

A consideration of the expected efficiency of proposed new structures for corpora...

[Business](#), [Company](#)



Literature review

Introduction

Corporate governance, the system used in the administration and control of corporate bodies has undergone a history of evolution to the point which it is today. In the last two decades, the advancement in technology have also seen a drastic change in corporate governance where the distinction between ownership and management has become more and more blurred and directors and management are usually now part owners of the firms that they work for. Ideally, corporate governance is a system which involves the establishment of a system of the management and control of companies through complex mechanisms of regulatory frameworks and money market dynamics. However, the simplest goal of corporate governance should be the protection of shareholders interests while the company works towards meeting the ultimate company goal of maximizing the shareholder wealth. However, in the last ten years, corporate governance under the established regulatory framework has come under scrutiny as major companies fall from grace and investors lost huge sums of money. The Enron scandal is a case on point where it is estimated that shareholders lost almost \$ 11 billion due to an audit failure which misled the company on high risk accounting practices. Other cases which indicate a lapse in regulatory framework for corporate governance include the WorldCom scandal, the Mardoff scandal and the controversies surrounding Olympus and HBOS. This lapses on what is considered the as some of the most effective regulatory frameworks indicated the need for the overhaul of the framework that was employed on the regulation of companies in the field of corporate governance. There have

been serious attempts to change the corporate governance regulatory framework to ensure that all the interests of stakeholders are protected. New regulations and legislations have been enacted to expand the accuracy of financial reporting for public corporations. The Sarbanes-Oxley act was enacted and provided for stiffer penalties for the destruction, alteration or fabrication of records in federal investigations or in attempts to cause malicious financial harm to investors. Since many of the failures of companies have been partially attributed to audit companies, the act also provides for the increased accountability of auditing companies to ensure their independence from their clients.

The efficiency of these new regulations that have been put in place to mitigate against future collapse and loss of shareholder funds due to improper corporate governance are not known and their ability to act as deterrence to future architects and players in such malicious plans is not known. This paper seeks to evaluate the academic works on this question and make an objective evaluation of the chances of success of these measures that have been put in place to assure investors on sound corporate governance practices.

According to the International Standards of Accounting and Corporate Governance (United Nations Conference of Trade and Development, 2008), corporate governance should be benchmarked on five broad categories for disclosure; auditing, management structures and processes, corporate responsibility and compliance, financial transparency and information disclosure and ownership structures and the exercise of control of rights. It is in these five categories that firms should be evaluated to gauge the level of

the effectiveness of corporate governance structures that they have in place and how efficient they are. It also gives a chance for an objective evaluation of the available methods that can be employed to ensure that compliance with the set regulatory framework is kept at its most efficient level.

The regulatory framework that has been put into place after the major scandals that have occurred in the past decade can be broadly divided into two categories. The first category is the legislations that have been passed to improve accountability and deter potential misfeasors. The other category is the codes and guidelines that have been put in place by the regulatory bodies in existence to ensure that the highest levels of integrity and accountability are maintained in the governance of companies.

In the legislation part, the most influential law that has been passed to influence positive corporate governance is the Sarbanes-Oxley Act of 2002 (Also known as the Public Company accounting Reform and Investor protection Act of 2002). This law was passed in reaction to the major accounting scandals that had occurred earlier such as the Enron scandal and the WorldCom scandal. This law sought to enhance the corporate governance practices for all the American public company boards of Directors, management and accounting firms. According to this law, it is a requirement that top management in publicly held companies personally certify the accuracy of the financial information that they present to investors and other users of financial information. The act in detail gives the criminal liabilities that will be borne by those who involve themselves in improper corporate governance.

In determining the effectiveness of the new laws and regulations regarding

the improvement of corporate governance, it is important to examine these new regulations against several factors. The role of the board of directors in the effectiveness of the new regulations has been examined by several scholars such as Peasnell et al (2005), Bedard et al (2004) and Osma (2008). One of the critical factors that they note is the need for board independence. Their studies indicate that there is a negative relationship between the presence of external directors in a board and the occurrence of fraudulence in financial statements of a company. By implication this means that for companies to be more effective in managing the affairs of the company to the best interests of shareholders, it is best to have a large proportion of the board as outside directors. Xie et al (2003) also reinforces this view by examining the characteristics of boards and audit committees and comes to the conclusion that companies with a higher proportion of outside directors are less likely to engage in dubious financial reporting than those companies with more executive directors.

