ACCOUNTABILITY IN THE NAME OF GLOBAL CORPORATE GOVERNANCE. A HISTORICAL PERSPECTIVE

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ABSTRACT

This paper argues for the pivotal role played by accountability in both corporate governance theory and practice. The reader is invited to take a journey through the history of the concept, by highlighting ten major points of interest, either real-life events or academic debates.

A historical research approach is used in this context. Pre-modern and pre-contemporary evidence is exposed, aiming to shed light on the evolution of the dispute between the two major corporate objectives: shareholder value maximization and social responsibility. In this context agency theory – pioneered by Jensen and Meckling (1976) –, and stakeholder theory – advocated by Freeman (1984) – form together the scientific foundation of the notion of accountability. The subsequent points track the evolution of corporate governance codes and the implementation of governance reforms in the European Union. However, reforms would have been improbable in the absence of a series of ‘unfortunate’ and confidence-shattering events that are gathered together under the title of ‘U.S. business scandals’. Among these, the most prominent are undoubtedly the Enron case and the fall on Arthur Andersen, the latter having a particular significance for accountancy and the formulation of profession ethics. The Sarbanes-Oxley Act of 2002 is a major chapter in the turbulent history of Anglo-American corporate governance reform. The historical overview ends with a consideration of globalization initiatives, mainly that of the OECD, through the issue and revision of the Principles of Corporate Governance, a major landmark in the assessment of ‘good governance’.

KEY WORDS Corporate governance, stakeholder theory, conceptual framework, accountability

1. INTRODUCTION

Any system that assumes the delegation of power can refer to this definition: ‘Accountability is a means of concretizing relations between institutions, delineating responsibilities, controlling power, enhancing legitimacy, and ultimately promoting democracy’ (Fisher, 2004: 510). The aim of devising accountability is creating trust in governance institutions.

Seal & Vincent-Jones (1997: 410) argue that the need for trust is especially acute in shaping long-term relationships. Any organization that claims sustainability cannot refrain from keeping business risk at moderate levels. Stanton (1997: 684) quotes Rosenfield who perceives accountability as ‘the justifiable holding of one to account for personal actions or to answer a charge, justifiability being conferred by an authority relationship between the persons concerned’. Inside the corporation, the authority relations may be evaluated from the two angles: the shareholder-value maximization theory, and stakeholder theory. Spira (2001:739) considers that individuals and organizations are discharged of their accountability duties by providing timely information to interested parties.
Romzek and Dubnick (quoted by Licht, 2002: 8) provide a representative description of accountability, as follows:

“A relationship in which an individual or agency is held to answer for performance that involves some delegation of authority to act; [...] accountability is a generic form of social relationship found in a variety of contexts… Accountability does not necessarily imply the existence of democracy; rather, it suggests any form of governance conducted through some delegation of authority.”

Accountability belongs to an important category of social norms that may collectively be called “norms of governance”. Norms of governance prescribe legitimate modes of wielding power – that is, they deal with use and abuse of power (Licht, 2002: 14). Accountability may be held as the trademark of corporate governance, and particularly of the two descendants of this field of study: agency theory and stakeholder theory.

The paper invites the reader to take a journey through the history of the concept, by highlighting ten major points of interest, either real-life events or academic debates. Pre-modern and pre-contemporary evidence is exposed, aiming to shed light on the evolution of the dispute between the two major corporate objectives: shareholder value maximization and social responsibility. In this context agency theory – pioneered by Jensen and Meckling (1976) –, and stakeholder theory – advocated by Freeman (1984) – form together the scientific foundation of the notion of accountability. The subsequent points track the evolution of corporate governance codes and the implementation of governance reforms in the European Union. However, reforms would have been improbable in the absence of a series of ‘unfortunate’ and confidence-shattering events that are gathered together under the title of ‘U.S. business scandals’. Among these, the most prominent are undoubtedly the Enron case and the fall on Arthur Andersen, the latter having a particular significance for accountancy and the formulation of profession ethics. The Sarbanes-Oxley Act of 2002 is a major chapter in the turbulent history of Anglo-American corporate governance reform. The historical overview ends with a consideration of globalization initiatives, mainly that of the OECD, through the issue and revision of the Principles of Corporate Governance, a major landmark in the assessment of 'good governance'.

