company's accounts in accordance with accounting standards and practice. The issues like clarity in financial disclosures and degree of aggressiveness or conservation of company's accounting principles and underlying estimates and other significant decisions made by management in preparing financial disclosures and reviewed by statutory auditors.

This was particularly important in environment of greed (stock options) the pressure to show improved results at the end of each quarter and where companies were in financial difficulties.

The audit committees should develop regularly scheduled meetings with statutory auditors independent of management for regular, frank and confidential dialogue. One of the

suggestions was to do some of the spade work a day ahead of the formal meeting by talking to the senior management, statutory and internal auditors.

The Professional bodies of auditors needs to consider how the statutory auditors can be made accountable and independent when a major share of income of some of the biggest firms came from large business groups handled by them. One way would be by rotating audits and or independent accounting boards to appraise the work of statutory auditors and to investigate lapses in skills ethics or independence, besides revisiting the accounting standards on the line of one exist in France.

The Blue ribbon Committee recognizes that the independent auditor is in a position to evaluate and report on the adequacy and effectiveness of internal control on ongoing basis. To effectively discharge their responsibilities audit committee's members must set their priorities.

They audit committees should encourage procedures that promote accountability ensuring that management properly develop and adhere to a sound system of internal control and internal auditors objectively assess accounting practices and internal controls.

The internal auditor occupies a unique position he is employed by the management but is also expected to review its conduct. Since thus can create a significant tension the internal auditors independence is absolutely necessary for an objective assessments of management actions. The Blue Ribbon Committee believes it is essential to have a formal mechanism to facilitate exchanges internal auditors and audit committees. In the forms of regular meetings, independent of management or regular confidential memos or reports circulated only to the audit committees.

The audit committees must therefore establish and support a culture that promotes open disclosure by the internal auditor and recognition that if the internal auditor identifies a problem and cannot claim the support of management then he has a duty to disclose the fact to the audit committees, Boards and stakeholders. The management should encourage such disclosure by work and deed.

In major Corporate legislation world over the internal auditor is neither independent nor enjoy status where his recommendation have any impact or seldom get the recognition they deserve. It is therefore necessary for the audit committees to make sure that the internal auditor has the right place in the organization by promoting a culture that values objective and critical analysis. The head of internal audit needs to be elevated in the hierarchy with that of CFO to minimize the discounting of internal audit inputs and enhance the quality of audit.

Finally Blue Ribbon Committee recommends candid discussions with the management the statutory auditors and the internal auditors regarding issues implicating judgment and quality.

According to the recommendations of blue Ribbon Committee a great deal of responsibility has been entrusted on the members of the of the audit committee. Even the US experience has been the happy one considering recent corporate frauds. It is necessary for the Eastern European countries including Romania to initiate serious discussion on the composition structure and responsibilities of audit committees and consider education and training programs to ensure that members of the audit committees have the right background knowledge base which stays current with the developments in accounting and finance. This will realize the independence of audit committee and ultimately strengthen the corporate governance in corporate world

## **IMPLEMENTATION OF SARBANES OXLEY ACT**

The one of the fallout of world major accounting scandals in corporate Americas was the enactment of Sarbanes Oxley act by US Congress the credit goes to Senator Schumer for taking lead in this direction. To understand the finer points of this statute primarily enacted to strengthen corporate governance and good standard practice at board level we have to understand its implementation. The implementation of this statute is left to Securities Exchange Commission and other regulatory bodies of US. The Public Accounting Oversight Board has been created for implementation of this Act, the members of which are named by SEC Commissioners. It is clear that members of PCAOB must be composed of individuals who are of highest moral characters free from both real and personal conflicts of interest and capable

of taking tough decisions required by the members. So the members chosen for PCOAB must be after thoughtful due diligence.

In addition to these responsibility SEC commissioners faces some tight rulemaking deadlines to implement key provisions of the Sarbanes Oxley Act. As the process moves forward during the coming years the public will be closely monitoring the PCOAB for being fair and consistent. As the first step of strengthening corporate governance the SEC has issued rules for its implementation these rules inter alia covers (a) auditors independence (b) pension funds blackout periods (c) disclosure of material off balance sheet transactions(d) presentation of proforma financial information (e) retention of audit records(f) analysts conflict of interest(g) disclosure of analyst conflict of interest. The SEC has further issued a proclamation that PCOAB is operational and prohibits any public company from being listed if it does not comply with audit committee rules.

