

**AZERBAIJAN STATE UNIVERSITY OF ECONOMICS - UNEC  
SABAH CENTER**



**Author: Fatima Mustafayeva**

**The effects of corporate governance and organizational environment on  
accounting system and reporting quality**

**Supervisor: Zahra Mirzayeva**



**Baku 2019**

## **Acknowledgement**

Above all it would be really nice to express my deep gratitude to my research advisor, Zahra Mirzayeva for great efforts she made to assist me in selecting an actual topic and, of course, for her considerable support in my research activities.

Another key person to remember is the director of SABAH Groups, Aida Guliyeva, who always stands by her students unconditionally and all the time does her best to afford us golden opportunities in our education life.

## **Abstract**

Recent shocks in the world relating to corporate accounting scandals have brought so many issues into existence. The most leading one was corporate governance and effects of it on reporting quality, as well as, its role in corporate accounting scandals. This paper explores abovementioned issues over developed countries – US & EU, in addition demonstrates various reformative measures taken in accordance with corporate accounting scandals. Besides that, necessary lessons left by these scandals are illustrated in this paper.

**Keywords:** accounting information quality; financial scandals; corporate scandals; corporate governance; board of directors.

## Table of Contents

Acknowledgement .....	2
Abstract.....	3
Introduction.....	5
<b>1.Chapter</b> , the ways corporate governance affects accounting system and reporting quality .....	8
1.1 Challenges and considerations in accounting information quality.....	8
1.2 Relationship between board characteristics and accounting information quality.....	17
1.3 Main measures to improve the functions of the board of directors.....	21
<b>2.Chapter</b> , Corporate governance against the backdrop of financial scandals: Case of developed countries .....	23
2.1 Analysis of corporate governance as leading factor in a set of financial scandals .....	23
2.2 Reformative steps around corporate governance to restrain corporate frauds .....	31
<b>3.Chapter</b> , Main results of research and lessons left by past experience.....	44
3.1 Primary outcomes shaped by research.....	44
3.2 Crucial lessons left by preceding accounting scandals .....	50
Conclusion.....	56
Literature List.....	58

## **Introduction**

In the market economy conditions the publicly revealed accounting information of corporations is an important starting point for corporations' stakeholders to make economic decisions. Because of their concern for their own expedencies, stakeholders have a request for high-quality accounting information. Therefore, the quality of accounting information has become a leading problem for companies, and it is also the focus of academic research. However, in recent years, the quality of accounting information of companies is hard to improve, and the problems are emerging one after another. Some companies have widespread financial frauds and serious distortion of accounting information. At this point, the question coming into existence is : “ What factors affect the company's accounting quality and how can we improve the quality of accounting information?” The relevant government bodies are constantly taking measures to solve this problem, but to improve the quality of accounting information must start from the root causes. This source is often mentioned as corporate governance of the company.

Recently, we hear more and more frequently about the significance of corporate governance for modern world companies. Today, worldwide examples show us that corporate governance plays an enormous role in development of organization and in improving its performance.

In the past everyone's awareness of corporate governance was not high, but corporate governance awareness has been greatly improved. After several financial crises and negative impacts of corporate fraud cases, corporate governance has become an extremely hot research topic.

Company owners are beginning to understand that despite having best products, companies can be inclined at any time without proper corporate governance mechanisms. Many studies have evinced that good corporate governance can not only raise the efficacy of the company's operations, but also protect shareholders' rights and interests, reduce formation of agency problems, and achieve the purpose of protecting good investors. As a result, the demand for the introduction and strengthening of corporate governance to strengthen the monitoring function of management and securing the profit of various stakeholders is considered to be rising.

Corporate governance refers to a mechanism and process for guiding and managing responsibilities of the company's operators. It protects shareholders' interests by strengthening the company's performance while taking into account the interests of other stakeholders. The classic definition of corporate governance was given by Sir Adrian Cadbury: "Corporate governance is a system of management and control over the activities of company". This definition is too superficial and does not reflect all aspects of such a complex concept, which is corporate governance. Later, many authors attempted to extend this definition. The same Cadbury in his later works notes that the main purpose of corporate governance is maintaining a balance between economic, social, and personal goals. Here it is meant that the interests of society, companies and their owners should be maximally interlinked, but mechanisms themselves, through which this relationship will be established are not disclosed. It reflects the decision-making direction of the company and the relationship between the various parties involved in the performance. A typical corporate governance structure is a certain interrelationship framework formed by the owner, the board of directors, and the executive manager. According to international practice, the internal governance structure of a large-scale company usually consists of a shareholder meeting, a board of directors, a managerial

level, and a board of supervisors. They divide the work according to the rights, responsibilities, and interests granted by law, and check and balance each other.

The concept of corporate governance can also be explained from various angles.

From a legal point of view, it focuses on the separation of ownership and management of enterprises, and supervises the activities of enterprise through the system of checks on legal requirements.

From an economic point of view, it is considered that corporate governance is the system that maximizes the company's economic value, that is, the pursuit of maximizing benefits of shareholders, creditors, employees and other stakeholders.

From financial point of view, it is considered that corporate governance refers to the provider of funds – investors, how to ensure that the company's operators can use their funds in the best way, and earn the rewards they deserve.

In short “corporate governance” generally refers to the company's management and monitoring mechanisms, and its goal to improve the company's operations to pursue the company's greatest interests.

## **The ways corporate governance affects accounting system and reporting quality**

### **1.1 Challenges and considerations in accounting information quality**

Like any other systems in the accounting system as well quality of information plays notably vital role for the development of corporations. To define the quality of accounting information it must be noted that accounting information quality can be clarified from various angles. In other words there is no “one suits all” definition for the accounting information quality. Different groups can see it in different ways. From users’ viewpoint the quality of accounting information is the way that accounting information addresses the needs of users. From producers’ viewpoint accounting information quality is the way that accounting information fulfils the requirements of accounting standards. The list of the ways that different groups see the quality of accounting information can be extended. All things considered one broader definition can be designated for the quality of accounting information: The quality of accounting information is the overall characteristics of accounting information which are essential for the meeting internal and external needs.

Currently six characteristics measure out quality of accounting information. Two of these six characteristics are considered fundamental and other four ones are considered enhancing characteristics.

Fundamental ones are :

1. relevance
2. faithful representation

#### **Relevance**

relevance of accounting information expresses suitability of financial data collected from financial statements to the needs and goals of economic decision



makers who are equally recognized as users of financial statements. Another element of relevance of accounting information is the notion of materiality. If some accounting information is able to create an impact on economic decisions of the financial statements' users then it is considered material information. To express the notion of materiality in a dissimilar way it must be pointed out that if unpublished or incorrectly published accounting data can affect users' economic decisions markedly based on financial statements significantly then this data could be mentioned as material.

### Faithful representation

In order to be serviceable for the financial statements users who make economic decisions based on those financial statements being relevant is not sufficient for accounting information. At this point one more fundamental qualitative characteristic coming into existence is faithful representation. Faithful representation implies that accounting information ought to put forward economic transactions in a veridical way.

The last four characteristics of qualitative accounting information are enhancing characteristics which add extra usefulness to the accounting information. These five ones are:

1. Comparability
2. Verifiability
3. Timeliness
4. Understandability

### Comparability

Comparable financial statements makes a user of financial statements able to compare his company's activity results, financial performance with the preceding years' results or with the other companies' results in the very same

field or industry. A serious requirement which makes it possible to compare financial statements is identical accounting policies followed by the company on the preparation of financial statements in the several discrete years. A user of financial statements should also be informed about other companies' accounting policies in order to compare financial statements of two or more companies in the very same industry.

### Verifiability

An accounting data is considered verifiable if independent users in the different level of knowledge are able to reach consensus in trustworthiness of presented economic transactions in the financial statements. Direct and indirect kinds of verifiability exist. An example for direct verifiability is counting cash in hand and reaching the result presented in the financial statements. An indirect kind of verifiability includes controlling data used in a formula or in a model again and reach the same results in calculations using same methods.

### Timeliness

Here by timeliness, we mean accounting information should be presented in a such time that it perfectly gives usefulness to the users of financial statements at decision making points. The usefulness of accounting information is getting lessened as it is getting older. However some accounting data may be useful for certain types of users even a long time after reporting period. Despite that fact it is undeniable that lateness of reporting for inessential reasons removes its usefulness.

### Understandability

For being useful to the financial statements' users with financial background accounting information should be understood by users. Again non-understandable information removes usefulness for the financial statements' users. This characteristic is usually applicable to financial statements, for the

reason that some information apart from financial statements may be considered difficult for some types of users to understand.

Together with the sustainable development of market economy and in light of globalization business world's current need for high quality accounting has gained its biggest value. However despite that fact a chain of challenges in reporting quality are emerging day by day in the business world. These challenges may vary from country to country, from industry to industry, and even from company to company. For a big period of time the significant reason why accounting information can be low quality is that accounting systems is not flawless. The process of accounting is dependent on artificial issues.

Low quality accounting information has been one or probably first of the most important problems in the business world. There are plenty of factors which affects quality of accounting information.