2. MILESTONES ON THE ROAD TO ACCOUNTABILITY: TEN HISTORICAL HIGHLIGHTS

2.1. Adam Smith and the emergence of the corporation

Corporations have a long history in the English-speaking world. They emerged in medieval times as a means by which a group of private citizens could combine their interests under a royal charter to differentiate (and protect) themselves from the changeable interests of the government. Early examples of chartered corporations include the East India Company, formed in 1600 to hold a monopoly on trade with India, and the Virginia Company, formed in 1606 to develop the land and trade opportunities in North America. Valuable monopoly provisions were included in a charter granted to the original founders of the Bank of England in 1694, which was quickly capitalized by public subscription of shares in the London market.

In 1711, the South Sea Trading Company was formed to exploit such opportunities as might be found in South America. This company was all illusion but nevertheless generated an overwhelming response from investors – the euphoria became known as the great “South Sea Bubble” after it collapsed in 1720. There were many other failures of companies traded on
stock exchanges at the time, and much anger and recrimination developed in their aftermath over the role of the public corporation as a form of business organization. As a consequence, the corporation – as a legal form under which to do business and subscribe funds was suppressed and did not resurface in England for the next hundred years.

Indeed, Adam Smith was highly critical of the East India Company and other incorporated monopolies in The Wealth of Nations, published in 1776. He saw the corporation then as a creature of privilege that was able to ignore the laws of market economics and to depend on taxpayer bailouts when it faced financial failure. In fact, a large bailout of the East India Company was undertaken in 1773, after which the government intervened more extensively in its management. The East India Company was dissolved in 1858 after the Indian Mutinies, which led the British government to step in and assume direct governance of the colony (Smith & Walter, 2006).

It is noteworthy that the publication of The Wealth of Nations and the signing of the U.S. Declaration of Independence both occurred in 1776. Each was, in its way, a revolutionary manifesto challenging the abusive alliance of state and corporate power to establish monopolistic control of markets and thereby capture unearned profits and inhibit local enterprise.

Adam Smith and the American colonists shared a deep suspicion of both state and corporate power. Adam Smith was also quite explicit that optimal market efficiency depends on the owners of capital being directly involved in its management – the owner-managed enterprise – because he believed that owners exercise greater diligence in ensuring the most efficient use of assets than do managers who have no ownership stake.

'The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less in the management of the affairs of such a company' (Adam Smith quoted in Korten, 1995: 74-80).

2.2. Pre-contemporary evidence: the birth of managerial accountability

In 1909, the U.S. Congress passed a series of legislative acts that developed into the basis of the corporate income tax. With the ratification of the Sixteenth Amendment in 1916, the taxation of corporate profits became a law. As a result, simple bookkeeping developed into more complex accounting issues. The income tax requirement coupled with the financial audit created large amounts of organized information about the financial position of the business. Managers were now expected to use this financial information to better manage the corporation (Washburn, 1996).

In 1919, a seminal ruling in the Michigan courts, Dodge v. Ford Motor Company, set the legal tone for management responsibility and corporate governance. The court ruled that: "A business corporation is organized and carried on primarily for the profit of the shareholders". Mere ownership of a business gave way to the new concept of creating profits for owners. Managers were responsible for coordinating the business to achieve this goal (Grant, 2003).

As the stock market plunged and the Great Depression unfolded, Berle and Means, published their landmark book, The Modern Corporation and Private Property. Written in 1932, it drew widespread attention to the fact that shareholders were legal owners of a corporation, but managerial authority was left to professionally trained executives. The book focused on the
fiduciary responsibility of the corporation and the separation of ownership and control corporations, by this time, had grown beyond the optimal means to carry on business, and had developed to become a "method of property tenure and a means of organizing economic life. [...] the corporation, within it there exists a centripetal attraction which draws wealth into aggregations of constantly increasing size, at the same time throwing control into the hands of fewer and fewer men” (Berle and Means, 1967: 3). Separation of ownership from control thus led to the evolution of a market-based control mechanism. In addition, this led to the development of nexus-of-contracts theory and the agent theoretic model of governance. While the nexus of contracts theorists argued that due to the incomplete nature of contracts problems of expropriation arise, the agent theoretic model focused on the behavioural motivations of conflicts of interests (Bhasa, 2004).

