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Accounting for Good Corporate Governance

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Abstract

Good corporate governance (*GCG*) is a mandatory requirement in today's corporate world by every stakeholder groups. Failure of giant corporate groups in last two-three decades strengthens the demand further. And surprisingly, in some of such failures, accounting as a discipline is held liable. The way accounting is practiced or the interpretations that may give different prescriptions in similar situations are some dark areas that may open some scope for the corrupted accountants. Still, the author believes that such claim against accounting is undue and unfounded. The paper is an earnest effort to uncover the issue and to protect it from such unfounded critics. It covers the concept of corporate governance, its legal framework, its current status and how accounting may be practiced to protect corporate from corruption by establishing governance.

Keywords: corporate governance, accounting, comply-or-explain, Sarbanes-Oxley (*SOX*)

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Introduction

Good corporate governance (GCG) in a corporate set up leads to maximize the value of the shareholders legally, ethically and on a sustainable basis, while ensuring equity and transparency to every stakeholder – the company's customers, employees, investors, vendor-partners, the government of the land and the community (Murthy, 2006). GCG is a must for ensuring the required values to different stakeholder groups. It enhances the performance of corporations, by creating an environment that motivates managers to maximize returns on investment, enhance operational efficiency and ensure long–term productivity growth. Consequently, such corporations attract the best talent on a global basis. It also ensures the conformance of corporations with the interests of investors and society, by creating fairness, transparency and accountability in business activities among employees, management and the board (Oman, 2001).

Again, GCG increases public confidence in a corporation, and lowers the cost of capital for investment. According to a McKinsey study (2002), over 60% of investors cite GG practices in a corporation as a key factor in their investment decisions. Today, GG becomes a slogan and a pride. The author, here, uses accounting as a mean for establishing and retaining corporate governance.

Accounting is a process of compiling information for reporting the internal affairs of any entity to different stakeholders at the end of a certain interval. It is defined as the language of business and can play a vital role for ensuring and continuing with GCG. As a discipline, accounting practice is highly controlled by accounting standards in a global set up. As accounting becomes an international discipline and the practice of accounting is harmonized aligned with the varied needs of stakeholders, it can be used as a tool for ensuring good governance within a corporate setup. The author has tried to devise the way out, how accounting may be used as a tool to ensure and enhance GCG. Thus, the basic objective of the paper concentrates on the issue of the interrelationship between accounting and governance; and how accounting may be practiced in such a way that corporate governance is achieved, by the by, both accounting and corporate governance is demanded for the betterment of the stakeholders, i. e., shareholders in most of the cases.

Methodology

The paper is completely a conceptual one whose basic foundation comes from various secondary sources like research articles, published and unpublished scholarly papers, books, various international and local journals, speeches, newspapers and websites. The linkage of accounting for successful corporate governance is the personal idea of the author. To remain with the main idea of the paper, GCG is defined followed by a discussion of different variant of frameworks of GCG, present status of corporation, accounting and GCG interrelationship, justification with the concluding remarks at the end.

Good Corporate Governance Defined

Recently the terms 'governance' and 'good governance' are being increasingly used in development literature. Bad governance is being increasingly regarded as one of the root causes of all evil within our societies. The concept of governance is not new. It is as old as human civilization. It means, 'the process of decision-making and the process by which decisions are implemented (or not implemented)' (UNESCAP, 2007). It originates from the need of economics (as regards corporate governance) and political science (as regards State governance) for an all-embracing concept capable of conveying diverse meanings not covered by the traditional term 'government'. It is the exercise of power or authority – political, economic, administrative or otherwise – to manage a country's resources and affairs. Referring to the exercise of overall power, the term 'governance', in both corporate and State contexts, embraces action by executive bodies, assemblies (e.g. national parliaments) and judicial bodies (e.g. national courts and tribunals) (EC, 2001).

