A COMPARATIVE STUDY ON CORPORATE GOVERNANCE FRAMEWORKS IN US, UK AND ROMANIA

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The corporate governance continues to be a challenging topic in international debates agenda, particularly in the current context of financial global crises. Even though companies in financial distress operate globally, corporate governance regulations are not uniform across the world. Considering these circumstances, our paper examines the major provisions of the codes on corporate governance from some of the EU member states and US. Based on an extensive relevant literature review, our research seeks to identify the common and different key features between the countries considered. The outcomes of this study are to be used further as prerequisites of a more comprehensive research[444].

Keywords: corporate governance, governance structures, governance models, governance codes

JEL classification: M19

Introduction

Corporate failures occurred during the last decade, followed by current financial crises which spread out globally have brought to the public attention the corporate governance framework and practices. The failures' causes were perceived to rest with a lack of management's integrity where individuals were involved in aggressive accounting, earnings management or fraudulent financial reporting to manipulate share prices, borrowings and bonus plans (Saleh *et al*, 2007). As a global response, the relevant international and regional organizations such as EU, IFAC, FEE, OECD etc. became conscious that their efforts aimed at regaining public confidence in companies' financial reporting must be extended beyond the convergence of auditing and accounting standards. In such circumstances, there was a stringent need to restore confidence in capital markets by enhancing corporate governance in order to support the convergence efforts and, ultimately, to provide financial information of the highest quality (FEE, 2003). In September 2001, the European Commission (EC) set up a Group of High Level Company Law Experts (HLCLE) with the objective of initiating a discussion on the need for the modernization of company law in Europe. To form de basis for its recommendations, the research conducted by HLCLE covered, among other issues, corporate governance practices across the EU. Subsequently, based on this report, in May 2003, the EC released an action plan that represents a benchmark in terms of corporate governance in the EU (EU, 2003). Basically, as one could notice, the major actions undertaken envisage the efforts toward identification of the key factors that underpinned corporate governance failures and the promotion of global convergence of corporate governance principles and practices. The latter was imposed by the major differences found between countries and consequently, between companies operating globally.

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444 A CNCSIS financed research project – „Rolul guvernanţei corporative în securizarea încrederii investitorilor: performanţa autohtona versus performanţele europene şi internaţionale", project manager, Camelia Liliana Dobroţeanu, 2009.

Lots of recently published papers reveal a boom in the corporate governance literature relevant to our research. Dewing & Russell (2004) published an article providing an overview of EU policy developments in accounting, auditing and corporate governance before and after the collapse of Enron. For EU policy-makers the article identifies areas for both encouragement and concern. It concludes that considerable progress has been made towards the harmonization of accounting, auditing and corporate governance within the context of the Financial Services Action Plan. However, the authors argue that, to achieve this, the EU has given too much ground to US hegemony, whether by embracing US practice as international “best practice”, or being forced to accept US practice where the US chooses to act unilaterally. Yeoh (2007) discuses the influences of the corporate governance models (German and UK) on the corporate governance regulations adopted in central and Eastern European countries, particularly in Poland. His findings indicate a stronger impact of Anglo-Saxon model in the detriment of the German one. Based on a set of corporate governance indexes, Khanchel (2007) examined the determinants of good governance in the US firms. His empirical results indicated that, except for the board index, there are statistically significant and positive associations between each governance index (board committees, audit committee, overall CG index) and firm size, investment opportunities, intangible assets, directors, and officers’ ownership. Also, institutional ownership and external financing needs are positively related to each governance index considered. However, his results show that growth opportunities and performance have no significant effect on governance quality. More recently, Aluchna (2009) develops a case study on Poland that questions about the utility of compliance with corporate governance rules in assessing corporate performances. Her results reveal the stronger the compliance, the weaker are corporations performances (measured by return on investment). Although the corporate governance – a complex concept strongly connected with economic, social and cultural aspects of corporations’ life – is extensively covered by an impressive number of research papers, our study focuses on certain specific issues related to corporate governance framework formally adopted in the countries selected for our comparative research. These issues are: current regulations relevant to corporate governance, the governance models and board structures, major responsibilities and composition of audit committees, considerations of internal and external auditing, and specific public disclosures on corporate governance required to companies. Similar comparative studies have been conducted by Hermes et. al (2006), Payne (2006), Rossouw (2009) and Li & Harrison (2007) providing valuable insights on corporate governance principles, practices and codes in various countries across the world.

