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EVOLUTION OF CORPORATE GOVERNANCE IN THE ERA OF FRAUD AND SCAMS

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ABSTRACT

Corporate governance can be defined in many ways according to the point of focus but it mainly deals with sustainable economic growth, shareholders' protection and protection of stakeholders' rights. The research paper focuses on the evolution of corporate governance, changes in the financial environment and the new challenges that have come across during such evolution such as frauds, scams, etc. The paper would also contain instances of some important scams that unveiled the weakness of the corporate governance. The paper also discusses the upcoming challenges, what corporate governance ought to provide and what it can encourage or promote.

KEYWORDS: corporate governance, corporate fraud, corporate scams, control, etc.

INTRODUCTION

It is important that the shareholders and stakeholders have the assurance that their rights are protected. For effective corporate governance, it is dependent upon efficient legal, regulatory and institutional environment. It was observed that there is a need of standardized procedures for management processes when the complexities started growing in the business field; so the OECD[1] published a principle "The Principles of Corporate Governance in 1999". It was accepted as an international benchmark for policymakers and stakeholders. The aim of this principle was to:

- To evaluate and improve legal, regulatory and institutional environment.
- To increase economic efficiency, sustainable growth and financial stability.

Corporate governance is a structure that assures proper management of a company. It involves mechanism of incentive and monitoring and building trust, transparency and accountability in order to manage the company efficiently and

[1] Organization for Economic Co-operation and Development.

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obtain the trust of the investors so that the company can grow and develop.

Many cases of scams in corporate world have been filed in which the financial statements and the functioning of auditors and accountants were put in question. Scam cases in Enron, WorldCom, Tyco, Parmalat etc were some of the cases that portrayed the weakness of the companies in controlling internally and externally. These problems, scams and frauds can be dealt with good corporate governance. Good or efficient governance can help reduce creative accounting and scandals.

Sarbanes- Oxley Act, 2002 got approval from the American Congress. It aimed to restore the confidence of the investors and to deal with the scams and ensure that no such frauds and scams occur in future. It demands for the reproduction of extensive documentation and to take such test and assessment that ensures effective internal and external control of the company.[2] This Act allows detection of errors in the financial reporting procedure even before the occurrence of the scam.

ORIGIN OF CORPORATE GOVERNANCE

The root of corporate governance can be found in the 17th Century, Dutch Republic. Corporate governance was used for the first time as a term in 1976 in the Federal Register in the US. Initially, corporate governance means regulating companies and defining a set structure that can be used as a benchmark for all the companies in order to reduce cases of scams and frauds. The first instance of corporate governance was when the New York Stock Exchange that required the listed companies to establish a committee for audit to their board. The members of the audit committee should be Independent Non-Executive Directors (INEDs).

According to UK Corporate Governance Code, corporate governance is "the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies."

According to Coyle (2007), practice of corporate governance began from United Kingdom in late 1980s and 1990s.

The British East India Company was a joint-stock that was established to help trade

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[2] Sarbanes-Oxley Act, 2002, Section 404.

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efficiently in India. It was established in early 1600, consisting 125 shareholder and £72,000 capital. The ownership of the company was distributed among some of the active members of the board of directors of the company. During that time, the companies were established for some specific purposes. The partnership of the company was formed to organize the business jointly and at that time the transfer of ownership was limited. Therefore, it was limited to transfer of ownership only to friends and relatives. The corporations at that time were small institutions that were established for some specific purpose like for transportations, etc. During those times, companies were restricted from owning any stock in other companies or to make political contributions.

In 1890 and 1910, the companies started transforming from state-controlled institutions to unlimited private institutions. Due to industrialization, big and more complex projects began to form and due to the change in the capital demand from MNCs, stock exchange was born. It acted as a bridge between entrepreneurs and investors. There was a need to develop a sustainable private enterprise sector for a credible and reliable functioning of the capital markets. Stock exchange markets were established in New York and Europe. "Corporate Governance" got encouraged by the liberalization of capital markets.