The concept of governance is currently used in contemporary social sciences with at least six different meanings: the minimal state, corporate governance, new public management, good governance, social-cybernetic systems and self-organized networks (Rhodes, 1996). Thus, good governance, as a concept, is applicable to all sections of society such as the government, legislature, judiciary, the media, the private sector, the corporate sector, the co-operatives, societies registered under the Societies Registration Act, duly registered trusts, organizations such as the trade unions and lastly the non-government organizations (NGOs). It assures that corruption is minimized, the views of minorities are taken into account and that the voices of the most vulnerable in society are heard in decision-making (UNESCAP, 2007).

Corporate governance is primarily the responsibility of the Board as a group. The Board performs its duties with the support of management and staff, in line with members' wishes, the constitution and the law, and ideally in partnership with stakeholders.

Different Variants of Frameworks for Good Corporate Governance

The U.S. Great Depression of the 1930s was widely perceived to have been triggered by corporate mismanagement. It even led to a 1933 Supreme Court ruling, which condemned corporations as *"Frankenstein monsters, capable of doing evil."* The public perception led to the establishment of the Securities and Exchange Commission (SEC) in 1934, leading to regulatory reform defining corporate ownership and control. During the 1970s, a series of business scandals led to an unveiling of pervasive, unethical practices in U.S. corporations. SEC investigations revealed widespread illegal contracting practices, insider trading, deceptive advertising, and savings-and-loan scandals. Over 500 publicly held U.S. firms, including 117 of the then Fortune 500 companies, were charged by the SEC or confessed to corporate misconduct.

The governance failures of the 1970s and 1980s set the minds of the public and the regulators on improving the governance of corporations. The result was a surfeit of GG codes issued across the globe by SECs, stock exchanges, and investors' associations. Some of the most influential initiatives have come from the Treadway Commission and the SEC Blue Ribbon Committee in the U.S., the Cadbury Committee in the UK, the Vienot Report in France, and the Peters Report in the Netherlands. The common view of all these committees was that GG required effective board functioning through informed, independent directors; empowered board subcommittees; and improved board transparency to management functioning. In the U.S., recommendations for auditors were taken up by the 1999 SEC Blue Ribbon Committee. The recommendations aimed to improve the independence, operations, and effectiveness of audit committees. Outside the U.S., the UK Cadbury Committee report has served as a pioneer in advancing the levels of corporate governance across the globe. It is interesting to note that the most effective codes, such as the Cadbury Code, have operated on a 'comply-or-explain' basis. That is, corporations are free to decide whether they will comply the codes or not. If they decide to comply, no problem; but if they decide not to comply, they must explain the reasons of such non-compliance. Thus, following the codes is not mandatory (Cadbury, 1992).

Corporate governance in South Asia is not so matured like U.S. or UK. In India, the effective initiative for corporate governance came from the listed companies and industrial association, Confederation of Indian Industry (CII) in 1997. In 1999, the Securities and Exchange Board of India (SEBI) made it mandatory for all listed companies in phases. Then in 2001, the listing agreement requirements of all the stock exchanges included the clause for CII codes. From April 2003, all the listed companies were brought under mandatory requirement to follow the SEBI corporate governance code. In Pakistan, the reform initiatives came jointly from the Securities and Exchange Commission of Pakistan and Institute of Chartered Accountants of Pakistan in 2002. They have adopted some codes and those were incorporated in the listing regulations of stock exchanges. In Sri Lanka, the first initiative to codify the principles of corporate governance came from the Institute of Chartered Accountants of Sri Lanka (ICASL) in 1997 (OECD, 2003). In Bangladesh, it is totally new. The first initiative was taken by a private consulting firm, Bangladesh Enterprise Institute (BEI), in August 2003 when it conducted a diagnostic study in this field. Based on the study, the BEI has published the corporate governance code for Bangladesh in March 2004 (Bangladesh Enterprise Institute, 2004). Subsequently the Institute of Chartered Accountants of Bangladesh (ICAB) has come up with principles and rules to be followed. In January 2006, the SEC has issued an order for complying with a number of governance codes.