1. Corporate governance framework in United States of America (US)

The Sarbanes-Oxley Act of 2002 (SOX), introduced in the United States of America in the aftermath of Enron, has fundamental governance implications for listed American companies, their foreign subsidiaries and foreign companies that have US listings. It applies to all Securities and Exchange Commission (SEC) registered organizations, irrespective of where their trading activities are geographically based[445]. The act is structured into eleven titles, each of them comprising a number of sections prescribing very tight rules on auditor independence, corporate responsibility, financial disclosure, corporate fraud etc. and accountability and setting up the public company accounting oversight body. In general, it appears to address almost exclusively the weaknesses of corporate governance revealed by failing companies. To some extend, as the Act is written, it is difficult to notice the difference between principles and provisions provided. While SOX lays down detailed requirements for the governance of organizations, the three highest profile and most critical sections – which were implemented in phases – are 302 (dealing with quarterly certification of financial reports, disclosure of all known control deficiencies, and

445 http://faculty.chicagobooth.edu/steven.kaplan/research/govern.pdf

disclosure of fraud acts), 404 (related to management certification of internal controls, attesting reports by independent accountant, and quarterly change reviews), and 409 (regarding the monitoring of operational risks and reporting material events). The board committees446 should be at minimum of three comprising only independent directors: nominating/corporate governance committee, compensation committee, and audit committee. The primary responsibility of the audit committee is to assist the oversight board on issues related to (i) the integrity of the financial reports; (ii) the company's compliance with legal and regulatory requirements; (iii) the independence of external auditors; (iv) the performance of internal audit function; and (v) the preparation of reports required by the SEC to be attached to company's annual reports. In addition, the audit committee is the sole authority to hire or fire external auditors and to approve significant non-audit relationships with independent auditors. The purposes, duties and responsibilities of the audit committee should be written in a charter. In terms of internal audit, the SOX stipulate that each listed company must have an internal audit function. As regards the external auditing, SOX prohibits providing audit and non-audit services simultaneously to a client. External auditors are required to provide the audit committee with a report on the auditor's independence quality control on annual basis. Listed companies must adopt and disclose publicly corporate governance guidelines and a code of business conduct, including waivers of the code for directors or executive officers. Other significant reports on corporate governance include: (i) an annual statement given by the chief executive officers (CEOs) in listed companies about his/her awareness of any violations of NYSE governance listing rules; (ii) management's report on the company's internal controls over financial reporting.

2. Corporate governance framework in United Kingdom (UK)

In UK there had been a sequence of revisions of the corporate governance provisions. The Combined Code published for the first time in 1992 was the result of a combination between the Cadbury and Greenbury codes. Subsequently, the revisions made in 1998 brought in additional reports – The Smith Guidance on audit committee, The Higgs Report on board' composition, role and remuneration, The Turnbull Guidance on internal control (Chambers, 2003). Following the Enron failure, the Financial Reporting Council (FRC) undertook a more regular approach to code revisions – on annual basis. In its current version, the Combined Code on Corporate Governance 2008 (CC-2008) sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. It contains broad principles, supporting principles and more specific provisions. Although its applicability was meant to be voluntary, the listed companies have the obligation of reporting their compliance or explaining the reasons of their failure to comply with the code's provisions. The Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Code. In the first part of the statement, the company has to report on how it applies the principles in the CC-2008. This should cover both the main and supporting principles. The form and content of this part of the statement are not prescribed, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. In the second part of the statement the company has either to confirm that it complies with the Code's provisions or – where it does not – to provide an explanation. This 'comply or explain' approach has been in operation for over ten years and the flexibility it offers has been widely welcomed both by company boards and by investors. It is for shareholders and others to evaluate the company's statement. Smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant in their case. Some of

446 The SOX provisions pay a particular attention to the criteria considered for assessment of director's independence, making a clear distinction between independent and non-executive.

