

## BENCHMARKING CORPORATING GOVERNANCE IN THE OECS

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### **WORKING DRAFT**

It has been stated that “Good corporate governance helps . . . to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole. It helps to maintain the confidence of investors – both foreign and domestic – and to attract more “patient”, long-term capital.”<sup>1</sup>

Unfortunately, there have been few attempts to explicitly develop a coherent set of requirements that have the backing of the law. The Sarbanes-Oxley Act (S-O) represents one such attempt. While the ultimate effect of the Act on corporate governance is still unknown, there is a considerable amount of conjecture that S-O will improve corporate governance in the U.S. and produce the types of benefits envisaged by the OECD in its documented principles of corporate governance. The available evidence offers no reason to doubt the potential effectiveness of S-O.

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<sup>1</sup> OECD Principles of Corporate Governance, April 1999.

The rationale for good corporate governance has been echoed in many different areas. It is clearest, however, in the following statement by Arthur Levit<sup>2</sup>, a former chair of the U.S. Securities and Exchange Commission:

“If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country--regardless of how steadfast a particular company’s practices may be--suffer the consequences. Markets must now honor what they perhaps, too often, have failed to recognize. Markets exist by the grace of investors. And it is today’s more empowered investors that will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors’ capital.”

While the literature does not uniformly support a positive relationship between good corporate governance and corporate economic performance, there is general support for a positive relationship between capital market effectiveness and corporate governance.

This paper uses S-O as a benchmark for examining corporate governance in the OECS. It identifies several areas of strength, possible weaknesses, and highlights three specific issues that can be viewed as an agenda for reform. It includes a discussion of important caveats that should be considered in pursuing the three reform agenda items. Besides the three areas that are highlighted, there is no doubt that other reforms are

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<sup>2</sup> Arthur Levit as quoted at <http://economicdevelopment.gov.mu/int/introbk.pdf>.

needed. The areas of weakness identified in the paper provide insight into some additional issues that deserve the attention of corporate governance reformers.

## **BACKGROUND**

The basic theory of corporate governance is summarized in Figure 1. Corporate governance has been studied from several different theoretical perspectives, including agency theory, stewardship, and sociology.<sup>3</sup> Each theory seeks to explore the relationship between various characteristics of corporate governance and desirable corporate, economic or societal goals. For example agency theory, originally espoused by Jensen & Mecklin,<sup>4</sup> is concerned with the alignment of the interest of owners (principals) and managers (agents). It recognizes the inherent conflicts between principals and agents, and posits the need for mechanisms to monitor and control agents' behavior and protect the interests of principals. Those mechanisms include an independent board of directors, financial reporting, disclosures and auditing. By contrast, stewardship theory discounts the possible conflicts between management and owners and shows a preference for a board of directors made up primarily of corporate insiders.<sup>5</sup> This theory assumes that managers are basically trustworthy and attach significant value to their own personal reputations. The market for managers with strong personal reputations serves as the primary mechanism to control behavior, with more reputable managers being offered higher compensation packages. Financial reporting, disclosure and auditing are still

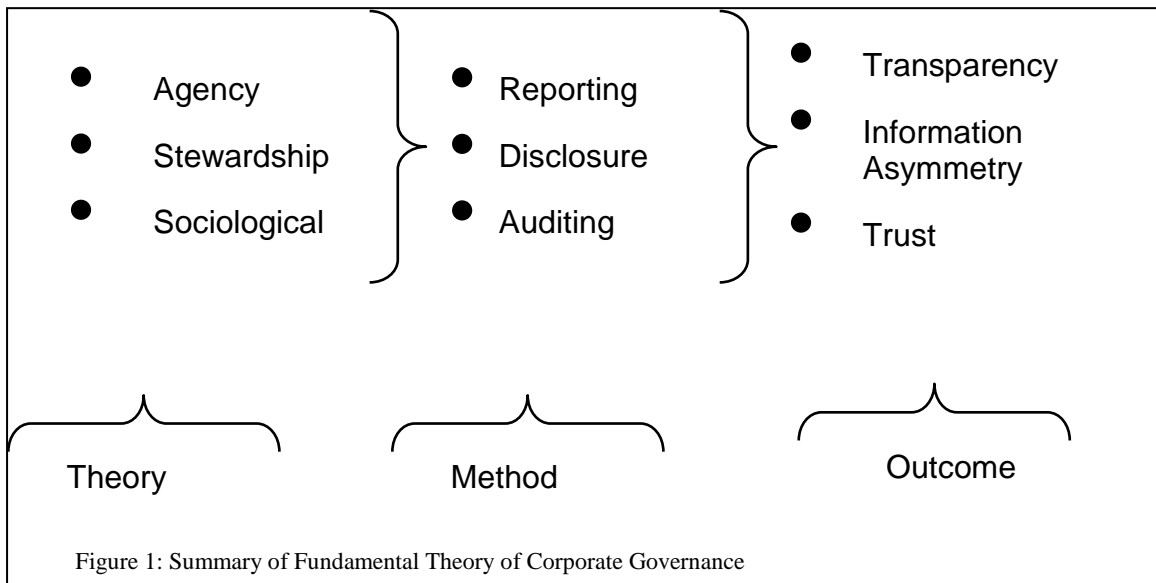
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<sup>3</sup> Niclas L. Erhardt, James D. Werbel, and Charles B. Shrader. Board Composition and Corporate Performance: how the Australian experience informs contrasting theories of corporate governance", *Corporate Governance: An International Review*. v. 11 issue 3, 2003, p. 189-205.