As a general rule the board of directors of corporations is responsible for financial reporting . Misreporting is highly dependent on human-related factors in corporations. A few strong reasons are considered big deal that lead corporations' workers and management to issue low quality financial reports. A list of these several reasons can be made as below:

- I. Opportunity
- II. Motivation
- III. Rationalization

These three reasons are called together "Fraud Triangle" too.

Opportunity is the component of triangle over which entrepreneurs have the most control. Constraining opportunities for misrepresentation is one way an organization can decrease it. The opportunity to carry out misrepresentation is feasible when workers have ingress to information and assets enabling them to carry out and cover misrepresentation. Workers are given ingress to records and

assets which enable them to carry out fraud. Throughout the years managers have turned out to be in charge of more extensive scope of workers and functions. This has prompted more access for them just as more authority over the organization.

Access must be constrained to just those data and valuables that are absolutely vital for workers to finish his work.

Opportunity might be introduced by conditions that are both outside and inside an organization. Inward conditions contain poor inner controls or an insufficient governing body. Outer conditions contain the usage of accounting standards which give extent to divergent decisions or minor consequences for settling inappropriate decisions.

Another component of the “Fraud triangle” called motivation is force or need felt by the individual who carries out misrepresentation. This component may result from a director feeling imposed to meet certain criteria all together for individual delight such as getting a reward or just for corporate reasons , for example concern about future financing. It may be money-related or other kinds of needs. Non-financial motivators include high pressure for better results at organization or need to conceal poor performance. Addictions, for example, betting and drugs may likewise motivate groups to commit misrepresentation.

The last component of the “Fraud triangle” is called rationalization. Rationalization - when worried about whether a decision is right, an individual will utilize rationalization as he needs to be certain about his decision. Employees can rationalize their misbehaviours by determining that carrying out misrepresentation is OK for some reasons. For individuals who are commonly untrustworthy, it is probably simple to rationalize misrepresentation. For individuals with great moral standards it is most likely not all that simple.

General rationalizations cover compensating for being underpaid or supplanting a reward that was merited but not given yet. An embezzler may persuade himself that he is simply borrowing cash from organization and will restore that money some day. Some embezzlers say themselves that the organization does not need that money and will not notice this fraud.

Entrepreneurs and officials must take responsibilities for misrepresentation by taking a shot at the component of “Fraud triangle” which they have greater control on. It might be very troublesome for the board to take care of workers’ needs or rationalizations, however by restricting opportunities for misrepresentation organization can diminish it to some degree.

There can be numerable factors that affect accounting quality. These factors could be divided into 2 categories:

- I. Country – specific factors
- II. Firm – specific factors

**Country - specific** factors include followings:

- a. Accounting standards – in some countries accounting standards are formed by professional accounting groups. However, in other countries standards are formed by committees in which public institutions are decisive. In such countries, standards are affected by state priorities and impacts of political parties are reflected in accounting system. At this point international accounting standards bring new breathe to the accounting system. Acceptation of international accounting standards on world – scale happened very rapidly. It was assumed that this situation would raise quality of accounting information and make comparability of financial statements from different countries very easy. It is proved that there is positive relationship between acceptance of international accounting standards and accounting quality.

- b. Development level of capital markets – development level of financial markets also plays a critical role in the accounting quality. It affects quality of accounting information directly. In the countries with developed capital markets capital is provided by numerous small investors. It is assumed that in a such environment accounting information is more transparent and faithful. On the other hand, companies are more eager to present high quality financial reports in order to attract mass of investors. In the countries which capital funds predominantly provided by banks, there are close ties between banks and companies. In the light of these ties, banks can directly get strategic information of companies like financial reports and plans for the future. For that reason companies have less motives for public disclosures.
- c. Taxation systems – an important factor which affects quality of accounting information is taxation. Close relationship between accounting system and tax regulation can decrease quality of accounting information. In the countries which tax rates are considerably high companies are motivated to calculate taxable amount low.

**Firm – specific** factors include followings:

- a. Capital structure – a combination of funds that is used to finance the company activities is called capital structure. Capital structure basically consists of two components. One of these is called equity which can be increased by share issuing and retained profits. Another is foreign resource which is called as debts. In capital markets investors take into account financial statements of companies when deciding on investing activities, therefore companies which wish to attract investors are expected to issue more of high quality financial reports. In the countries which creditors are protected in a high level companies get capital funds by banks in an easier way and with lower costs. It is claimed that

accounting quality is low in the countries where bank loans are widespread as capital funds.

- b. Ownership structure – companies formed by a few shareholders with large shares have “concentrated ownership”. Two theories exist about the impact of concentrated ownership on the accounting quality. According to first theory concentrated ownership increases accounting quality. The reason is that there is less conflict of interests between managers and shareholders. Additionally as the small number of company shares circulates in the market, market pressure is less felt by the company, and this circumstance decreases motives for mispresenting financial reporting and increases quality of financial reports. According to the second theory concentrated ownership decreases accounting quality. In this theory, it is thought that concentrated ownership increases the risk of exploitation of minorities’ rights. Companies with concentrated ownership tend to keep true accounting information inside the organization, thus the quality of reported information is decreasing. An example for concentrated ownership is family business. According to first approach it is supposed that family members with control power provide better supervision over the company, thus accounting quality is expected to be high. In non – family businesses professional managers are charged with governance and they maximize their own benefits at the cost of shareholders’ benefits. In alternative theory family businesses with concentrated ownership tend to manage profits with opportunist approach. In addition it is highly probable that there is information asymmetry between family members and other shareholders. Family members are able to manipulate accounting profits for their own benefits. As a result according to this view there is positive relationship between concentrated ownership and low quality financial reporting.

- c. State ownership – a number of state owned shares has relationship with accounting information quality. If the company is state owned then government is the main body of its property rights and government and relevant departments of industry are responsible to supervise reporting quality of company and its performance at all levels. However, there are large regulatory evasions in internal governance structure of state owned companies, which also leads to failure of accounting quality. In state owned companies internal control is weak and permits financial frauds . Here internal control means monitoring and evaluation. Phenomenon of the act of accounting information fraud has become inevitable. However, in recent years, the number of state owned shares held by companies has been decreasing, and the corporate governance structure has been gradually optimized. The improvement of the supervision coupled with the increase in information transparency has improved the quality of accounting information disclosure.
- d. Principal - agent factor – principal agent theory refers to some actors who employ other actors to perform services based on contracts. They are given some decision making rights simultaneously. The split of management and ownership rights is the root of agency problem. The existence of information asymmetry is the main subject in agency problem. In other words asymmetric information is the main reason for this problem. Asymmetric information is such a kind of information that some stakeholders have, but others do not own. Asymmetric information is the result of hidden actions of some participants. It is considered that there is some relationship between executive incentives and accounting information quality. The focus of theory is how to make agent more effective in management of principal's assets. The incentives will increase agent's loyalty with no doubt and make them to do their best to serve the



client. The target of boosting value of the company and the value of shareholders will also make quality of accounting information certain.

As a result it can be said that:

Financial reports prepared for informational purposes are more of high quality than reports prepared for tax purposes;

In countries where investors' rights are protected more than creditors' rights quality of financial reports is higher than other countries;

Financial reports are more of high quality where capital markets have high level of development;

In countries where international accounting standards are used there are high quality financial reports than in countries where not used.

Another firm specific factor which contains link between board of directors, managers and varied stakeholders and may have a huge impact on the reporting quality is corporate governance which is defined more broadly under the next subheading.

## **1.2 Relationship between board characteristics and accounting information quality**

Board of directors is in the central position of corporate governance structure. It is apparent that impact of board of directors on an accounting quality can not be denied. Different characteristics of board of directors may affect accounting system and reporting quality in different ways. First it would be reasonable to look at what are the characteristics of board of directors. These characteristics include following:

- A. Scale of the board of directors
- B. The proportion of independent directors

- C. Leadership structure
- D. Board of supervisors
- E. Board diversity
- F. Board expertise

Now let us look at impact of each characteristic separately:

Scale of board of directors - scale of the board indicates the number of members in the board. There are varied arguments on the impact of the number of board members on the firm performance and accounting quality as well. Some researchers postulates that an increase in the quantity of board members boosts performance of the firm meanwhile other researchers claim that board members in large numbers can cause various troubles and affect firm performance and accounting system in a negative way. According to those researchers who think that large numbers of board members impact in a negative way, in boards where there are so many members communication, coordination, and decision making process between board members are turning into challenging situation.