the provisions do not apply to companies below the FTSE 350. Such companies may nonetheless consider that it would be appropriate to adopt the approach in the Code and they are encouraged to consider this (FRC, 2006). The board structure has to include at least three board committees. The first one – the nomination committee – should have a composition that allows for a majority of non-executive directors, chaired by either the chairman of the board or a non-executive director. The next –which is the remuneration committee – is required to be staffed entirely with independent directors, while the audit committee should expose a fully non-executive composition, being allowed to accommodate a majority of independent members. Assessing the independence of committees' members is left to the board responsibility, based on a limited number of criteria. The main role and responsibilities of the audit committee should be set out in written terms of reference and should include: (i) monitoring the integrity of the financial statements of the company; (ii) reviewing the company's internal financial controls and risk management447; (iii) reviewing the company's internal control and risk management systems; (iv) monitoring and reviewing the effectiveness of the company's internal audit function; (v) making recommendations to the board and shareholders in relation to the appointment, re-appointment and removal of the external auditor; (vi) approving the remuneration and terms of engagement of the external auditor; and (vii) reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process. Providing non-audit services by external auditors is allowed subject to a disclosure about the measures taken to secure the auditor's independence and objectivity, and audit committee's approval. Companies which do not have an internal audit function are required to review the need for one from time to time. Although, corporate guidelines or codes of business conduct are not required to be disclosed by companies, other Code's requirements, supplemented by the listing rules, cover an extensive disclosure on corporate governance issues, such as: information about the audit committee's functions and composition, a brief presentation of the activities conducted by the board's committees, a statement on internal controls that include a description of the company's internal control and risk management systems etc.

3. Corporate governance framework in Romania

In 2001, the OECD with the support of USAID, developed a specific program to improve corporate governance in Romania. The OECD/USAID views envisaged by the program were pointing out the following objectives: (i) evaluate corporate governance in Romania; (ii) offer a set of key recommendations for improving corporate governance in Romania and bring it closer to the international standard of the OECD Principles; (iii) identify needed technical assistance in the area of corporate governance; (iv) improve the understanding of present corporate governance practices in Romania, informing the international community about progressive national reform initiatives; and (v) facilitate full Romanian access to the ongoing international dialogue on corporate governance. In conducting the assessment and program formulation, the *OECD Principles of Corporate Governance* was considered the benchmark (OECD, 2001). The key recommendations constituted a comprehensive agenda for reform, including legislative changes, enforcement, institution building and private behavior/capacity building (Dobroteanu, L. et. al, 2008). Later, in 2002 and 2004, some re-assessments of the corporate governance practice in Romania were conducted by the World Bank (WB) as part of the joint WB-IMF Reports on the Observance of Standards and Codes (ROSC). The major improvements were driven by Romania's effort to join the EU and the continuing transformation of the Romanian capital markets. The WB report noticed that legislative changes have improved the corporate governance framework. The 2002 and 2004 revisions to the securities laws in particular have increased

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447 unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself.

protections for minority shareholders of publicly held companies (examples include the introduction of cumulative voting, rules to ensure the payment of dividends, and rules governing related party transactions). However, the report indicated several areas for further improvement. It recommended that policymakers consider (i) giving a clear mandate to the CNVM to protect shareholder rights, and providing additional resources to allow it to carry out this mandate; (ii) protecting shareholder rights for all publicly held companies; (iii) moving forward on the creation of a Corporate Governance Institute, to both provide training to board members, and develop a new Corporate Governance Code, refocused on role of the board of directors; and (iv) revising the company law, with emphasis on shareholder rights and the board of directors (WB, 2004).

In Romania, the obligation to comply with the EC recommendations on corporate governance materialized in the revision from 2004, 2006 and 2007 of company legislation (Law 31/1990). The last two revisions introduced in the Romanian regulations provisions regarding the corporate governance models applicable to all companies, and especially to the listed companies. These provisions enlarge upon the following aspects: (i) the one-tier governance model; (ii) the two-tier governance model; (iii) the oversight role exerted by the board and supervisory committees on the executive management; and (iv) the structure and the compositions of the board committees etc. The legislation prescribes the obligation of listed companies to comply with the two-tier corporate governance model. Although the recent revisions of the company law brought in significant improvements in terms of audit committee and internal audit, the requirements are still incomplete and difficult to implement (Dobroţeanu, C. & Dobroţeanu, L., 2007). The law merely describes the composition, role and responsibilities of audit committees, and leaves important issues uncovered, particularly regarding the protection of auditors' independence, appointment, renewal and removal of internal and external auditors. Moreover, the company law currently includes some puzzling provisions according to which, the companies should have a censors[448] committee, whose role overlaps with the audit committees'. However, following the WB recommendations, the Bucharest Stock Exchange (BVB) has recently issued a revised version of the code on corporate governance (initially released in 2007), and a Corporate Governance Institute was established. The Code provisions are voluntary except for the listed companies which are bounded to observe it and to report on a "comply or explain" in a special statement attached to the annual reports. The Code is structured into articles, principles and recommendations covering a significant area of corporate governance issues: board committees and their composition, role and responsibilities, rights of shareholders, external and internal audit, transparency and disclosure etc. The minimum requirements indicate the board should set up three supervisory committees: the nomination, remuneration and audit committees. While only the audit and remuneration committees should be staffed entirely with non-executives, all three committees have to accommodate a majority of independent members. Independence is assessed based on a list of specific criteria. The major responsibilities of audit committees described by the Code include: "(i)to assist the board in the discharge of its responsibilities in the areas of financial reporting, internal control and risk management, (ii) to make recommendations to the board regarding the selection, appointment, reappointment and removal of the external auditor and, in addition, the terms and conditions of their remuneration; and (iii) to monitor the independence and objectivity of the external auditor, in particular by monitoring the rotation of the partners of the audit firm" (BVB, 2008). In addition to the comply or explain statement, companies should disclose information about their governance and ethics codes adopted, the structure and composition of the board, activities conducted by the board committees etc. However, the enforcement of the Code provisions is to be monitored, since its first version