2.3. Jensen & Meckling (1976): the fathers of scientific corporate governance

Agency theory applies to relationships in which one party (the principal) delegates the responsibility of running the firm to another (the agent), who performs that task. In an abbreviated terminology, the agent "acts for" the principal. Two problems exist in agency relationships. First, the agent and the principal might have conflicting goals, and it is difficult and/or expensive for the principal to verify the agent's activities. Second, the principal and the agent have different propensities to accept risk. The central question of agency theory becomes: What type of contracts best suit agency relationships of various types?

Some contracts focus on the agent's behaviour, and others focus on outcomes of interest to the principal. Contracts are thought to be efficient if they minimize the sum of the following agency costs:

1. Monitoring costs borne by the principal to reduce agent actions that would harm the interests of the principal;
2. Bonding costs borne by the agent to guarantee that the agent will not take actions to harm the interests of the principal;
3. A residual loss incurred because monitoring and bonding may not fully align agent behaviour and principal interests.

Agency theorists consider a system of corporate governance as efficient if it ensures that suppliers of finance get an appropriate return on their investment (Shleifer and Vishny, 1997: 741). The interests of other stakeholders, such as employees, suppliers and customers, are mediated by labor and product markets. As agency theory models generally assume that these markets are functioning efficiently, this suffices to guarantee their interests. Weak corporate governance can lead to principal-agent conflicts between owners and management, and between different groups of owners. In the presence of incomplete contracts, managers retain discretionary control and possess inside information, such that owners incur considerable monitoring costs (Jensen, 2001).

In the Jensen and Meckling (1976) model of the firm, an owner-manager who decides to issue equity bears all of the agency costs from this action. Potential shareholders, possessing rational expectations, recognize that the owner-manager will engage in more on-the-job consumption of various sorts, once he is no longer the firm’s sole owner, because the costs of such consumption are now shared with the new owners. They lower their bid for the firm’s shares, therefore, so that all of the costs of the on-the-job consumption fall on the owner-manager. This reasoning leads to two predictions. First, the greater are agency costs in a country (the weaker are shareholder protections), the less incentive founders of firms have to
issue equity. In the extreme, agency costs convert the equity market into a market plagued by adverse selection, and lead to its disappearance. The first prediction is, therefore, that equity markets will be thinner in countries with poor shareholder protection. The second prediction follows immediately, namely that ownership concentration is higher in countries with poor shareholder protection (Gugler et al. 2004: 137).

2.4. Stakeholder theory and business ethics

‘The firm is characterized by relationships with many groups and individuals ("stakeholders"), each with (a) the power to affect the firm's performance and/or (b) a stake in the firm's performance’ (Freeman, 1984). In many cases, both conditions apply. Stakeholders include, but are not limited to, shareholders.

Pioneering work in the area of stakeholder management was provided by Freeman (1984), who outlined and developed the basic features of the concept in a book entitled Strategic Management: A Stakeholder Approach. Freeman defines them as ‘any group or individual that can affect or be affected by the realization of the objectives of the company’ (quoted in Pesqueux & Damak-Ayadi, 2005: 6). Ethical considerations are what have driven stakeholder theory’s rise, having been deployed as a way of constructing its normative aspect – the idea being that we are all stakeholders.

Donaldson and Preston (1995, quoted in Jones, 1995, and in Pesqueux & Damak-Ayadi, 2005) argued that stakeholder theory explicitly or implicitly contains theory of three different types – descriptive/empirical, instrumental, and normative. Descriptive/empirical formulations of the theory are intended to describe and/or explain how firms or their managers actually behave. Instrumental theory purports to describe what will happen if managers or firms behave in certain ways. Normative theory is concerned with the moral propriety of the behaviour of firms and/or their managers. Briefly summarized, descriptive/empirical, instrumental, and normative theories address the questions: what happens? what happens if? and what should happen?, respectively (Jones, 1995).