Alternatively, rising number of board members makes joint decision making and strategic step-taking harder. In contrast, coordination between board members is provided in a better and easy way, and communication difficulty is decreasing on a small scale boards. Researchers who postulates that large scale board increases accounting quality clarify this case with various reasons. One of the significant reasons is that rising number of members in the board of directors causes concentration of more ideas, competencies, and skills. In this way an increase in the number of board members influences quality of accounting system in a positive way. In other words large scale boards are able to decide more accurately and effectively. Small scale board of directors may have not enough professional services. Members in the board are responsible for plenty of tasks and their load is heavy and thus quality of their performance including accounting information is decreasing. Therefore, scale of the board should not

be extremely small or extremely large. Some researches indicate that the board with 7 or 12 member is more effective in firm performance and accounting system as well

Independency of the board – one of the characteristics that forms structure of the board is independency of the board. Independent members of the board have strategic significance on the provision of capital to the board in context of relationship with the external environment. Independent board members supervise other board members and increase transparency of accounting information in the company. Independent board members estimate company and its financial reports from neutral point of view and make neutral decision related to the company equally. As the independent board members have no straight relationship with management, they value management quite objectively. Independent board members are usually senior managers of other corporations. Many researches depicts that percentage of independent board members significantly has negative correlation with untrue financial reports and earning management, thus a rise in the number of independent board members enhance quality of accounting information.

Leadership structure – leadership structure and accounting information quality have negative correlation if the chairman's and general manager's roles are carried by a single person. Board members need to supervise general manager, but if the chairman of the board himself carries functions of general manager, thus supervision by the board will not be valid which may lead decreasing quality of accounting information. As the supervision is weak in a such situation, general manager may conceal disapproving information which also lead to a decrease in accounting information. Therefore duality in governance is likely to cause financial frauds. Person who is supervising and who is supervised is the same one. As a result chairman and general manager should be different people in order to get more effective board of directors.

Board of supervisors – the scale of supervisory board has positive relationship with quality of accounting information. The members of supervisory board basically include shareholders and employees. The primary function of the supervisory board is to supervise management and board of directors. The formation of supervisory board is an effective step to restrain board directors and management from harmful decisions that are not suitable for stakeholders' interests.

Board diversity – one of the key board characteristics in an organization is board diversity. Diversity in the board causes better decision making and innovation in the organization. Age, gender, educational background, industrial experience, etc., are considered features of the diversified board. A blend of people with varied knowledge, skills provides best board. Some studies have indicated that there is a straightforward link between diversified board and reporting quality. That is more diversified board, higher quality of financial reporting. Some other studies implies that there is negative relationship between reporting quality and board diversity. Third group of studies claims that there is not any relationship between reporting quality and diversified board at all.

Board expertise – all the time there is some high level of confidence in reported financial statements if the board consists of directors who are experts of their job at the same time. According to some sources the directors should have sufficient professional experience in order to become an expert in his job. The other sources say that the expertise is something that is about age. In other words if the director is older then he or she is better. Better directors will cause high level of financial reporting quality. On the other hand board expertise may have negative impact on the reporting quality as the expert directors can use earnings management.

### **1.3 Main measures to improve the functions of the board of directors**

It is undoubtedly an apparent fact that the performance which is not evaluated cannot be developed. The performance of corporate governance is highly dependent on one of its main bodies which is called board of directors. The performance of directors' board is the principal root of sustainable corporate success. Evaluating and developing directors' performance is the essential key to make organizations strong for the future. Therefore, many different ways were developed to evaluate performance level of corporate governance which gains more and more significance in the business world day by day. It ought not to be left out that the intent in evaluating board performance is not to grade them, but is to trigger development of their performance level. Generally, organizations which have board with competent members, efficient resource usage, non-existent internal conflict, corporate culture which makes incentives for strong teamwork is considered to have high corporate performance. The key question here is that how to improve functions of board?!

One of the ways is the improvement of board's independence. The independence of directors in the board is starting point for the board of directors' objective assessment and supervision. Without independence it could not be guaranteed that management can be objectively and fairly evaluated and supervised.

Investors will anticipate it to be not realistic if the directors in the board is fully supervised by insiders and controlled by main shareholders. The accounting information quality is likely to be lower and the risk of financial fraud is considered seriously high in this way. It is an essential key to enhance independence of directors in the board in order to improve accounting information quality. Particular measures for achieving this independence level include the followings:

- Rising percentage of independent directors
- Ensuring and protecting independence of independent directors

- Separating positions of general manager and chairman

In the interest of increasing accounting information quality and decreasing the degree of financial fraud risk it is notably essential to empower directors of the organizations to definitely perform their supervisory functions. If the chairman of the board and general manager of the organization carry out supervision of their own, it will affect their objectivity and independence inevitably. It should be pointed out that to make board of directors more effectual and productive it is significant in particular to split up positions of chairman and general manager of an organization.

Another measure to take for improving board is setting up proper incentives and constraints. Rationally designated compensation plan heats up enthusiasm of independent directors. Compensation plan contains details about incentives, rewards, bonuses, and commissions for directors. As an example, we can show stock option systems which is widely used in USA and other developed countries. In addition to proper incentive systems, constraint mechanisms such as a sound certification system of independent directors qualifications should be developed. From one angle, it will ensure that only professional groups with relevant level of knowledge and experience background will perform functions as independent directors. From another angle, it will help to avoid repealed certificates of qualification and thus independent directors will be surely more operative and supervision will become more effectual.

Developing institutional setup for the board of directors could be another measure to take in order to improve functions of the board. If the strict institutional setup for the board is absent, it will definitely lead to uncertain responsibilities. In order to increase quality of accounting information and decrease the risk of financial fraud it is necessary to establish audit and nomination committee for improving accounting information quality as well. Predominant role of audit committee in the company is to supervise credibility

of accounting information and reporting quality. The responsibility of reducing information asymmetry between stakeholders lies in the hands of effective audit committee. The establishment of Nominating Committee can also assist to stop independent directors from being supervised by insiders, in this way it will improve supervision of independent directors and accounting information quality at the same time.

Developing governance standards for directors' board is one more step for improving functions of the board directors. There are usually well – structured standards for governance of the board in developed countries. A sound standard for board governance may have legitimate basis for directors to define their obligations and rights and make them more efficient and effectual.

## **Corporate governance against the backdrop of financial scandals: Case of developed countries**

### **2.1 Analysis of corporate governance as leading factor in a set of financial scandals**

Regardless of country's development level, we can observe financial frauds in all countries, including both developing and developed ones. When these frauds happen in giant companies of developed countries it shakes business world. In latest years, financial scandals and bankruptcies of giant companies in developed countries brought necessity to review corporate governance into existence. When looking at fraud examples in developed countries we can see that these scandalous frauds are mostly related to firm specific factors.

Corporate governance is in the top of these firm specific factors. As we know, responsibility for preparation of financial statements lies in the hands of board of directors. If financial condition of the company is deliberately misrepresented then

it is called financial statement fraud which turns into accounting scandal at the same time. Before analysing role of corporate governance in accounting scandals, it would be really nice to look through corporate governance models followed by corporations of developed countries. If we keep eyes on the models followed by corporations of developed countries we can observe that mainly two models followed :

1. Anglo – US Model (shareholder approach)
2. Continental European Model ( stakeholder approach)

Let us give a brief information about each model of corporate governance:

One of these two corporate governance models is called **Anglo – US model**, which is widely followed in English speaking countries such as USA, UK, Canada, etc. Anglo – US model supports the idea of protecting shareholders' interests and rights. Profitability is accepted as main expectancy of shareholders, therefore main purpose of corporate governance in this model is to increase profit per share. Major participants of corporate governance in Anglo – US model are management, board of directors, and shareholders. Responsibilities and rights of these three major participants are clarified by well established legal framework. In Anglo – Us model shares are allocated among many small shareholders. Small shares owned by shareholders are not sufficient for those shareholders to manage the corporation. Anglo – US model has lower concentrated ownership and it causes management to have major role in governance. In this situation management decides on all things that concern corporation. Usually in such corporations management including strategic planning is carried out by strong management team. In majority of corporations which follows Anglo – US model, board of directors contains insiders as well as outsiders. Here insider means an executive director and outsider means non - executive director .



In the corporations with Anglo – US model of corporate governance, major method of capital raising is equity financing.

**Continental European model** of corporate governance is widely scattered in countries like Germany, France, Italy, etc. This model of corporate governance is opposite to Anglo – US model of corporate governance. In continental European model shareholders own high percentage of total shares and it enables them to decide on key issues concerning corporation. Thus, there is concentrated ownership here and small number of shareholders may have huge impact on governing. In Continental European model of corporate governance the idea of protecting all stakeholders' rights and creating value for corporation is supported rather than protecting only shareholders' rights and interests. One of the main participants of Continental European model which plays external governance role is banks. Banks provides financial services and monitors in cases of financial distress.

Keeping these in mind, corporate managers in dispersed ownerships are tricksters of the scandals, whereas controlling shareholders are considered tricksters in concentrated ownerships. Corporate managers slant to manipulate earnings whilst dominantly controlling shareholders slant to misuse personal advantages of that control.