It is evident from the above discussion that accounting profession got involved directly or indirectly with GG. However, the objective of accountants is to ensure good corporate governance by reducing the gap between insiders and outsiders to a corporation through the disclosure of right information timely. Accountants may miss this type of assignment that they are doing throughout the year knowingly or unknowingly.

Present Status of Corporation

In this section, the present status of corporation is highlighted. It was expected that the efforts of the Cadbury Committee and SEC committees would usher in an era of disciplined corporate behavior and good governance. Unfortunately, this confidence was short-lived. The decade of 1990s was the era of the stock-option-fattened, superman-superwoman CEOs who could do no wrong in the eyes of their admiration-heavy boards, and who were seen as demigods. Accountants found ways to circumvent accounting rules, and investment bankers invented complex financial structures to make mandatory disclosures look rosier. It is no wonder that this climate led to Enron's spectacular collapse in 2001 and the collapse of WorldCom, Qwest and Tyco in 2002. It is estimated that the scandals at Enron, WorldCom, Qwest, Tyco and others resulted in a loss of more than $7 trillion in market capital, the largest in the history of capitalism.

The abuse of power is a relative issue. This is not confined in some selected companies rather different companies face this devil to different extent. The companies that failed become some examples in history. The lack of corporate governance *"was not a case of the odd duck or the five-legged cow, but one of widespread malfeasance"*. Most of the listed companies in Bangladesh are owned by family members or peers. The owner is the chief executive officer or managing director and chairman of the board in most cases. According to a survey of BEI, 73% of the non-bank listed companies' board is dominated by family (Sobhan et al., 2003). Management has the opportunity to use the company materials to nominate directors; shareholders do not. And shareholder elections are procedurally much more akin to the elections held by the Communist Party of North Korea than those held in Western democracies (Epstein, 1986).

Excessive pay of senior management has been just one illustration of a broad failure in governance. The ratio of U.S. CEO compensation to the pay of the average production worker jumped to 431 to one in 2004. In 1990, that ratio was 107 to one; in 1982, it was 42 to one. The aggregate compensation for top-five corporate executives was 10% of aggregate corporate earnings in 1998-2002, up from 6% of aggregate corporate earnings during 1993-1997 (Bebchuk and Grinstein, 2005).

Accounting and Corporate Governance

The high profile scandals and rising investor dissatisfaction with governance practices have led to demands to 'raise the baseline' of mandatory disclosure and compliance by corporations. These concerns have triggered a shift away from "soft law" such as comply-or-explain requirements. In the U.S., the Sarbanes-Oxley (SOX) Act, and the revised, New York Stock Exchange (NYSE) and NASDAQ listing rules have created more stringent standards for financial disclosure, committee and board nominations, and audit policies. In Asia, revised corporate governance regulations in several countries such as Hong Kong, Singapore, and India mandate a much stricter standard of compliance for corporations. SOX Act is obviously a great achievement in response to the scandals for restoring investors' faith in corporation. It represents a shift toward government regulation of corporate standards relating to auditing, accounting, quality control, ethics, and independence, through the Public Company Accounting Oversight Board (PCAOB).

The recent move, by SEC, to mandate full disclosure for managerial compensation and perks, is a welcomed one. Because, many CEOs have created significant asymmetries in compensation within their corporations, through undisclosed perks and incentives. For example, the CEO of a corporation was paid $800 million including perks, over a 13-year period – a period during which his company profits had plunged, and shares provided lower returns than even Treasury bonds.

Table 1 gives a pictorial view of the reasons of confliction among different stakeholder groups that give rises to the crises (bad governance) and also devises some ways of getting rid of it by the accountants. These are some examples as the author thought best and one has the sufficient scope to customize it depending on the situations. Some common problems have been pointed here like agency problem, tunneling, power (ego) crisis, non-compliance, policy crisis etc.