Proponents of stakeholder theory strive to describe what managers actually do with respect to stakeholder relationships, what would happen if managers adhered to stakeholder management principles, and what managers should do vis-à-vis dealing with firm stakeholders. Donaldson and Preston (1995) concluded that normative concerns underpin stakeholder theory in all of its forms.

2.5. The creation of corporate governance codes

In May 1991, The Committee on the Financial Aspects of Corporate Governance (Cadbury Committee) was called ‘to review those aspects of corporate governance specifically related to financial reporting and accountability’ (Cadbury, 1992: para. 1.2). The final report was issued in December 1992. In April 1993, the London Stock Exchange amended the listing rules in order to include the incumbent statement of compliance with the Cadbury Code. In July 1995, the Greenbury Committee issued a report and an attached code concerning the disclosure of director remuneration, which also became compulsory for the stock market. In January 1998, the Hampel Committee Report assessed the stage of implementation of the Cadbury recommendations, and decided to urge the adoption of a Combined Code (June 1998) that would sum up the provisions of former codes in a less bureaucratic way. In September 1999, the Turnbull Report was published, providing guidelines on the set-up of
internal control. In January 2003, the Higgs Report reviewed “the role and effectiveness of non-executive directors”, in the light of the U.S. capital market’s downfall. The Combined Code of 2003 is still effective in the present.

Almost fifteen years after the issue of the first governance code (Cadbury, 1992), these collections of best practice recommendations, which have proven to be extremely influential in the European Union, are still regarded as a hot topic in the turbulent environment of the capital markets. Whittington (1993: 311), as well as Keasey, Short & Wright (2005, p. 21), are enumerating some of the causes that have cumulatively led to devising these codes:

(a) Creative accounting, the direct consequence of multiple accounting options and policies the managers could use as a detour from the ‘true and fair view’;
(b) The financial scandals and famous bankruptcies – in particular of British firms – that had drawn attention to the failures of corporate governance institutions and piled up criticisms of the reporting and audit systems;
(c) Directors’ remuneration schemes, which had come to be seen as an oversized expense directly extracted from investors’ yield, without a fully justifiable connection to performance;
(d) The directors’ short-termism, a major distraction from sustainable performance – which in turn the perfect trigger for opportunistic takeovers, erroneously considered to be the most efficient way of disciplining corporate executives.

The widely accepted positive outcomes of that initiative have instigated the adoption of similar codes of best practice in almost all European Union countries. Yet, the appreciation for codes as an instrument to improve corporate governance systems increased only after 1997. Between 1992 and 1997 only three countries (Spain, The Netherlands and France) established a code. From 1998 several other European countries decided to come up with their own version of a corporate governance code. By 2004, a total of 22 European countries has established their own code, and in some cases even more than one (Hermes, Postma & Zivkov, 2006).

2.6. European policy concerning corporate governance

On the 10th of December 2003 The European Economic and Social Committee adopted the final version of a ‘plan to move forward’ in order to enhance corporate governance in the EU. This opinion (2004/C80/05) was the Commission’s response to a report of the High Level Group of Company Law Experts, which was presented in 2002, and provides that the Council cannot impose a pan-European governance code, given the plurality and often divergence of the provisions of member states Company Laws and national corporate cultures. Internal corporate governance codes, where found, seem to adopt a unitary cross-border view of the necessity of strong shareholder and third party protection.

European countries with long-standing tradition in the matter of unitary boards, have reconciled several implicit and well-documented conflicts of interest by relying upon the system of ‘accountability through disclosure’. The two essential elements to this system of accountability – shareholder rights and information disclosure – are attained by adopting a regulatory regime comprising the Company Law, stock market regulations, supplemented by one (or more in the case of the UK) voluntary codes of practice, which are aimed at forging the much-sought investors’ confidence. It is noteworthy that the European Commission argues (2004/C 80/05, para. 2.4) that (potential) shareholders will punish poor voluntary compliance from companies that do not observe governance standards, mainly because
efficient capital markets are assumed to act as powerful disciplining mechanisms for managerial underperformance. Thus, corporate governance codes are intended to become a necessary complement to the legal requirements for incorporation (Dragomir, 2007).