A notable explosion of corporate accounting scandals have shocked the world of business. The American market in particular was severely scarred by the flood of continuous scandals arose in the immediate aftermath of the 2000 market downturn. Revenue recognition issues showed significant shift in terms of management's behaviour in United States. Throughout earlier times, managers in United States were trying to generate "rainy day reserve" out of excess income and defer recognition of it till relatively late dates where there can have gap in annual earnings. It is called as "income smoothing" too. Using this method of earning management, managers meant to conceal revenue

volatility and assure shareholders that could have been disturbed by sudden earning fluctuations. Conversely, in later times, managers tried to steal earnings from future with the purpose of generating a rise in current earnings which technically not supported. Although restating companies have long been known as companies with higher market expectations for growth in the future, the pressure on those companies to indicate higher rate of growth in earnings tends to have risen. What was the reason for management to become so optimistic on earning growth? One reason that explains dissimilarity between United States and European Union is sudden shift in executive compensation in United States. Executive compensation shifted from cash based to equity based system. To demonstrate effects of this shift, let us suppose that company's CEO holds options on 3 million shares of the stock of his company and company trades at the price/earning ratio of 20 to 1. On just these, because the CEO may lead the premature revenue recognition resulting in a mere \$1 per share increase in annual earnings, the CEO causes \$20 increase in the price that would make him \$60,000,000 wealthier. Definitely, motivation for short run financial manipulation is generated when CEO is paid stock options. Financial scientists have identified a significant correlation between higher equity compensation levels and earnings management coupled with restatements. For fraud and corruption Enron has become a synonym: the ultimate example of corporate scandals. The start of story was dissimilar, however, and it was difficult to guess it would wind up as the scandal that affected corporate America so much. That is why expressions such as post - Enron as well as after – Enron are used very often to highlight the huge change that occurred in the corporate world.

Enron was an energy company based in Houston. A brilliant businessman, Kenneth Lay founded it in 1985. The role of the board of directors of the company is to supervise management and to protect shareholders. However, the board of directors in Enron did nothing to protect shareholders of the company,

thus made a significant contribution to the breakdown of seventh biggest public company of United States by enabling their company to start engaging in high risk bookkeeping. Generally speaking, Enron's corporate governance was weak in every aspect. The board of directors was made up a number of individuals lacking moral character, thus they were eager to engage in fraudulent activities. It can be considered real root cause of corporate failure in Enron. During several years, The Board observed countless clear signs of management's unethical practices but decided to ignore it to the expense of shareholders and employees and the others. The board of Enron rescinded rules about conflict of interests and let CFO to establish private partnerships with Enron. In addition, one more thing leading to misstatements and false decisions that were made by executives was stock options. Remuneration of executives was straightforwardly related to stock prices, therefore, they were motivated. Review of cases concerning meltdown of Enron adds depth to its historical importance if they are connected to the theory of shareholder value. This has occurred as a result of shareholder value maximization. It is also called as "short termism". They concentrated on the prices of their stock alone. Higher prices were the only sign of success in the company. Short term stock performance substituted long term investment and patience. The structure of incentives caused this situation. Generous salaries especially combined with stock options given to senior management inspired managers to concentrate on raising their income whilst also maintaining shareholders happy with the higher dividends.

As a result of Enron's meltdown several corporate governance issues have begun to emerge. Completely unrestricted power in chief executive's hands is an inherent issue characterizing management of Enron. In Enron, there were also various unethical activities that seemed to come into light even after meltdown.

Many Europeans sensed that corporate frauds were meant to be purely American subject, however, the opportunity and motivation for fraud are not

restricted to any specific governance system, geographical area, industrial sector or company size. This issue was ought to be apparent well before the scandals like Parmalat in Europe. Enron also pointed out that global market is mutually dependent and any deficiency may quickly pass the Atlantic ocean and thus may become European issue as well. Europe started to feel its negative effect and had to adjust its corporate regulation perspective. Continuous American scandals combined with European scandals demonstrated that there was no guard that protects Europe from poor management. However, the trend in concentrated ownership structures which is wide spread in European Union countries is quite distinct, but it is not considered technically better. There is indeed a dominant shareholder or a group of shareholders in most European corporate scandals. To encourage management, a dominant shareholder need not focus on indirect control methods, like stock options or equity compensation. As dominant shareholders can supervise and substitute management in a direct way, they can use “command and control” method cavalierly unlike dispersed shareholders in United States. Corporate managers, therefore, seem to have less motivation to take part in opportunistic earning management and to generate a sharp rise in earnings, as managers are not compensated with share options. Furthermore, a dominant shareholder will not have much desire to be into his company’s daily stock price. The reason for it is that a dominant shareholder rarely sell his control wall in the public market. Parmalat’s fraudulent behaviour was just as huge and widespread as Enron’s. The SEC described Parmalat scandal as “one of the biggest and most shameless corporate fraud in the world”. The case of Parmalat was also marked as “European Enron”. It gave the corporate governance discussion a different dimension as it raised the issue of successful control over family owned businesses and, more broadly, businesses with one powerful major shareholder. A group of companies with complex structure owned Parmalat. Moreover, one dominant shareholder – Tanzi family were controlling it through hierarchal structure. There were dominant shareholders

and minority shareholders unprotected. Code of corporate governance in Italy states that if the company is totally controlled by a dominant group of shareholders, then certain directors should be definitely independent from those controlling shareholders. This principle was not promoted by Parmalat. Tanzi shareholders illegally channelled corporate resources to the family at cost of other minority shareholders. Moreover, the company did not provide adequate explanation for this non – compliance. In December 2003, the Parmalat Group, a global leader in dairy products, started to collapse and reached bankruptcy after admitting large holes in financial statements. Although the most obvious issue was financial misreporting, Parmalat scandal was essentially falsified accounting arose from failures in corporate governance. The financial statements of Parmalat did not break the accounting standards. The key issue in the Parmalat scandal was falsified accounts instead of just exploiting a gap in accounting standards that made it possible to hide true results. Classical fraud methods have also been coupled with forgery of “ cut and paste” and shell companies. Researchers have found a set of other serious failures in corporate governance that triggered Parmalat scandal. There was no independence of non – executive directors in Parmalat. Furthermore, positions of chief executive officer and chairman were not separated. What is more, Tanzi was holding both positions himself. In retrospect, Parmalat exposes certain characteristics widely known to companies facing disastrous financial failures: rapid growth, debatable accounting practices, lawbreaking accountants, underperformance, strong dominant shareholder, political relations, and complex corporate structure.

There are many other European companies that broke down or experienced problems in terms of poor governance and accounting frauds apart from Parmalat that is best known and very well publicized example of corporate failure. It is possible to characterize list of European corporate failures as long as

American corporate failures. Some of the companies that challenged scandal monopoly of United States are: Maxwell, Ahold, Marconi, Baring Bank, Vivendi. Particularly, Ahold and Baring cases are two demonstrative instances. It is obvious that Europe has no exemption from scandals and breakdowns. Corporate scandals, especially when occurring frequently in a sudden period pose serious concerns that have been ignored by scholars for too long. Two concerns standing out here are: why in different economies do various kinds of scandals happen? And why is the wave of scandals taking place in one economy and not in another, although all economies are strongly interlinked within the same international economy and subject to very same macroeconomic environment? A quite popular explanation is the differences between US and EU and dissimilarities in ownership structures between EU and US companies. Shareholder structure differences in corporate scandals reflect differences in corporate scandals, in aspects of both in fraud nature and victims. When Europe already had financial scandals during same period most of them were different by character from United States' earning manipulation scandals. The iconic instances are Enron and Worldcom. Enron's and WorldCom's stories highlighted the need for a corporate awareness and culture to understand the difference between wrong and right.

There is no any business school that tells potential managers ways of distorting profits, falsifying accounts and defrauding shareholders. The reason why manipulation of financial statements and book cooking were so common was not only the blindness of managers by greed. They were much more probably persuaded that their primary task is to make shareholders happy even when this involves falsifying material information. Long time prior to actual scandals, there were clear signs, however no one paid close attention to these signs even during first blasts. Enron's, WorldCom's, Parmalat's directors, auditors, managers, shareholders were indeed liable for their behaviours, errors

in judgement and bad decisions. All of them were guilty, however, to some degree. It is impossible to see all these examples isolated from relevant environment.

Companies were familiar with rules and regulations for corporate governance. The real issue was that they did not follow the rules. What is more crucial than law is the spirit of law. The wrong thing that they did was not to carry out their duties in accordance with law, and therefore, they could not stop disaster from happening.

When it developed, the corporate governance system made corporate actors increasingly accountable in the market. It is not inherently negative situation if the protection against managers who distort accounting information and manipulates is well provided. It goes without saying that the results itself tells whether sufficient protection has been provided or not. The case studies mentioned above illustrate that executives were trying to look for ways to operate business that could possibly fit into law whilst avoiding true intent of themselves. No law is able to be sufficiently effective to address such a mentality. There were weaknesses in the corporate governance systematic structures, uncovered by the disaster of each of abovementioned companies. Legal provisions alone can not support and encourage ethics. It is responsibility of everyone from accountants to CEO.

## **2.2 Reformative steps around corporate governance to restrain corporate frauds**

### **Reformative steps in US**

Experience of past years has showed us that a great majority of reformative steps around corporate governance had been triggered by previous financial

scandals. Government, ordinary citizens and press started to examine corporate boards' behaviors somewhat more closely due to corporate scandals in the beginning of current century. As a result, endless stream of governance reforms came into existence in order to restore public trust and confidence.