EVOLUTION OF CORPORATE GOVERNANCE

- ***From 1929 to 1970s***

The 1929 disaster grew to become specific issues that have been being left out through traders and shareholders. It confirmed that capital marketplace evolved sufficiently to acquire greater interest with the aid of using authorities. During the 1920s, hundreds of thousands of human beings tried their fortune in inventory marketplace and misplaced excellent part of it. Public have misplaced self-assurance on capital marketplace and through this time, it constituted a crucial economic supply. It became pressing to repair investor self-assurance on it.

In 1932, the primary massive company scandal became the Kreuger & Toll, the king of fits that used subsidiaries transfers to keep away from taxes and diffuse the shortage of asset given as collateral for more than one loans, exceeding the credit score limit. Discovered after Kreuger's death, this scandal attracted press and U.S. Congress interests. Something must be

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performed concerning securities, company structure, accounting and auditing.

By 1933, the Securities Act received permission that required that the buyers have to obtain proper economic records and restrict frauds, indicating civil liabilities and consequences to fake communication. To empower this Act, through 1934, Securities and Exchange Commission (SEC) was enacted. It provided laws to manage the transactions in securities, to represent a country-wide public interest. This Act also created an authority that keeps check upon the records of the companies periodically. The regulatory authority also had disciplinary powers over the corporations registered under the Act.

As the capital marketplace became complex, different legal guidelines have been being accepted like ones to alter debt securities(1939), funding agencies and funding advisory(1940). All these legal guidelines may be perceived as variations to marketplace surroundings.

Due to many explosions in technologies, economy was developing with the help of executives in the 1960s. Usually Stock exchange was the major instrument that was used. Senator Albert Gore later initiated a campaign for the elimination of tax advantages. During 1970s, there has been a stagnant financial system in the functioning of oil disaster and unemployment. In this context, restrained inventory have become greater famous as proportion that was to be paid over 3-5 years relying upon the monetary functioning or any other goals.

After the Second World War, America skilled robust financial growth, that had a robust effect at the records of the company governance. Corporations had been thriving and developing rapidly. Managers used to call the shots and board of directors and shareholders had to abide by them which they usually did that turned into an exciting dichotomy, seeing that managers rather inspired the choice of board administrators. Unless it got to the subjects of dividends and inventory prices, the traders tended to persuade clean from governance topics.

In the 1970s, matters started changing as the Securities and Exchange Commission (SEC) introduced corporate governance to the vanguard as they introduced official corporate governance reforms. In 1976, “corporate governance” was first introduced inside the Federal Register which is an authentic magazine

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of the federal government. During 1960s, the Penn Central Railway initiated diverse strategies such as pipelines, hotels, commercial parks, and industrial real-estate but in 1970s, it filed for bankruptcy. In 1974, SEC introduced complaints towards 3 outdoor administrators for misrepresenting the company's monetary circumstance and an extensive variety of misconduct with the aid of using Penn Central executives. During that time, the SEC found out that to misrepresent the corporate records, foreign officials are paid hefty amount of money. Thereafter, the companies were required to establish audit committess and appoint some outdoor directors in the company. Then in 1976, SEC introduced NYSE[3] that required for all the listed companies to establish an audit committee in their company that has independent board of directors. The advocates played a crucial role at that time as they required the establishment of audit, nomination and compensation committees.

- ***1980s-1990s***

During this period, a drastic change was observed that resulted into great level of remuneration. The period also was a period in which due to lack of corporate control, many big scandals occurred during 2000s. This period basically entails the main facts and movements which are very crucial to identify the reason behind the scams that occurred in 2000s.

The 1980s began with the end of the 1970s motion because of the political drift of the Congress which brought opposition to deregulation. The deregulation was a major change in the evolution. The Protection of Shareholders' Rights Act, 1980 was enacted but the Congress struck down this Act.