Under Commission’s Recommendation 2005/162/EC (para.1.1), Member States are invited to take the steps necessary to introduce, at national level a set of provisions concerning the augmented role of non-executive or supervisory directors of listed companies. The scope of this recommendation seems narrow, providing that listed companies form only a statistical minority of the joint-stock companies, in spite of their material contribution to national revenue.

In order to promote credible financial reporting processes across the European Union, Directive 2006/46/EC amending the Forth and the Seventh Directives, impose on members of the company body the responsibility for the preparation of the company’s financial reports and the duty to ensure that the financial information included in a company’s annual accounts and annual reports gives a true and fair view – para. (4). At the same time, disclosure should encompass related-party transactions, the material risk and benefits of off-balance-sheet arrangements. Furthermore, ‘Companies whose securities are admitted to trading on a regulated market and which have their registered office in the Community should be obliged to disclose an annual corporate governance statement as a specific and clearly identifiable section of the annual report. […] The corporate governance statement should make clear whether the company applies any provisions on corporate governance other than those provided for in national law, regardless of whether those provisions are directly laid down in a corporate governance code to which the company is subject or in any corporate governance code which the company may have decided to apply’ – para. (10).

2.7. The U.S. business scandals and the Enron case

‘What happened?’ asks William J. McDonough, president of the Federal Reserve Bank of New York. Speaking at Trinity Church in New York on September 11, 2002, he said, ‘Sadly, all too many members of the inner circle of the business elite participated in the overexpansion of executive compensation. The policy of vastly increasing executive compensation was also, at least with the brilliant vision of hindsight, terribly bad social policy and perhaps even bad morals’. (Vogl, 2004, quotes McDonough). The U.S. system of corporate governance, with its myriad rules designed to make officers accountable to shareholders and to protect the latter’s rights, has not proved worthy of its fame of superiority. The catalog of reputation-sinking scandals may start by the following enumeration, however incomplete:

- Boards of directors grant executives multimillion-dollar loans that they know will never be repaid, while simultaneously agreeing to plans to lay off thousands of employees (for example, WorldCom, Enron, and Tyco).
- Securities firms advise customers to buy junk so that these firms can make quick profits at the expense of the customers who trust them.
- Major American companies that seek to dodge U.S. taxes by finding a legal loophole that enables them to place their corporate headquarters in an offshore tax haven (for example, Tyco registered in Bermuda, and Enron created 881 offshore subsidiaries, 692 of them in the Cayman Islands, as part of its strategy to avoid taxes, according to a report by U.S. Congress experts) (Vogl, 2004).
France's *Le Monde Diplomatique*, for example, published an article in March 2002 under the headline "Enron, symbole d'un système" (Enron—symbol of a system) that argued, "The extraordinary aspect of the Enron affair is that it is not extraordinary at all." It then suggested that corruption is pervasive across American business and politics (Vogl, 2004).

The Enron implosion has had very serious impact on the world capital markets; trust in accounting and accounting profession, and the effectiveness of corporate governance. Enron’s collapse shattered investor confidence and billions of dollars of market capitalization evaporated. The published financial statements do not give any indication of the financial disaster awaiting thousands of investors, creditors and employees. Chandra (2003) transcribes the legend of the rise and fall of Enron, from which we extract the points of interest for any accounting historian and critic:

- Enron Corp. filed for bankruptcy on December 2, 2001 and restated its financial statements for the years 1997 through 2000.
- Enron started out as a producer and distributor of natural gas but as opportunities presented themselves it got into a variety of other businesses.
- On June 7, 1984, the then 40-year old Kenneth Lay joined Houston Natural Gas (HNG), Houston, Texas as the president of a traditional natural gas production and distribution company.
- Jeffrey Skilling joined Enron in 1990, rising to become its president and chief operating officer in 1996 and its Chief Executive Officer (CEO) in February 2001.
- Skilling saw an opportunity in trading natural gas and extended the logic of securitization to gas industry. Skilling saw an opportunity in trading natural gas and extended the logic of securitization to gas industry. He thus worked on the idea of *gas bank*. He thought that like the stock options, gas contracts could also be standardized and traded.
- Enron devised standardized gas contracts/options and it became a counter party (either a buyer or a seller) to every energy contract. Thus from a broker, Enron catapulted into a giant trading company.
- Being a counter party to big gas contracts in which Enron was making an active market, it needed huge amounts of liquidity to finance its trading operations. Enron found the answer in accounting: adoption of the mark-to-market valuation of investments, and creation of the special-purpose entities (SPEs). Just as Skilling initiated the idea of gas bank, Fastow created SPEs to hide debts and losses from Enron’s financial statements.
- Although energy contracts had no open market (other than buyers and sellers of those contracts and Enron being the counter party in all of them), Enron was too eager to value these contracts at their current value and recognize the resulting (mostly) gains and losses.
- To cope with its growing volume of business, Enron needed a mechanism to borrow an ever increasing amount of money and yet maintain an acceptable debt/equity ratio.
- It succeeded in hiding its debt by resorting to off-balance sheet financing. Enron saw a creative use of special-purpose entities (SPEs) similar to that of gas bank. Enron followed the letter of the accounting standards and did not consolidate SPEs’ financial statements with its own. The SPEs became a convenient vehicle to unload losing trading contracts and to borrow money from outside for Enron. The SPEs borrowed money heavily on the basis of Enron’s guaranties or by collateralizing its stock.
In 1999, against Enron’s policy, its management entered into two very complex partnerships (known as the LJM transactions) in which Andrew Fastow was the manager and an investor. To report a quick profit, Enron would sell assets to LJM at a profit at the end of a fiscal period and buy the assets back at the beginning of the next fiscal period. These were sham transactions as the risks and rewards of ownership stayed with Enron (the seller).

As the Internet bubble burst open, Enron’s merchant investments and unfortunately, its own stock swooned. Consequently, some of its SPEs ran into insoluble credit problems. Finally, in September 2001, Enron terminated the SPEs and announced a $544 million after-tax charge against earnings as a result of hedging (an investment by itself—a self-dealing). Additionally, Enron also reduced its equity by $1.2 billion for reasons of accounting errors made in 2000 and 2001.

Although Enron had disclosed the existence of SPEs and its auditors and legal counsel approved the disclosures, the disclosures were too vague to be of any help to the investors and did not communicate the nature or extent of the officers’ financial interest in the SPEs.

2.8. The fall of Arthur Andersen

A public accounting firm’s responsibility is to ensure that the financial statements fairly present a company’s financial position and operations in order for users to make decisions. In an unqualified audit report, the firm certifies that the “financial statements present fairly in all material respects, the financial position” of a company and that the audit was conducted in accordance with generally accepted auditing standards (GAAS). These standards include independence, specifying that the auditor must be independent in fact (mental attitude) and in appearance (perception by financial statement users) by maintaining objectivity and freedom from bias (Niece & Trompeter, 2004).

In June 1979, the SEC issued Accounting Series Release 264 (ASR 264): SEC Interpretation of Effects on Independence of Auditor Performance of Management Advisory Services (MAS), which set forth key factors that accountants should consider before performing non-audit services. It stated: ‘Accountants should examine the relationship between the audit fee and the proposed MAS fee . . . any firm which finds that a substantial portion of its aggregate revenue arises from non-audit engagements should seriously evaluate the resulting impact on its image as a professional accounting firm and from the standpoint of the potential for impairment of its independence’. ASR 264 stressed that an accountant’s role was to advise management and not to act in any way as a decision maker.

As Arthur Andersen LLP worked to expand its consulting services (ultimately to the point where it competed with Andersen Consulting), the firm also increased other services, such as internal auditing for clients. This role was pioneered at companies like Enron. The Enron account had become so lucrative for Andersen that the firm was unwilling to step away, even when it determined the engagement was one of its most risky.

By the summer of 2001, even Enron employees began to question the company’s accounting practices. As the uncertainty became public, Enron’s complex web of partnerships began falling apart and its stock plummeted. The Andersen auditors struggled with how to properly restate and account for losses that had been ignored. In addition, it was alleged (but never proven) that David Duncan, the partner-in-charge of Enron, attempted to avoid retaining material that could potentially cause harm during litigation. He ordered the destruction of
numerous documents related to the Enron audit. In a press release, Andersen announced that it would fire Duncan because it would “not tolerate unethical behaviour, gross errors in judgment or wilful violation of [its] policies” (Niece & Trompeter, 2004, quoting Alexander et al.).