The scandal that started process of reforms was Enron. However, domino of scandals made case increasingly more distressing while building right formula.

On 25<sup>th</sup> of June in 2002, Paul Sarbanes the Senator, presented Bill of 2673 to whole senate. The same day, it was confirmed that WorldCom overestimated earnings over past 15 months, more than \$7.2 million. The circumstance seemed uncontrollable almost. Therefore it is not surprise that during just 3 weeks, the bill was approved unanimously. The purpose of the new law was to be broad – based and revolutionary. For public businesses and accounting firms it set different and improved standards, however, it did not address to private companies. It comprises issues that are wide from board responsibilities and independence of auditors to criminal punishments. The act underlines significance of good corporate governance and emphasizes the connection among effectual control, corporate performance, supervision and government regulation.

The Sarbanes – Oxley Act reflects attempts of government to develop corporate governance, defend investors, strengthen their confidence and raise financial statement transparency and accuracy. Regulation and insider supervision of internal misconduct had been primary concern after this bill. It reinforced legal liability for criminal corporate frauds. Independence of audit committees was required to be increased, meanwhile non – executive directors' power became to be high. For directors corporate loans were banned, meanwhile CEO and CFO were demanded to obtain certifications of internal control that ought to be fair and reasonable, thus standards for corporate governance have been raised.



Dozens of businesses are facing the challenge of ensuring compliance with SOX act for their accounting procedures. Typically, audit departments of corporations first get a detailed external audit conducted by SOX Compliance professionals to find risky areas. Then, advanced software must be installed providing necessary “electronic records” to assure compliance with SOX. Keep in mind that companies are required of particular public actions and certification to maintain SOX compliance.

The formation of “ Public Company Accounting Oversight Board” ( PCAOB) was one of the most crucial innovative products of the Act. PCAOB is non – profit organization with 5 members and its goal is to protect interests of public and investors in terms of fairness and independence of audit reports. The Board is sponsored by public company fees, even if it does not monitor and control them, however it actually supervises audit procedures and external auditors of public companies. SOX Act demands auditors of all public companies to be registered in PCAOB. PCAOB forbids consultation between businesses and their auditor firms. Consultation on tax is exemption.

101<sup>st</sup> section of the SOX Act provides listing of powers afforded PCAOB and these powers are dependent upon SEC approval and supervision. Thus, The SEC has authority for appointing and removing members of PCAOB and approving its budget and also amending or abolishing rules of PCAOB.

103<sup>rd</sup> section of SOX act enables PCAOB to set audit and relevant certification standards for registered accounting forms.

Below are the overview and highlights of the most essential compliance sections of SOX Act :

### **302<sup>nd</sup> section of Sarbanes – Oxley Act : Corporate Responsibility on Financial Reporting**

- a) All financial reports ought to be reviewed by CFO and CEO.

- b) There should not be any misrepresentation in financial reporting.
- c) Information should be presented “fairly” in financial statements.
- d) CFO and CEO carry responsibility for internal auditing.
- e) Any shortcomings of internal audit controls and any fraud that involves audit committee’s management should be reported by CEO and CFO.
- f) All material changes within internal accounting controls ought to be indicated by CFO and CEO.

#### **401<sup>st</sup> section of Sarbanes – Oxley Act: Periodic Report Disclosures**

In addition to requirements for financial statements such as to be accurate and not to include misrepresentation, financial statements must also contain every single material transaction off-balance sheet.

#### **404<sup>th</sup> section of Sarbanes – Oxley Act: Assessment of internal control by management**

Annual financial reporting should contain Report of internal control which states that management of the company is liable for internal control and management assessment of control structure’s effectiveness as well.

Furthermore, external auditors should certify the accuracy of the assertion made by company management that internal controls are effective.

#### **409<sup>th</sup> section of Sarbanes – Oxley Act: Real – time disclosures**

This section requires companies to disclose data about material changes in their financial position and transactions on a relatively real time basis.

**802<sup>nd</sup> section of Sarbanes – Oxley Act: Criminal penalties for document alteration**

This section specifically states penalties for document alteration in pending legal investigation or in bankruptcy stage.

**806<sup>th</sup> section of Sarbanes – Oxley Act: Protecting employees of public companies that provide fraud evidence**

This section of Sarbanes – Oxley Act deals with protection of whistle-blowers.

**902<sup>nd</sup> section of Sarbanes – Oxley Act: Conspiracy & Attempt to commit fraud**

It is a criminal offense for any individual to change, disfigure or hide any documents with the aim of affecting the availability of item to be used in official proceeding.

**906<sup>th</sup> section of Sarbanes – Oxley Act: Corporate responsibility on financial reports**

This section deals with punitive measures such as criminal penalties to attesting financial report that is fraudulent or misleading. Penalties may be \$5 million in terms of fine and 20 years in jail under section 906.

Historically, all reforms had have vigorous supporters and dissidents. The similar situation happened again once more with SOX Act reforms. Reform supporters actually think that, considering situation in 2001, the Act was

necessary and helpful, whereas opponents think that firms were forced to spend unacceptable amount for the wrongdoings of Enron.

Having started with criticism, the Act attracted some researchers' and financial analysts' criticism and disapproval. So first, the most common argument was the cost of compliance which for small companies is particularly high. Dozens of small public companies were forced to think about leaving public – market for less controlled private markets. Arguing that reform started opening “exit door” would not be safe, but it definitely made these firms redesign their strategies. Small businesses have rightfully started complaining since its implementation that the Act does not distinguish between companies, thus small companies have to shoulder very same burden with big companies. As the compliance costs are dissatisfied, it might be argued whether these costs could ensure reliable accounting information has been produced and costs worth it. The fact that, high costs are simply one time costs is widely used oppose argument to the critique of high compliance costs. Firms invest money on improving their internal control system and start raising their financial reporting standards. Ultimately, compliance costs will now be considerably reduced once they attain expected level.

Criticism arguments have a solid base, however, simultaneously it would be completely wrong to dismiss the fact that the Act is a worthwhile regulatory instrument for businesses that wish an enhanced control climate, as well as, for public that requires guarantees that Enron and Worldcom scandals will never happen.

A number of supporters do not criticize the Act and think that this attempt will remove past mistakes in future.

There was a strong response to scandals and reformative steps had been taken very rapidly. Practically speaking, Sarbanes – Oxley brought advantages that are

hard to compute. It reflects efforts to promote business world with an enhanced corporate culture and higher standards of ethics. Compared to time - consuming and costly compliance process, accuracy, powerful whistle – power strategies and trust are intangible advantages. Despite that fact, main goal of the Act was to restore confidence of investors and trust of public after scandalous era.

### **Reformative steps in EU**

For a variety of reasons it is worth taking a look more closely at European reaction. Given the size of Union, its impact and power of its members, the EU is considered second wall in the general debate of corporate governance.

The structure and decision – making process of the Union is dissimilar from US. It is therefore noteworthy that EU did not pursue US and did not accept reform act similar to Sarbanes – Oxley. In addition, EU has been able to lock its ears for all the anxiety screams calling for action, reforms and regulation. Eventually, although general approach was introduced at the end, it was spiritually dissimilar from US's strict regulatory response. Regulators of EU had stated that regulation of corporate governance must take totally distinct form, because Union's complexities require different regulations and different perspectives of rules. Unlike US, EU is not federal state, it is made up 27 member countries – 27 independent states with different history, language, culture, tradition and religion. As a consequence, the EU is virtually unable to get consensus and take key decisions in short space of time. The process of decision making takes time, particularly when unpredictable things occur and adds extra pressure on Member Nations.

The models of control and ownership prevailing in EU were also subject of debate. There really are 2 practical models : outsider system or model dominated by financial markets which is pervasive in United Kingdom as well as United

States. The other is insider system or model based on banks, which is pervasive in Continental Europe.

It must also be mentioned that there is no one single system of corporate governance . Europe splits into two ways, as there are two distinct corporate board systems: one – tier VS two – tier systems

There is apparent separation between managerial and supervisory structures in two – tier board systems. In contrast, the unitary board or one – tier board unites both functions. The upsides and downsides of abovementioned internal governance systems have been discussed for considerable period of time rather than sound measures to pursue common principles.

Member Nations of EU put corporate governance to their regulatory agenda's top priorities. They pursued UK and dedicated time and resources to enhancing their own company law as well as corporate governance framework.

The UK had set the foundation for self – regulated system of corporate governance. Self – regulation symbolizes open – minded model based on government non – interventionism and its roots are related to concept of laissez – faire . The UK has the largest share of codes so far, because it has developed and released more codes than other countries. Most European countries pursued UK's glaring example and chose to release corporate governance codes of themselves based on the notion that disparities in legislation, and, history triggered drastic obstacles for European Union to release one single code. Each national code was intended to include commonly agreed principles, best practice suggestions for corporate governance concerns while simultaneously projecting each country's unique characteristics and its disparate business environment.

The downturn for EU was completely unpredictable as in US. The initial response was dissimilar however, the reason was not that economic loss was non

– existent, the reason was that mainly institutional investors felt the loss, unlike US where individual investors felt the loss.