Table 1: Role of Accounting to Ensure Good Corporate Governance (GCG)

Stakeholder Groups	Complex Relationship with others	Point of Conflict	Nature of Confliction	Remedies (Accountant's point of view)
Shareholders/ Owners	Shareholders Vs. Board	Boards are highly paid as compared with their functions.	Agency Problem	May work to streamline the payment, based on the study on salaries at Board and Management level.
	Shareholders Vs. Management	Management is highly paid as compared with their functions.		
	Shareholders Vs. Shareholders	Controlling shareholders expropriate the firm's assets at the expense of minority shareholders	Tunneling	May reduce the gap by appropriate disclosure, like, Minority Interest.
Board of Directors	Board Vs. Shareholders	Boards are held responsible for sustainability but not rewarded accordingly.	Reverse Agency Problem	May work to streamline the payment on the basis of job study.
	Board Vs. Management	Management is not capable enough to carry out the policy as set and delegated by the Board.	Goal Congruence Crisis	May help management to carry out the policies timely by Strategic Planning & Budgeting.
	Board Vs. Regulatory Authorities	Regulatory authorities are not supportive rather slow and sometimes, disturb the activities.	National Policy Crisis	Professional accounting bodies may help the regulatory authorities to frame supportive rules, codes and regulations.
Management	Management Vs. Board	Board always wants to exercise and exert power on management that widens the gap between these two important interacting parties.	Power Crisis	May work as an intermediary to consummate the so-called power that gives rise to confliction.
	Management Vs. Shareholders	Management is held responsible for maximizing values for the owners but not paid accordingly.	Mini-agency Problem	May resolve the problem by helping to devise authority-responsibility-duty relationship in a proper way.
Regulatory Authorities	Regulatory Authorities Vs. Board	Confliction arises on the ground of compliance of various rules, codes, principles etc that various regulatory authorities requires.	Non-compliance	May act as a compliance expert to suggest the Board and Management regarding the ways of complying various requirements, as they are a part of designing such requirements.
	Regulatory Authorities Vs. Management			
Customers	Custoers Vs. Board	Customers want quality product at a cheaper price, but the Board or Management never give respect to the 'Voice of Customers' that results massive dissatisfaction.	Demand – Supply Mismanagement	Can justify the commitment of the Board or Management to the customers, if any, through disclosures like 'Value Added Statement', 'Boards Commitment to Customer', to reduce the dissatisfaction to a greater extent
	Customers Vs. Management			

Agency problems arise when people in different position sacrifices the corporate wide goals to materialize the personal interest. Tunneling is a situation where majority shareholders capture minority shareholders. Non-compliances originate from the avoidance of different local, regional and international laws, regulations, codes, treaties or other requirements. And power or ego crisis is very common at top level management which may turn hundreds years' achievement into zero in a day. These are the different type of problems that corporations face and bad governance gets scope to spread over the organization. The final column of Table 1 shows accountants' role in such a situation when different stakeholder groups got involved with confliction. The only requirement to get such benefit is to have a code of conduct for accountant with defined power, authority and responsibility may be in the form of a manual.

Hurdles to be passed

To have GCG established through the practice of accounting, some hurdles are needed to be addressed. These are the preconditions for the good interactions between the practice of accounting and the establishment of GCG. Some of such important hurdles are stated below.

We need a sequential and gradual move from 'soft' to 'hard' laws. An unethical company can bypass even the most draconian regulation. It can incorporate every governance practice in form, and still possess none of them in substance. It is instructive to remember the words of former U.S. President Bill Clinton who said, *"We must consider how excessive business regulation and 'box-ticking' will ensure business performance"* (Murthy, 2006).

Another hurdle is the designing of compensation package for different levels of management. Senior management compensation must be based on the principles of fairness, transparency and accountability. The current practice of the 'platinum handshake'[2] in the form of severance pay norms for top management should be stopped. It should be changed to a uniform norm valid across all levels in the corporation.

