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CORPORATE GOVERNANCE LISTING REQUIREMENTS: PROTECTING INVESTORS FROM FRAUDULENT FINANCIAL REPORTING

by
Khaled Aljifri
Professor of Accounting, United Arab Emirates University

Hugh Grove
Professor of Accounting, University of Denver

Lisa Victoravich
Associate Professor, University of Denver

Introduction

A major lesson from recent spectacular financial reporting frauds and the 2008 financial crisis is that effective reform of corporate governance is needed now more than ever. This paper analyzes the corporate governance listing requirements of major stock exchanges to assess the level of investor protection from such investment disasters. This issue is especially critical to emerging stock exchanges, like in the United Arab Emirates (UAE) and Russia, where these countries are trying to attract foreign investors. Thus, the corporate governance listing requirements of the well-established stock exchanges in the United States (both the New York Stock Exchange or NYSE and the over-the-counter-stock-exchange or NASDAQ), United Kingdom (London), and Singapore, are compared to listing requirements of the emerging stock exchanges in the UAE and Russia. The effectiveness of these corporate governance listing requirements for protecting investors is assessed by determining how they address ten common corporate governance factors[1] in fraudulent financial reporting that represent lessons learned from recent spectacular frauds and the 2008 financial crisis.

[1] These factors are: (1) all-powerful chief executive officer (CEO), (2) weak system of management control, (3) focus on short term performance goals, (4) weak or non-existent code of ethics, (5) questionable business strategies with opaque disclosures, (6) senior management turnover, (7) insider stock sales, (8) CEO uncomfortable with criticism, (9) independence problems with external auditors, and (10) independence problems with investment bankers.

This paper examined the corporate governance listing requirements in different major stock exchanges in the world for investor protection against ten common factors that caused fraudulent financial reporting. The paper concludes with the recommendation that ten factors that impinge critically on financial fraud should be controlled for, in order to improve risk management. Moreover, individual high risk areas need to be monitored closely. For example, it has been estimated that over half of the financial reporting frauds and earnings management cases involve revenue recognition practices. Aljifri (2007) stated that earnings management is generally conducted in areas of the timing of expenses and revenue recognition. Also, a recent 2012 survey of 170 Chief Financial Officers (CFOs) of U.S. public companies found that up to 20% of U.S. companies misrepresent economic performance by managing earnings at approximately 10% of earnings per share (Whitehouse, 2012). Consequently, the U.S. Securities and Exchange Commission (SEC) has reorganized its enforcement division to increase its focus on accounting fraud, including computer screening programs (Eaglesham, 2013).

A global survey of 3,500 corporate officials and employees in 36 countries in Europe, Africa, the Middle East, and India found that 20% knew of financial manipulations to either understate expenses or overstate revenue. Among just senior managers and directors, the number was 42% (Norris, 2013). Consequently, risk management practices and guidelines are still relevant and should be summarized for investors in corporate governance listing requirements. The paper concludes that such fraudulent practices will continue unless major stock exchanges and public companies strengthen their corporate governance listing requirements and practices, respectively.

Brief Literature Review

Ten common corporate governance factors have been identified in fraudulent financial reporting research dating back to the early 1980s (Grove et al., 1982) and have continued thereafter (Basilico and Grove, 2008). In fact, these ten factors were present approximately 90% of the time in major financial reporting frauds of the 21st century, including Citigroup, Lehman Brothers, Enron, WorldCom, Tyco, Parmalat, and Satyam (Grove and Basilico, 2011). Five of these ten factors appear to be adequately covered by the various stock exchanges' listing requirements for corporate governance: all-powerful chief executive officer (CEO), weak system of management control, focus on short term performance goals, weak or non-existent code of ethics, and questionable business strategies with opaque disclosures. The other five factors did not appear to be adequately covered by these same listing requirements: senior management turnover, insider stock sales, CEO uncomfortable with criticism, independence problems with external auditors, and independence problems with investment bankers. The major section of this paper assesses these ten fraud factors for investor protection by analyzing the various stock exchanges' listing requirements (and related statutory regulations) for corporate governance.

Major Findings and Practical Implications

Fraudulent financial reporting practices, which were analyzed with the ten "structural" and "behavioral" factors described in this study, will probably still occur in the absence of effective corporate governance listing requirements and related company practices. The global listing requirement comparisons reveal that investors seem to be quite well protected from the five "structural" factors but not the five "behavioral" factors. Thus, governments and regulatory policy makers should adopt effective corporate governance systems and mechanisms. However, “one size does not fit all” and finding an effective pattern of corporate governance listing requirements for different stock exchanges in different countries should take into account the different nature of these countries.

Conclusions

This paper has assessed the corporate governance listing requirements of major global stock exchanges (i.e., United States, United Kingdom, Singapore, UAE, and Russia) for investor protection against ten common corporate governance factors that facilitated fraudulent financial reporting as well as the 2008 financial crisis. The paper has shown how fraudulent financial reporting can occur in the absence of strong corporate governance. Investors appear to be protected by the corporate governance listing requirements of major global stock exchanges concerning five of the ten common corporate governance factors:

1. All-Powerful CEO
2. Weak system of management control
3. Focus on short-term performance goals
4. Weak or non-existent code of ethics
5. Questionable business strategies with opaque disclosures

This paper has now labelled these first five common items as “structural” factors of corporate governance, as opposed to the five following common items, which this paper now has labelled as “behavioral” factors of corporate governance. These latter five factors are intrinsically much harder to regulate in order to protect investors. Thus, investors appear to be unprotected by the various listing requirements of major global stock exchanges from these five “behavioral” fraud factors:

1. CEO uncomfortable with criticism
2. Senior management turnover
3. Insider stock sales
4. Independence problems with external auditors
5. Independence problems with investment bankers

Listed companies on these different stock exchanges should consider the listing requirements as an opportunity to improve their corporate governance practices, their financial reporting, and their own investors’ protection, rather than as an obligation or threat.

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