Returning to Europe's immediate post – scandal era, it can be claimed that there was sensible doubt about what European response was supposed to be. There was confusion on line of actions to take either at EU level or Member States level. All of these causes showed us that why act like SOX had not been adopted in EU. Their schemes were based to some extent on voluntary application, transparency and self – enforcement.

Their intention of promoting ethical business background and compliance with no government or EU interference quickly vanished when the number of companies involved in fraudulent behaviours started to rise. It was crucial to enforce codes of best practices, however, voluntary compliance demonstrated that it was harder goal to reach.

European Union did not pursue American federal government's example at that point. Instead, approach of Commission was actually to persist its project of harmonization, collaborate with Member States meanwhile tolerating its time – consuming nature. Establishing compliance culture all across EU was vital as the EU could not easily obtain caused by absence of voluntary compliance combined with human selfishness and fraudulent practices.

## **EU Action Plan on Company Law Modernization and Corporate Governance**

Harmonizing rules on corporate governance and corporate law and also on auditing and accounting was vitally important for founding single market on financial services. The reasons why it was absolutely needed to update both corporate governance and company law was the negative effects of corporate scandals.

### Preliminary goals of Action Plan:

- Presentation of annual statements of corporate governance
- Enhancement of legal framework to assist shareholders to practice greater Rights
- Adoption of Recommendation to support the role of non executive or Independent directors
- Adoption of Recommendation related to Remuneration of Directors
- Establishing European forum on corporate governance

### **Guiding principles of Recommendation for board of directors:**

- i. Boards must provide a balance between non executive and executive directors, thus neither certain director, nor a group of directors can monopolize decision – making process.
- ii. The roles of CEO and chairman ought to be completely separate and CEO should never become board chairman promptly.
- iii. Audit, Remuneration and Nomination Committees must be established and recommendations should be made to board. The board may assign authority for decision making, however, board itself ought to be responsible for its decisions completely.
- iv. The board must conduct yearly performance assessment based on board members' effectiveness and competence.
- v. The board must make sure that shareholders are fully informed about company's daily business and strategy and in the company conflicts and risks are managed.
- vi. An orientation program should be given to all new directors. Every year, a skill assessment with upgrades recommended properly should also be done.



- vii. Accurate guidance on board composition and roles of board committees should be provided. The Nomination Committee must consist mainly of independent non - executive directors. Audit and Remuneration Committees must consist primarily of non executive directors with an independent majority.

### **Recommendation on Directors' Remuneration**

For executive directors, Remuneration is one of the hot points of possible Interest conflicts. In numerous corporate scandals, excessive remuneration has arose as significant element leading to adoption of Recommendation on Remuneration. It prescribes that Member Nations must ensure that companies publicly announce their policy for Remuneration of directors and inform shareholders how much and in what form individual directors earn. In addition, companies must focus on ensuring that shareholders have sufficient control over these issues.

Recommendation for directors remuneration states that:

- Public companies must release and display an annual statement of their remuneration policy on their website.
- Each public company must release and thread annual statements of remuneration and policy on their website. The statements must also encompass contract terms of executive directors.
- In annual remuneration reports complete remuneration and rewards awarded to directors should be published.
- Share based programs for directors like share options must be subject to shareholder approval.
- Shareholders should vote on remuneration policy. This voting could be advisory or mandatory.

### **Directive on Takeover Bid**

This Directive aims at creating beneficial regulatory environment and boosting corporate restructuring. The directive as well enhance minority shareholders' protection.

The primary basic standards that this directive encompasses :

- Same class shareholders must be treated equally.
- Shareholders of the target company must have enough information and time to accept or decline an offer.
- The board of target company ought to provide guidance to shareholders on impact of bid on the company.
- The offeror firm's board should first behave in the company's interest as whole and should not dismiss security holders the opportunity to determine merits of bid.
- False markets should be established in offeror company's securities.
- The bidder is only allowed to make offer when he is certain he could pay price.
- Process of takeover should not hamper business of target company unnecessarily.

### **Transparency Directive**

The Directive on Transparency substituted and upgraded existing legislation in EU. (" Consolidated Directive on Admission and Reporting"). Public Companies' obligation on Transparency Directive aimed at improving quality of accounting information for investors about performance of companies, financial performance there, and significant shareholding changes.

The Directive sets minimal requirements for :

- Periodic financial reporting :

- 1) The objective of Directive is to assure that financial details supplied by public companies standardized.
  - 2) A crucial part of this approach is the requirement that either interim management statements or quarterly reports be issued by issuer of shares, that broadly provides an overview on financial position and performance over relevant period and illustrates material transactions and influence if them on financial position.
- Disclosure of main shareholdings to issuers. Shareholders must notify issuer, who notify market in turn.

### **Directive for Company Law, Auditing and Accounting Rules**

A new “Annual and Consolidated Accounts Statutory Audit Directive” was introduced in 2006 and had to be enacted by 2008. A key idea of this directive was “Article 41” which necessitates that public companies (Credit and Insurance firms as well) must have Audit Committees. Member states can decide on compromising of committees with regard to non executive directors. For auditing and accounting, one member at least should be independent and skilled. The tasks of audit committees can also be conducted by whole board in certain public companies. Where chairman is member in executive board, there Audit Committee must not be chaired by him.

The operations of audit committee typically involve revising:

- Process of financial reporting
- Internal audit
- Risk management mechanisms
- Account auditing
- Auditors’ independence

As a result toward reformative steps in EU, we see that these reforms were aimed at lessening dominant shareholder power and also harmonization of

corporate law throughout European Union. Indeed , amount of European regulations and directives toward corporate governance started to increase mostly in early 2000. While these measures responded to massive US and European scandals, most of them were taken as key part of Action Plan on financial services, with the goal of achieving highly integrated financial market in EU.

To what degree, these steps have been successful in achieving convergence is an open question.

### **3. Main results of research and lessons left by past experience**

#### **3.1 Primary outcomes shaped by research**

Main goal in my research was to discover and analyse miscellaneous factors, corporate governance in particular, that impressing accounting quality. As result of my research, I discovered that pool of factors impressing accounting quality bifurcate. First category encompasses factors inside the company – internal corporate governance, in contrast second category encompasses factors outside the company – external corporate governance. It would be sensible to summarize every one of factors embraced in both categories.

#### **First, link amongst accounting information quality plus corporate governance**

Essentially, it would be logical to remark that accounting information naturally is affected by environment where it is housed. Thus, to some extent, quality of accounting information relies on that environment. Most consequential component of that environment is corporate governance, therefore in operation of business accounting system together with corporate governance

are indivisible. Every aspect of accounting information produced, reflecting businesses' operational activities necessitates corporate governance comprising audit committee, management, board of directors, etc.

System of incentives and checks and balance amongst shareholders plus board of directors plus supervisory board is most necessary to evade disorders. Disparate structures in corporate governance have disparate incentives and checks, plus balances and, thus this disparity will simulate accounting information quality. Sloan, 2001, expressed that, accounting information exclusively is product formed by corporate governance operations and a chain of varying corporate governance mechanisms is primarily practiced to insure that information afforded has not been misplayed immensely. Corporate governance guards accounting quality and yields high-quality information using a line of intuitional settlements.

Accounting information is prime groundwork for corporate governance. As Whittington expressed, in 1993, financial reporting is indispensable component for corporate governance to function effectually. Without high-quality financial reporting, capital benefactors cannot effectually supervise directors actions. Therefore, reporting must be high – quality, as it is groundwork for enhancing corporate governance, empowering them to function effectually.

Accounting information acts crucial role in both internal and external systems of corporate governance. Trustworthy and pertinent accounting information could dispassionately and impartially radiate situation in the firm.

The profitability of organization in internal corporate governance, assists board of directors to direct organization business activities appropriate to fair and trusty information, apply decision – making might, and as well dispassionately and justly judge and inspire management performance. It also

assists managers make rational provisions for everyday manufacturing and functioning activities to enhance performance of organization.

Accounting information which is high-quality in external corporate governance can also empower corporations to attain more entrust and funding, diminish transactions expenditures, and elevate efficiency of operations in market.

Therefore, it can be deduced that accounting quality is sharply appropriate to corporate governance. Two-way intercourse exist here: mutual influence and interdependence which together institute an imperative which together institute an imperative component of the all-embracing operation of the enterprise.

## **Second, the impact of corporate governance over the quality of accounting information**

### **(I) The impact of internal corporate governance over the quality of accounting information**

#### **1. The influence of shareholders**

At present, many entities in world have a exclusive phenomenon. The general manager and the chairman of the board are concurrently assigned by one person. The might is immensely concentrated. The super-large shareholders predominate the board of directors, supervisory board and the managers. The might of the board of directors is elevated, and the board of supervisors is ineffectual. Supervision and control mechanisms cannot act their legitimate position. Large shareholders habitually use their commanding attitude to encroach on the company's interests and infringe other shareholders' interests. In order to obscure their illegitimate activities, the leading shareholders will educate the accountants to whitewash the financial statements, so that the trustworthiness of the revealed accounting information is lessened.