The American Law Institute brought "Principles of corporate governance" in 1981 which initially received support from NYSE but after reviewing its first draft, NYSE denied from giving support to this project and the Business Roundtable also opposed this project. The major issue with this draft was that it increased the accountability risks for the board directors. Law and economic experts also criticized this project because the draft didn't consider the pressure of market force and the empirical evidence. Since the time it got approval and publication in 1994, it had almost no impact. The 1980s was termed as "Dead decade". During those times, the shareholders of the company hold control on the

[3] New York Stock Exchange.

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company by buying more shares and restricting any other person to hold power in the company. State lawmakers have fought takeovers with state-level takeover laws. This, along with the growth of the debt market and the economic downturn, discouraged the merger. Institutional Share Services (ISS) was created to support voting rights. Shareholders prefer legal protection, but judges often prefer company decisions with outside directors supporting board decisions. Investors are beginning to advocate compensation for outside directors and executives that exceeds the size of the company.

A section of the Internal Taxation Act 1994 restricts overpayment packages for employees but exempts stock options from tax breaks. Section 162m of the Code provides an environment in which two trends in governance tools can develop:

(a) Increasing share options as part of the compensation plan,
(b) Consulting with outside directors.

It is important to point out the role that the high-tech phenomenon of the 1990s played in governance change. Unlike the general industry where only executives were paid with stock options, in high-tech companies this is given to every newcomer. An institutional survey shows that biotech and computer companies made 55% of stock options available to non-executive employees from 1992-1997. Microsoft, Intel, and Cisco systems are examples of companies that provide share options to all the employees. This shows the importance of this industry for anti-regulatory lobbying.

The board must develop and monitor executive compensation plans and corporate strategies. Experience (and the 2000s scandal) over the past two decades has shown that there is a lack of board independence that there are basic tools or skills to evaluate compensation plans and financial reports that are provided and hence simulated observations while board members have acted as members of other bodies and maintained the status quo. This strengthening mechanism is expected because members of the board of directors are also CEOs of other companies. Consultants should help, but consulting firms are not independent either. Many of them also examined or were in close contact with management. This monitoring problem is the worst and most complicated because at this time there is no accounting valuation for stock options. If they are not recorded in the account, the costs are unknown

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to the manager and the board of directors and investors. There is a price that is hidden by law.

National Fraud Financial Reporting Commission, initiative of the American Accounting Association (AAA), American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), Institute of Internal Auditors (IIA), and National Association of Accountants, The Institute of Management Accountants (IMA) examines the causative factors that can lead to fraudulent transactions and is involved in identifying steps and recommendations to reduce the frequency of fraudulent transactions. In 1985, he organized the Committee of Sponsoring Organizations (COSO) to develop an internal control framework that provides criteria for evaluating an internal control system. The first document was published in 1992, "Internal Control- Integrated Framework", known as COSO. This document assigns internal control responsibility to the Board of Directors, Directors and staff who are responsible for ensuring:

a) Efficiency and effectiveness of operations
b) Reporting in annual financial reports;
c) Compliance with laws and regulations.

These developments fit so well with the efforts of regulators that the AICPA replaced the definition of internal control in SAS 55 with the definition of COSO when SAS 78 was published. Since then, COSO 1 has served as a reference for independent auditors to assess and comment on internal control. In 1996, COSO published another paper, "Problems of Internal Control When Using Derivatives", because this type of financial instrument is new and complex.

Important steps have been taken around the world in relation to the principles of corporate governance. Founded in 1991, the Financial Governance Committee established the UK's first organized principles. This report is known as the Cadbury report and was published in 1992 in response to growing investor confidence in the honesty and accountability of listed companies and low confidence in auditors' ability to take the expected safeguards. The 1980s are considered the golden age of creative accounting in Great Britain. Several frauds and spectacular damages between 1990 and 1991 angered the public and investors, such as International Trade and Credit Bank (BCCI),

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The Mirror Group, and Polly Peck. This led to the creation of the Cadbury Report, which established an illegal code of good practice for financial management- the Combined Code. Among all the recommendations there are:

a) The majority of board members must be non-executive directors (the fraud case is non-executive, but ineffective directors).
b) Establishment of an audit committee with overall responsibility for reviewing financial reports and the accounting principles used.
c) Separation of the chairmanship from the executive director.
d) Emphasize the director's responsibility for building an internal control system.