448 Censors are described by the law as independent experts in the area of accounting or auditing playing a supervisory role on the financial reporting activities of the company. This corresponds to a French-inherited model of board supervision over the executives.

application hasn't yet yielded the expected observance outcomes[449]. In the audit field, the revised legislation forbids the external auditors to provide simultaneously audit and non-audit services to a client, and it also underlines the obligation of the companies in question to organize the internal audit function as well as the latter's role in consolidating corporate governance.

4. Concluding comments

The above comparative analyses reveal certain common features of, and major differences between the national governance frameworks considered. Firstly, SOX is different from the UK's Combined Code, and from BVB's Code, in that observance is mandatory, rather than 'comply or explain'. Such a difference indicates a rule based approach (US) as opposed to a principle based approach to corporate governance (UK and Romania). If this is not a surprise for the UK case, Romania's adherence to a flexible system governed by principle deserves to be praised, particularly because it comes after a long tradition on rule-based national regulations. In terms of code structures and requirements, even though there are similarities such as provisions for board structures, models and composition of audit committees etc., UK' and Romania' Codes seem to be much closer to each other, while US provides for a more extensive and tighter coverage of governance issues (i.e. those related to assessing the independence status of the board members). Such a strict approach might create adverse effects in the sense that US companies' officials would be tempted to identify ways to avoid complying, due to high costs implied by observance of the SOX provisions. The proportion of independent and non-executive members of the board committees vary between the national frameworks considered, although all of them provides for a majority of independent members. The audit committee's role and responsibilities and internal audit function are, by far, best described by the UK Code. The Romanian provisions in this regard fall short behind, given that there are still issues to be developed, such as eliminating the actual errors from the legislation, and releasing supporting guidelines similar to the UK Smith' ones. The US is very different in this regard, by giving absolute authority to audit committees in relations with external auditors, although such an approach gives raise to further doubts on auditor's independence: to whom is he responsible for audit opinions issued? Is he serving the public', shareholders' or audit committee's interests? Moreover, the US and Romania's position regarding the prohibition of providing non-audit services to an audit client is, as we believe, not going to produce in long run the expected outcomes in terms of safeguarding the auditor's independence. Real life has already shown that more pervasive means of avoiding these requirements are identified. UK has a more balanced approached in this regard. One final remark on auditing points the excessive pressure placed external auditors under the US systems: auditors obligation to report, as part of audit engagement, on client's internal control systems and management's assessment of it. Apart from some legal problems raised by such a requirement, this has led to an increase of audit fees and, implicitly, of audit costs to audit clients. Considering the governance reporting and transparency, one could notice that US is very demanding and strict in this regard, attitude that, again, triggers higher costs to reporting companies in exchange for no returns (Aluchna, 2009). On the opposite, both UK and Romania have a more balanced view on this, particularly through "comply or explain" statement. As an overall conclusion of our research, the BVB corporate governance code was formulated by drawing up characteristics from both systems, with a strong preference for UK best practice. It is to be seen in the future whether such an option proves to be a viable one for Romanian companies and national particular circumstances.

449 A survey conducted on the BVB listed companies websites revealed that very few of them (statistically insignificant) have observed the disclosure requirements of the 2007 Code.

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