The other issues need to be addressed under Sarbanes Oxley Act are : (a) setting up requirements for recognizing a body to establish Accepted Accounting Principles (b) Issue of rules relating to management assessment of internal control one also recognized by Blue Ribbon Committee Report (c) promulgating the rules regarding real time public company disclosure. The Federal Register will announce about the rules and also to monitor the implementation of these rules with public support.

## **SEC FUNDING**

Another area to watch is How Bush Administration Fund the Sec operations. SEC is America's most independent regulatory body. But with just 3100 employees it is unable to implement the Act in entire corporate America and also act as a watch dog for any violations. Further the SEC budget is completely insufficient for the purpose. Even prior to The Corporate Scams coming to surface SEC was finding it difficult to keep up with growth of Business and the expansion of stock ownerships to a new class of investors.

In light of the new responsibilities added to SEC after Sarbanes Oxley Act Congress authorized 77% increase in SEC funding. Though keeping the tight situation of Federal budget even keeping that funding is doubtful.

Therefore it is imperative that professional bodies, trade associations must join hands in getting an increase funding to SEC in light of additional responsibilities. Though Sarbanes Oxley Act has become most fearful legislation in Corporate America the honest corporate officials have nothing to fear from increased SEC scrutiny of their quarterly and annual reports and other disclosure requirements in Financial Statements.

We must admit that support to SEC and other regulatory bodies can best ensure Corporate Governance in Corporate America of 21<sup>st</sup> Century. There is no better way to run an organization then to prove that they run clean operations.

The Act gives an opportunity to SEC to uncovering minor compliance requirements before they take shape of major scandals.

## **THE UNFINISHED AGENDA**

It is clear that Congress is yet not finished with the job of Strengthening Corporate Governance. The Senate Banking, Financial, Housing, Urban Affairs committee will keep a close watch on How SEC and PCOAB are implementing this Act. One of the recommendations which come from professional quarters was that public trading company's the internal audit function to explain to shareholders and creditors as well as potential Investors as to why certain decisions were not taken by the Board having financial implications on financial health of the company. This will help audit committees to take care of minor and major compliance requirements under the Act.

The audit committee as envisage in the Act must have access to internal controls set up in a public trading company to evaluate and review organization governance, risk management and control process including internal control relating to financial operations.

## **A CENTURY OF CORPOARTE INTEGRITY**

It is the job of regulatory agencies to protect the public interest. This means we must ensure that laws and rules are in place to reassure the investors of the integrity of the country's commercial actors while taking care that these regulations do not inhibit these companies from maximizing their economic performance.

To achieve this all public company's must have audit committees. These audit committees should be duly supported by internal audit staff in their operations. This system will insure the economic Performance of these companies by sparing them from SEC investigations and safeguards them from pitfalls of corporate mismanagement which have seen large corporations falling like pack of cards.

The Legislators and Law maker's world over should not just leave the tasks to internal audit staff or Audit Committees to do this task they themselves have to speak when these companies are off base. We must remember the large senators are key stakeholders in major corporations. In case if the public confidence has to be restored then these measures are absolutely essential.

The Sarbanes Oxley Act has forever changed the responsibilities of corporate managers. Directors and auditors both external and Internal. Because of Corporate Scandals such as Enron Corp, World Com, Tyco International the auditor's role has assumed new dimensions.

## **CONCLUSION**

The major corporate scandals which dates back to Ralph Nader to Enron has shaken the investors' confidence world over leading to a sluggish growth, creating acute unemployment and loss of face. To come out from such situation we need to have fusion of Blue Ribbon Committee report and Sarbanes Oxley Act requirements. Both of these can act as a guiding force to emerging economies of Eastern Europe to come to terms with corporate pitfalls. The Lawmakers as well regulatory agencies in Romania can take a cue from them in strengthen the financial disclosure norms in their Corporate Laws as well in standards of professional body of auditors.