But Andersen could not avoid the legal repercussions and was indicted by the U.S. Justice Department for obstruction of justice. However, the matter did go to trial, and on June 15, 2002, the jurors found Andersen guilty of obstructing justice. (It is noteworthy that the firm was not found to have conducted an inadequate audit.) The firm immediately announced that it would cease auditing publicly traded companies on August 31, 2002 (Niece & Trompeter, 2004).

2.9. The Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, which contains many reforms intended to protect investors by raising corporate governance standards designed to improve the accuracy and reliability of corporate disclosures. On November 4, 2003, the Securities and Exchange Commission (SEC) approved reforms to the corporate governance requirements of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). On December 1, 2003, the SEC approved similar reforms for the American Stock Exchange (AMEX). These reforms are designed to enhance the accountability, integrity, and transparency of the exchanges’ listed companies.

The cornerstone of the aforementioned corporate governance reforms is outside independent directors. The reforms increase the role and authority of these directors, as well as tighten the definition of ‘independent’. Additionally, the reforms require companies to focus on good corporate governance, and give shareholders more opportunity to monitor and participate in the governance of their companies (Petra, 2006).

The Sarbanes-Oxley (SOX) Corporate Fraud and Accounting Act was authorized in July, 2002, with the purpose of improving practices of public companies. A new agency is created – Public Company Accounting Oversight Board (PCAOB) – that covers the above area in several ways: internal versus external controls, and accounting and auditing vs. non-accounting services. From that dual perspective, a realistic assessment of company performance and actions is made. The agency authority is to inspect and investigate in scope and depth (Yakhou & Dorweiler, 2004).

Statutory standards contained in the SOX have multiple effects, noted in the following categories:

(1) External:
- registration of public companies, with the PCAOB and registration of associated persons;
- PCAOB authority to discipline violations of public companies, including suspension of registration;
- rotation of auditor, serving a maximum of five years for lead, review auditor, not an audit firm itself;
- document retention of workpapers related to audit for time period of seven years; and
- elimination of discharge of obligations as relief under the Bankruptcy Reform Act.
Audit committee, with all members independent directors, to appoint the external audit firm with assurance of auditor independence, principally by limiting non-audit services; to establish confidential complaint procedure and protection of “whistleblowers”; and certification of financial statements, by CEO and CFO, including assessment of internal control system, and reconciliation to GAAP in financial statements on financial condition and results of operations.

2.10. OECD Principles and the convergence of governance

The OECD experience in the area of corporate governance includes undertaking work to try to improve the understanding of the implications of corporate governance on economic performance and specific reviews conducted on individual corporate governance regimes. On the recommendation of a special OECD Business Sector Advisory Group (which included widely acknowledged experts such as Sir Adrian Cadbury), the OECD was given a mandate to develop a set of corporate governance principles in April 1998. The task force included representatives from all OECD countries and relevant international organizations such as the World Bank and the IMF etc, representatives from the corporate sector, investment community and trade unions. The task force also consulted with non-OECD countries.

An influential report by the OECD’s Business Sector Advisory Group on Corporate Governance (chaired by Ira M. Millstein) details four core governance standards necessary to attract private capital:

a) **Fairness.** Protect shareholder rights, including the rights of minority and foreign shareholders (and the contractual rights with resource providers).

b) **Transparency.** Require timely disclosure of adequate, clear, and comparable information concerning corporate financial performance, corporate governance, and corporate ownership.

c) **Accountability.** Clarify governance roles and responsibilities, and ensure that managerial and shareholder interests are aligned and monitored by the board of directors.

d) **Responsibility.** Ensure corporate compliance with the other laws and regulations that reflect the respective society’s values. *(Report to the OECD on Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, April, 1998. Available from [www.oecd.org](http://www.oecd.org)).*

Issued to OECD Ministers at the height of the Asian crisis, the Report recommended that the OECD promote and further articulate these core standards. The *OECD Principles of Corporate Governance* issued in 1999 expand the four core standards into five broad and non-binding principles. The corporate governance framework should:

**I.** Protect shareholders’ rights.
**II.** Ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
**III.** Recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
IV. Ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. V. Ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.