Since then, other countries and even Europe as a community have debated debates about governance. In 1996, the European Association of Securities Dealers (EASD) founded the EASDAQ, an electronic stock market for fast growing international companies, and in 1997 established a corporate governance committee. In 1997, Frankfurt created the Neuer Market specifically for new high-tech businesses, but required stricter corporate governance rules regarding the nature of inventory and the transparency of quarterly financial reporting. They should be based on a friendlier accounting system such as USGAAP[4] or IAS[5]. In 1998, the Japan Corporate Governance Forum proposed Governance Principles, which reproduce several aspects of American corporate governance practices, as well as oversight of pervious European practices, such as documents such as board independence.

Finally, in 1999, a set of principles that become global reference was published. This appears to be a coincidence from previous attempts. The reduction in oversight in severity and the likelihood of being punished for fraudulent accounting practices complements the lack of expertise of board members, analysts and regulators and complements the implementation context of the 1990s and early 2000s.

- ***2000s crisis – 2008***

Corporate scandals took center stage in the early 2000s and coercive measures were designed to curb corporate behavior. A survey of CFOs (40 countries, between 2000-2001) found that a lack of adequate disclosure (risk appetite, company strategy, and financial plans and objectives) is a

[4] Generally accepted accounting principles developed in the US.
[5] International Accounting Standards.

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major problem worldwide. This shows that the spectacular scandal is not an isolated case.

The most embarrassing scandals of the time included Enron, Worldcom, Tyco, and Parmalat. The first to explode was Enron in late 2001. They faked revenue, misreported cash flows, and used SPEs and offshore companies to hide off-balance sheet liabilities and increase sales, among other things. It is worth noting that Enron was still considered one of the largest companies in the United States in 2000, ranking seventh on the Fortune 500 list.

The company scandal has sparked a critical response that gave birth to laws, regulations and codes of conduct. Over time, these terms become cumulative and the environment becomes more complex. Increased punishments and stricter regulations do not appear to preclude creative book-keeping and abuse. Instead of being effective against mistakes, all these efforts make the environment more complex and vulnerable.

It should be noted, however, that SOX has not changed the deregulation of financial markets. There was a SOX amendment that was passed in 2003- the Securities Fraud Prevention and Investor Recovery Act, which actually limits the state's fraud detection activity. Therefore, investment funds are protected from over-regulation. The FASB and SEC continue to be influenced politically by the lobby.

- ***After 20th Century***

By the end of 20th century, everyone was talking about corporate governance, the United States was doing well, and its system of corporate governance seemed powerless. Suddenly a sharp decline in equity markets accelerated due to the bursting of the "dot.com" bubble. Scandals involving large US public companies such as Enron and WorldCom have destroyed the transparent US model of corporate governance. Since then, corporate governance has been a topic of global debate.

In short, the growth of companies and their new financial instruments changed the way organizations were structured and managed in more complex institutions. Lack of ownership/ control and numerous scandals related to abuse of power and control have raised concerns about the way businesses are run and the need to regulate their practices. Today's good corporate governance should aim to serve the interests of shareholders by adopting the right framework and practices.

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CONCLUSION

Unfortunately, the global governance survey conducted by McKinsey in 2011 did not produce better results than the previous survey conducted in 2008. The board did not increase the time spent discussing corporate strategy and 44% simply reviewed and approved the proposed corporate strategy. The main finding was that some of the directors lacked sufficient business experience and did not have time to be further involved. The Delloite Risk Management Report shows the market instability caused by ERM in companies experiencing crisis.

If this study reflects the realities abroad, we still have a big problem. It seems that managers and board of directors are not applying what they have learned from the previous crisis with the required speed and intensity.

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