#### **2. Influence of the board of directors**

The board of directors is the midpoint of the company's internal governance composition. The staff composition and competence of the board of directors will touch the efficacy of the board of directors, which in turn touches the quality of accounting information. First, the composition of the board of directors. Board members incorporate the chairman, internal directors and independent directors. If the chairman and the general manager are simultaneously assigned by one person, the synthesis of the two positions will ineluctably conduct to the damage of the supervisory functions of the other members of the board of directors. The complete board of directors is checked by the managerial level, which forms the company's accounting actions more sloped to the manager's desire, thus, authenticity will not be pledged to some extent. Additionally, the immediate research data evinces that entities with a prominent rate of independent directors have meager financial reporting fraudulence. Independent directors do not contain definite positions in the entity and do not possess shares in the entity, so they can retain full abundant independence and absolutely utilize their supervisory might. Therefore, independent directors in secure scale should be retained to restraint the inner fraudulence and immoral earnings management actions of the entity, so as to enhance the efficacy of decision-making and oversight of the board of directors and guard the quality of accounting information. Second, the competency of board members. The board of directors necessitate to form decisions on the entity's vital concerns, adjudicate and gauge the manager's business performance, so the competency in directors is notably vital for effectual functioning of the board. If the board members are accustomed with the entity affairs and have vigorous proficiency, it will assist enhance the oversight side of the board of directors over accounting information disclosure, and simulatenously empower the inspection, control and supervision rights to be effectually exerted, thereby shortening the deformity of accounting information arises.

### **3. Impact of the Board of Supervisors**

The Board of Supervisors has a confidently positive effect over Accounting quality. A weighty and effectual supervisory board can lower financial accounting fraudulence at the managerial degree and heighten the quality of accounting information. However, intermittently from the angle of the existent standpoint of the Board of Supervisors, the Board of Supervisors cannot heighten the advancement of the quality of accounting information. Essentially world has a practice of more administrative might than supervision. Despite the reality that the board of supervisors is nominally compeer to the board of directors, still merely has the power of surveillance and no decision-making might and mastery, it cannot counterbalance with the board of directors, and substantially begins to be body underside the dominance of the board of directors. Furthermore, the composition on supervisory board ascertains that it cannot effectually realize the supervisory function. The members in board of supervisors comprise a undeniable portion of employee representatives plus shareholders of company. Authoritative, these factors inescapably undermine their supervisory roles.

### **4. Managerial influence**

The management layer exerts the managerial right of the entity, straightforwardly directs and checks the accounting and financial report preparation of the accounting department, perfectly comprehends the inner information of the organization, and systematize healthy governance procedure, which would inspire the management to make the glorious efforts for the long-run expansion and operation outcomes of the entity. Failing to systematize the unhealthy governance procedures will engender the management to exploit its might and collude with accounting resources for fraudulent activities. Conversely, managers might have a notably positive impact over yielding of high-quality accounting information. As the shareholder cannot pursue everyday



activities, the manager is compelled to execute business responsibilities and carry out effectual inner control and management procedures.. The manager ought to boost high-quality accounting information, formulate measures appropriate to accurate and flawless information for realization of the decision-making and the culmination of schemes to attain the entity business ambition. Moreover , the manager's earnings is linked to its execution. In order to attain a substantial individual income, the manager might have impulse to pervert accounting information.

## **(II) The impact of external corporate governance over quality of accounting information**

### **1. The impact of the capital market.**

The impact of the capital market over quality of accounting information is largely radiated in stock market. When investments are anticipated misconducted the company's futurity may happen, at that time they will trade multitude stock, this case raises the likeliness of the entity being taken over. Possible takeovers will attain control of the entity by obtaining stocks, reorganising the company's business, and sacking inexpert and inefficient managers. The race character of the capital market construct entities facing hazard of being taken over eternally, and the functioning cadre also have the strain to be discharged . This mechanism continually impulse entities to self-adjust, boost their business status, in the fierce market competition to endure and expand, to receive the investors reliance, gain the backing from capital market. It has lifted the charge of fraud by management to a some degree , which is contributory to the betterment of the quality of accounting information.

### **2. The impact of the manager's market.**

The vicious race and election mechanism of proficient managers can restrain their misbehaviours , form them working hard and yield existent and effectual

accounting information. Anyhow, if the manager market is lacking race, it will influence accounting quality badly. As an instance, in almost bulk of state-owned public entities, the assignation of managers has governmental intervention colour, which shapes the management not have too much ambitious pressure, which conducts performance of him in business through accounting statements.

### **3. The influence of the government**

If firms mishandle accounting information, it will touch the market mechanism and the effectuality of national macro-control, lower domestic tax revenue, and is not contributory to the effectual apportionment of market wealth. The government has remote public role, and ought to formulate analogous regulatory systems and to guard the interests of investors, insure equitable and effectual market, weaken stock market hazards as governance goals, and impulse enterprises to found effectual accounting information disclosure system.

### **3.2 Crucial lessons left by preceding accounting scandals**

Preceding two chapters concentrated on relationship between corporate governance and corporate accounting scandals as well as regulating corporate governance in wake of American and European scandals. This chapter summarizes a number of lessons left as a result of previous two chapters.

When looking at past we could see that since 2001, series of scandals happened in US and EU, leading to downfall of Enron, Parmalat and Worldcom. And these scandals in developed markets leaves us some lessons. In developed countries, US in particular a number of reform measures have been introduced, along with implementation of numerous laws and regulations, the most significant of which was Sarbanes – Oxley Act. Upcoming Parmalat scandal also horrified Italy and whole world of business as well as started raising

concerns on accounting information quality, extent of corporate governance and level of supervision in European public companies.

Normally, in learning process from failures, human society is continually developing and changing. We can also learn from lessons left by previous scandals.

One piece of lesson left by scandals was that **if companies do not pay sufficient attention to corporate governance, and if they do not enhance information quality they will pay extra heavy price.**

The capital market is, as we all realize, kind of an information market. Information disclosed to public, particularly financial information is backbone of presence and boost capital market development. History clearly demonstrated us that when financial information is gravely false, then it is influential basis for public companies to confront twists and turns. A weighty motive for US and even worldwide economic crisis in 1930 was that public businesses dishonestly counterfeited financial information and in that environment there were practically no audit and accounting norms, and there was virtually no government regulation and civilized affairs for public firms.

Recent collapses like Enron, Parmalat, and WorldCom are all – out indication of above – mentioned issues. Those financial scandals make it troublesome for investors to bear losses. It tends to be seen that costs of not focusing on corporate governance, not enhancing inside control framework, not raising quality of accounting information, and not enforcing supervision are tremendous and overwhelming. This is first lesson left by developed market financial scandals.

Consequently, we should continually enhance governance in public companies, improve information quality, enforce supervision in order to block cases such as Enron and Parmalat.

Another lesson left by **preceding cases is that significant financial scandals are disorders requiring all – inclusive governance.**

At early stages of Enron crash, all sides concentrated their efforts on untrue accounting information and accounting firms. In reality, conditions leading to Enron meltdown were not exclusively audit and accounting. Nearly all leading financial institutions in US accused of being involved in such cases. With ongoing investigation of case, it revealed that corporate governance in Enron was root cause of meltdown. In overview, real lesson left by developed market financial scandals are disorders requiring comprehensive governance. We should therefore examine troubles of public companies when it comes to financial information and we should place greater emphasis on corporate governance.

**“Governmental regulations should be designed to prevent formalism and manage relationship amongst companies and rules properly and adequately”** is another lesson for us left by preceding financial scandals.

This can be accepted that basic system of regulation relating to capital market is generally most advanced and healthy one in US, however serious meltdowns had also happened there. Biggest reason is that final concept of regulatory system might be formal and had not played its primary and intended role. After numerous scandals exposed by US there was worldwide debate on whether

accounting standards must be guided by principles or rules. For considerable period GAAP of US was widely assumed to be best. However, scandals clearly indicated that US GAAP also went wrong. When requirements are devised too specifically, particularly where there are different quantitative borders, the firms could skip borders of requirements by designing fictitious transactions, and thus results would not really reflect economic situation in business. Enron used SPEs

to incorporate particular provisions to conceal liabilities of company in consolidated financial statements.

Most of US companies misused gaps and loopholes of rules and deemed their own interests by manipulating financial datas and stocks prices. Can see that in developed markets, one more lesson left by financial scandals is that designed governmental regulations have to minimize formalism. It must be rigorously enforced once it is enacted. Therefore, once regulations are adopted, we need to find means to rule out all types of resistance, preserve their authority, and make sure that regulations are imposed precisely and impartially.

**“System’s merits and demerits are relative and for any system no superstition can be produced” is a lesson for us.**

As we know, ownership structures in corporations of developed countries is based on classic free market economy. It is troublesome for small shareholders to unite effectually due to scattered equity and instable ownership structure. Senior management monitoring by shareholders is significantly weak, this situation leads to trend of weak shareholders and strong managements. Principal decisions like appointments and sackings are indeed dominated by senior managers such as CEO of company.