Important focus should be given on balancing power of the management and the board. Board independence from management continues to be affected by directors who have limited accountability to shareholders, and are ill-equipped in exercising management oversight. It is estimated that, on average, one-third of the board members of American corporations lack the necessary industry knowledge and experience to contribute effectively to management oversight (Morgenson, 2005). This percentage is even more in South Asian countries like Bangladesh. Thus board failure is a common phenomenon in most of the corporation.

As Accounting is intentionally referred to as a vehicle for ensuring GCG, it is believed that the world should adopt a uniform global accounting standard and that has already been done. The journey started long ago. This move will make it easy to compare the performance of corporations, in an industry, across countries. Infosys has demonstrated its investor-friendliness by becoming the first company on NASDAQ to produce its balance sheet and income statement according to the Generally Accepted Accounting Principles

[2] Platinum Handshake is a package for top level managers that never justifies equity and people at the top level has got the option to switch over the jobs with no tension and due to such option they may not have love and affection to the jobs they are doing.

(GAAP) of eight countries from where they have investors – India, U.S., Canada, UK, France, Germany, Japan and Australia. These are the basic hurdles to be passed before ensuring GCG.

Why do we need Good Corporate Governance?

A commitment to good corporate governance in terms of, say, well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, an empowered board of directors etc. make a company both more attractive to investors and lenders, and more profitable (Barger & Lubrano, 2006). Investors always look for this that attracts premium valuations in every respect. A study reveals that well-governed firms in Korea traded at a premium of 160 percent to poorly governed firms (Black et al., 2006). Again, Brazil based firms with the best corporate governance ratings garnered 2004 price-earnings ratios that were 20% higher than firms with the worst governance ratings (Erbiste, 2005).

A study of Russian firms concludes that a worst-to-best improvement in corporate governance predicted an astronomical 700-fold (70,000%) increase in firm value. The study's sample size was small (21 firms), so it's unlikely that such a huge increase would occur in a larger, more representative sample. However, the study still demonstrated a correlation between improved corporate governance and firm value (Black, 2001). Another study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19% over a two-year period (Grandmont et al., 2004). A Harvard/Wharton study showed that if an investor purchased shares in US firms with the strongest shareholder rights, and sold shares in the ones with the weakest shareholder rights, that investor would have earned abnormal returns of 8.5 percent per year (Gompers et al., 2003). In a 2002 McKinsey survey, institutional investors said they would pay premiums to own well-governed companies on an average of 30% in Eastern Europe and Africa; and 22% in Asia and Latin America (IFC, 2006).

A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA) in 2001 showed that companies with the best corporate governance in each of a large number of emerging market countries had eight percentage points higher measures of economic value added (EVA) than firms in their country average (CLSA, 2001). U.S. based firms with better governance have faster sales growth and were more profitable than their peers (Gompers et al., 2003). Brazilian firms with above-average corporate governance had ROEs that were 45% higher and net margins that were 76% higher than those with below-average governance practices (Erbiste, 2005). Thus for an integrated success, GCG has no alternative.

Conclusion

Good corporate governance is a must for today's complex and dynamic business environment to ensure long-term sustainability. So, it should be cultivated and practiced regularly within the current structure of the business. We may institute international awards for good corporate behavior, and promote a global corporate governance ranking system for Fortune 500 corporations and alike. If, as corporations, we ignore the lessons that companies like Enron, WorldCom and Tyco have to offer, we will fail to regain the public trust that is so essential to our long-term success and survival. Corporations that genuinely recognize and embrace the principles of 'good governance' will derive enormous benefits, the availability and lower cost of capital, the ability to attract talent clients and business partners, improved competitiveness and financial performance, and truly sustainable long-term growth. And, undoubtedly, accounting will show us the way to proceed with corporate governance where bad governance generally comes from financial dissatisfaction and over exercising of power.

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