The size of the board of directors in relation to the efficiency of corporate governance has also been examined. Notable works on this include Alonso et al (2000) who argues that smaller boards are ideal for better corporate governance since they exhibit proper coordination and easy decision making processes unlike large boards which exhibit poorer coordination and communication among members, resulting more often than not in significant negative effects on the corporate governance policies.

The effect of the regularity of boards of directors meetings to the efficiency of the application of the existing regulatory framework for corporate governance has also been studied. It is the general agreement among most

of the studies that regular meetings by the boards of directors of companies more often than not translate into better and effective corporate governance. This is because boards that meet regularly have more time to discharge their duties in accordance with the interests of shareholders. The opposite is also true, boards that meet rarely have little or no time to make complex decisions on issues that are related to corporate governance and such companies, and as a result the effectiveness of the regulatory framework on corporate governance is low. Xie et al (2003) in his study on this issue found the above arguments to be true.

The quality of corporate governance can also be based on the gender diversity of the board. Clikeman, et al (2001) investigated on whether gender impacts n the quality of decisions that are made by a board and found there was no relationship between the gender composition of a board and the quality of corporate governance decisions that were made. A similar study was conducted by Krishnan and Parsons (2008) and found out that companies with more female directors were more profitable, thus to an extent implying high efficiency levels of corporate governance decisions. This study is however constrained because of the different perceptions of women in different culture. It is however arguable that more women representations in boards of directors of companies would result in better and more effective corporate governance decisions. With more women representation in the board of directors, the effectiveness of the existing regulatory framework would be considerably improved.

The characteristics of the board of directors in terms of expertise, independence and activity on the effectiveness of corporate governance

decisions were investigated by Bedard et al (2004). The study found out that independent and expert boards were more likely to make effective corporate governance decisions which were in conformity with the existing legal framework. Bradbury (2006) examined the relationship between board and audit committee characteristics and the quality of accounting information presented and found out that higher independence of a board of directors is related to higher quality of decisions made regarding corporate governance issues. The same findings were arrived at by Davidson et al (2005) who conducted his study in Australia and Pit and Janin (2007) who conducted a similar study in France. It can thus be conclusively said that the quality of the composition of the board of directors in a company in terms of expertise and independence is a critical factor in the direction that a company takes regarding the quality of corporate governance decisions and thus determining the effectiveness of the regulatory framework in place.

Since many of the regulations that are envisioned in most of new rules and codes involve audits, it is also important to determine their effectiveness in light of the audit committees that exist in the companies. Osma and Noguer (2007) investigated this in a study conducted in Spain and found that audit committees do not act as deterrence to the manipulation of accounting records. The same findings were found by Baxter and Cotter (2009) who conducted a similar study in Australia. This implies that the mere existence of audit committees in companies cannot guarantee the quality of decisions regarding corporate governance without examining their composition in terms of independence and efficiency.

The GAAP have been instrumental in giving precise directions on the

accounting principles that are to be applied in the collection of data and preparation of financial accounting reports. The proper application of the GAAPs would generally result in the preparation and presentation of proper accounting records. However, bending the requirements of the GAAPs to suit particular situational needs of companies is the major reason that companies have collapsed in the past. To ensure efficiency of the improved regulatory framework, the application of the GAAPs should be done in good faith and industry standards formed to ensure that there is no deviation from the norm in the presentation of financial records and that no improper accounting practices are allowed to pass through as proper and presented to shareholders and other consumers of accounting information.

The application of the International Auditing Standards should also be improved in the quest for efficiency of the new regulatory frameworks. In conducting audits, care should be taken so that the independence of the auditor is never compromised and the audit report is an unbiased opinion of the material truthfulness of the accounting records presented by a company to its shareholders. High liability costs for those who deviate will ensure that full compliance with IASs contributes positively towards improving efficiency in corporate governance.

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