The Principles are the first set of international standards on the subject. They are not intended to substitute government or private sector initiatives to identify more detailed corporate governance practices to suit individual circumstances. They are however intended to provide guidance and assistance to governments, regulators, stock exchanges, investors and corporations in evaluating and developing the regulatory framework and supporting corporate governance systems. The Principles were revised in 2003 to take into account developments since 1999, through a process of extensive and open consultations, and drawing on the work of the Regional Corporate Governance Roundtables for non-OECD countries. The new Principles were agreed by OECD governments in April 2004. This Policy Brief outlines the salient features of the Principles and illustrates how they address key corporate governance issues (Policy Brief: The OECD Principles of Corporate Governance, 2004, www.oecd.org).

The latest version of the Principles covers six key areas of corporate governance: ensuring the basis for an effective corporate governance framework; the rights of shareholders; the equitable treatment of shareholders; the role of stakeholders in corporate governance; disclosure and transparency; and the responsibilities of the board. There are explanatory annotations for each area that also indicate the range of policy measures which have proved useful in achieving them. Key to the success of the Principles is that they are principles-based and non-prescriptive so that they retain their relevance in varying legal, economic and social contexts.

On the issue of ‘disclosure and transparency’ (Principle V), the principles contain the following recommendation: “The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company”. The framework should ensure:

1. disclosure on all material matters regarding the corporation:
   - financial and operating results of the company;
   - company objectives;
   - major share ownership and voting rights;
   - members of the board and key executives and their remuneration;
   - material foreseeable risk factors;
   - material issues regarding employees and other stakeholders; and
   - governance structures and policies.
2. That information is prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure and audit.
3. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.
4. Channels for disseminating information should be provided for fair, timely and cost efficient access to relevant information by users.
The newly revised Principles should therefore be seen as part of a continuing process to build trust for workers and the wider public in the role of corporate governance to build effective corporate accountability. Beyond the outcome of the Review, the process itself helped contribute to an increased internal dialogue within the international labour movement on the issues of corporate governance reform. Similarly, the Review process helped to build bridges between trade unions and active responsible institutional shareholders around key issues of mutual importance (The OECD Principles of Corporate Governance: an Evaluation of the 2004 Review by the TUAC Secretariat, October 2004, www.tuac.org).

3. ACCOUNTABILITY AND ACCOUNTING: CONCLUSIONS IN A PHILOSOPHICAL TONE

For the English philosopher Jeremy Bentham (1748-1832) it was an ‘indisputable truth’ that ‘the more strictly we are watched, the better we behave’. Accounting is central to Bentham’s scientific and administrative thought. In effect, he sought to greatly enhance accounting's importance in society. For Bentham, the purpose was to enhance ‘wellbeing’. Thus, he understood that accounting publicity, in consequence of its effects on behavior, could contribute to human happiness. Bentham explicitly suggests that if the management of a body (in that case a joint stock company) is subject to accounting publicity then that management will behave well in terms of moral and economic criteria. He expresses this in the language of duty and service to humanity and economy. He seems to argue that the principle of publicity is the optimal mode of securing the duty to humanity in particular and that the securing of this latter duty is the primary role of publicity:

‘The duty of the manager has two main branches: duty towards those under his care, resolvable into humanity – and duty to his principals (the company), resolvable into economy. Publicity, the most effectual means of applying the force of moral motives, in a direction tending to strengthen the union between his interest and the human branch of his duty; by bringing to light, and thus exposing to the censure of the law and of public opinion, every instance of contravention’ (Bentham, 1797, quoted in Gallhofer & Haslam, 1995).

Prosperity or accountability? This is definitely a false dilemma, because these two concepts are indisputably linked. It is apparent that claims to accountability expressed after US scandals are very different from those of the Cadbury days. That is not because the human need for freedom, welfare and justice has changed so much during a decade, but because the stakeholder society is much more aware of the dangers a malfunctioning governance system can bring. In these circumstances, the corporate objective function, whether we called value-maximization or value seeking, should adjust the increasing claims to accountability formulated by all stakeholders.

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