Under “weak shareholders & strong managements” to overcome agency problems US continually designed a number of mechanisms in preceding decade comprising: highlighting presence of institutional investors in establishing equity restraints on management; determining independent directors , audit committees, etc.

In this way, board of directors can oversee for interests of greater number of shareholders.

For a long time, abovementioned institutional settlements were regarded as most effectual. After the financial scandals of Enron and other public

companies exposing, developed countries including US started to understand that shareholding structure and governance models of them has many weaknesses and deficiencies. It is traditionally presumed that in the world there is no best. Effectiveness of relationships between structure of shareholding and model of governance in companies should be evaluated combined with certain historical period encompassing specific political, cultural, historical, economic and legal factors. In short, strengths and weaknesses in system are relative depending on environment and alter when environment alters. No superstition can therefore be generated and copied for all systems. This is another lesson left by developed markets financial scandals. We should therefore earnestly consider economic and socio-political backdrop, applicable capital markets' system guidelines and regulations, and examine notably their root causes of different systems' failures or successes combined with national conditions.

**“Government has to carry its role in the market fittingly, and adjust it promptly as environment changes” is lesson as well.**

In world today, no pure market economy exists without governmental regulations, as well as, there is not any purely planned economy in developed countries. The success or failure of any governance system, in this context, is immensely dependent on balance amongst market mechanisms and government roles. Depending on definite conditions of various terms, government has to carry its role in the market and regulate it instantly when environment alters. This is one another lesson left by developed market financial scandals.

**“Start taking decisive and effectual measures when there are crisis in market, but avoid overcorrection” is lesson for us.**

Following Enron meltdown, government in US took a series of influential and curative measures instantly, including Sarbanes – Oxley Act that comprises

many striking and revolutionary measures in short period. On contrary, we are also concerned in particular, if US is overkilling. For instance:

1) Was it worth putting Andersen, who made considerable contributions to miscellaneous entities and countries ?

2) Do we over – highlight regulatory role of government and disregard significant role of civilized self – regulation mechanism?

3) Is cost of countless reformative steps too high?

4) Can we enforce concepts of US regulations over other countries ?

It should be viewed that, besides technical reasons like despondency and paranoia within entire economy due to “9-11” and financial scandals. Distrust and aggression climate towards US was dominating. To reverse that climate, drastic measures had been taken to generate instant results, but simultaneously there were incomplete estimation of costs and side effects of these measures. In reality, various levels of resistance from varying countries, combined with necessity to enliven capital markets, IPO market in particular, US had started to grant foreign public companies, regarding implementation of corporate governance regulative rules. Companies were handled with some level of flexibility. This demonstrates that decisive and effectual actions should be taken when there is a market crisis, however it is essential to avoid overcorrection. This is one another lesson left by developed markets financial scandals. With this in mind, when devising policies and laws for capital markets and enforcing supervision, we must avoid going to extremes and have to manage correlation amongst doing things.

**“We should equalize engagements amongst both integrity and interests, and fairness and efficiency regardless of society” is lesson from past.**

The model of market economy underlines that economic interests are verily stimulant. However financial scandals that have been unveiled recently, evinced that unending self – interests pursuits can also engender greed. Any laws and supervision will be ineffectual in light of rapacious greed and social equity will vanish. In 1998, when US was involved in excellent successes of knowledge economy and when the world was conquered by fresh achievements of US, SEC Chairman – Mr. Levitt, commented on report “ Digital Games”. It is mentioned that there were games that infringe principles which essentially nurtures market success. Levitt mentioned gravely :

“ If actions are not carried at the earliest opportunity, quality of profits and financial reports too will be eroded. Management will be supplanted by manipulation and mispresentation will substitute credibility.”

Following revelation of scandals like Enron, Time the US magazine and “ International Herald Tribune” noted that issue was not accounting, but morality issue. Notable finance market speculator – Mr. Soros also condemned self – interest and people who chase their narrow personal interests. In response to progressing reformative steps he specified that law is not handy alone, altering basic attitude combined with altering laws is requisite. Not just self – interests public interests as well should be chased by people.

New laws and regulations will not be serviceable without this mystical change. It can be perceived that regardless of society, connection amongst interests and honesty, must be taken into considerations. This is last lesson left by developed market financial scandals.

## **Conclusion**

The incessant incidences of financial scandals assuredly exhibits that there is a trouble with the corporate governance system. In reality, the rise of



corporate governance in preceding decades alone itself is an earnest reaction to corporate governance troubles.

Highlighting corporate responsibility has been one of key aspects of corporate governance in nations around world for approximately two decades. Corporate scandals in world giant companies made huge noise. In my research activities, I witnessed that developed countries' were disparate by nature. The reason for this disparity was varying models of corporate governance followed in different regions. Mainly two models: Anglo – Saxon & Continental Europe models. In first one, dispersed equity, in second one concentrated equity predominates. In first case there is apparent strong management & weak shareholders; in second case, there are apparently predominant shareholders. Regardless of these models, corporate scandals occurred in developed market economies, but not in same way.

Effects of corporate governance over accounting information relies on different characteristics. These characteristics encompass: scale of board; portion of independent directors; board diversity; board of supervisors; board expertise; leadership structure. Every one of these characteristics may have either positive or negative effects over accounting information quality.

Prominent scandals like Enron in US and Parmalat in Italy had happened as a result of poor governance. Financial scandals are highly connected to accounting system, however, accounting system alone does not entirely cause problem. Public companies with heavily concentrated equity have shareholder predominance. In those companies shareholders can manipulate and distort accounting information. In contrast, public companies with intensely dispersed equity, rely heavily on financial statements. Shareholders principally use financial accounting reports to realize operations of company. If equity is highly dispersed, then shareholder are not entangled in management, they merely visit general meetings to appoint managers and authorize certain issues. Capital

markets and shareholders realize operational and financial status of company primarily through examining financial statements in company. Fundamental logic for this system's operation is external auditors, who provides professional audit services and act in accordance with principles of their own credibility, professionalism and pressure they face on market competition. However, whereas, world is rich with greed and self-interests, professionalism credibility and principles are readily thrown back.

To solve this problematic situation governments of developed countries immediately took responsive measures. Begin with United States, Sarbanes – Oxley Act was approved throughout country. In European Union, Action Plan for Company Law Modernization and Corporate Governance was enacted.

Put everything aside, we must take lessons from past experience of variegated corporate accounting scandals. For me, most significant lesson is :

Viewing all these problematical cases – financial scandals as an accounting issue is narrow – sightedness, as these scandals are morality issues rather than accounting issues.

## **Literature list**

- I. ACCA F3 – Financial Accounting textbook, 2017
- II. Financial accounting quality and its defining characteristics, Theoretical article by Andra H. Achim; Anca O. Chis, 2014
- III. Factors influencing the quality of financial reporting and its implications on good Corporate governance, International Journal of Business, Economics and Law, 2014
- IV. A literature review on the determinants of accounting quality, 2017
- V. The effect of board structure on the firm performance: An evidence from Turkey
- VI. Journal of International Financial management and accounting, Article: Board characteristics and financial reporting quality, 2019
- VII. The EU approach to Corporate Governance. Essentials and Recent Developments, International Finance Corporation, World Bank Group, 2008
- VIII. Corporate governance in the Aftermath of the scandals: The EU response and the Role of Ethics, 2010
- IX. A theory of Corporate Scandals: Why US and EU differ, by John C. Coffee, Jr
- X. Accounting scandals: Beyond Corporate Governance by Ifedapo F. Avalogo, Nigel Garrow, Murray Clark and Dora Chan
- XI. Comparative analysis of Corporate Governance Systems, Annals & Proceedings of DAAAM International 2011
- XII. Three models of Corporate Governance from Developed Capital Markets, January 2008
- XIII. Corporate Governance, textbook by Rustamov Ilham Samil, Baku 2013
- XIV. Executive compensation, Christop Lütge, Technische Universitat Munchen, July 2016
- XV. Corporate Governance Policy in the European Union, CFA Institute, August 2016

- XVI. Principles and standards of corporate governance, by Asiye Nur Zengin, Ayshe AltioK Yilmaz, February 2017
- XVII. How is dealt with agency problem and what is the role of board of directors in in?, Bachelor thesis by Ashley Kuypers, May 2017
- XVIII. Corporate Governance and Reliability of financial reporting, by Mustafa Ari, Eskishehir University, IIBF Journal 2008
- XIX. Corporate Governance Reforms in Continental Europe, by Luca Enriques and Paolo Volpin, Journal of Economic Perspectives
- XX. Corporate Governance Failure: The Case of Enron and Parmalat, by Rezart Dibra, PHD, European Scientific Journal, June 2016
- XXI. Corporate governance and financial performance: The role of ownership and board structure, by Jordi Paniagua, Juan Sapena Bolufer, and Rafa Rivelles, February 2018

### **Websites**

- I. <https://www.sarbanes-oxley-101.com/sarbanes-oxley-compliance.htm>
- II. <https://www.allbusiness.com/the-fraud-triangle-and-what-you-can-do-about-it-4968017-1.html>
- III. <https://www.europeanceo.com/finance/europes-biggest-bankruptcy-remembered/>