<sup>4</sup> Jensen, M. C. and Meckling, W. H. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, Vol. 3, 1976. pp. 305–360.

<sup>5</sup> Donaldson, L. The Ethereal Hand: Organizational Economics and Management Theory, *Academy of Management Review*, Vol. 15, No. 3, 1990, pp. 369–381.

important mechanisms but there is a fundamental presumption that these mechanisms are needed to confirm management’s inherent trustworthiness.



The sociological approach to the study of corporate governance has focused mostly on board composition and the implications for power and wealth distribution in society.<sup>6</sup> Problems of interlocking directorships and the concentration of directorships in the hands of a privileged class are viewed as major challenges to equity and social progress. Under this theory, board composition, financial reporting, disclosure and auditing are necessary mechanisms to promote equity and fairness in society.

Notwithstanding the theoretical perspective used in studying corporate governance, financial reporting, disclosure and auditing are important mechanisms used in business to assure key deliverables that are prerequisites for capital market efficiency. These deliverables include increased transparency and accountability, reduced information asymmetry, and trust. Recent developments have produced what some have referred to as the “perfect storm” (a confluence of corporate governance failures, erosion

<sup>6</sup> Pettigrew, A. M. On Studying Managerial Elites. *Strategic Management Journal*. Vol. 13, 1992, pp. 163–182.

in market confidence, and extreme market volatility), which have challenged the underlying premise of the stewardship theory and highlighted the importance of the agency and sociological perspectives. As shown in Figure 2, S-O is an attempt to ride the “perfect storm” and place corporate governance on a more effective course.

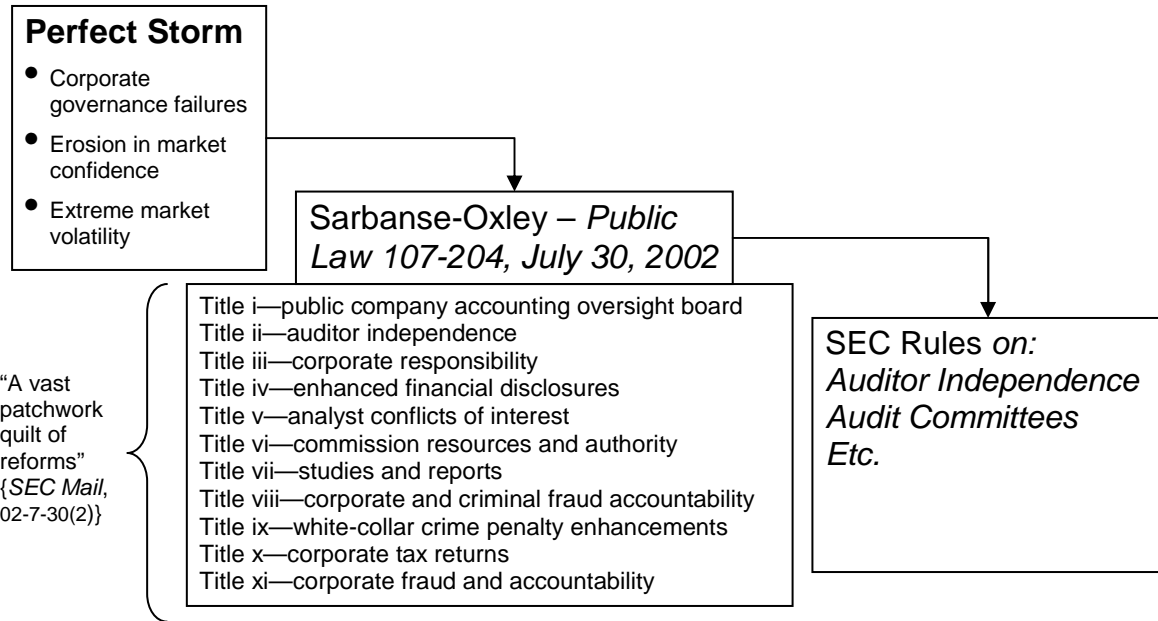


Figure 2: Summary of the S-O Corporate Governance Regime

Some might argue, with good reason, that S-O is an effort to stabilize and improve the corporate governance environment in a specific country (the U.S.) and that the tight regime of controls that make up S-O are not relevant to the OECS. For a number of reasons, this argument is only partially correct. First, the scope of S-O could very well extend to the region as many U.S. subsidiaries operate in the region. Indigenous OECS entities that raise capital in the U.S. and are required to file periodic reports with the SEC could also be subject to S-O’s requirements. Second, world capital markets are interlinked and the U.S. is a dominant player in that market. Third, many of S-O’s requirements are consistent with principles of “good” corporate governance that have

been espoused by professional organizations (e.g., AICPA), private sector commissions of inquiry (e.g., Blue Ribbon Committee; Hampel Committee), institutional investors (e.g., CalPERS), and international organizations (e.g., OECD). Thus, S-O could serve as an important benchmark for assessing the efficacy of corporate governance in the region, particularly in relation to financial reporting, corporate disclosures, and auditing.

## **METHOD**

This benchmarking study is based on a 37-item instrument that included many of the key reforms in the Sarbanes-Oxley Act. A copy of the instrument appears in Appendix A. The contents reflect corporate governance issues relating to auditing, financial reporting, and disclosure addressed in S-O. Respondents were asked to indicate whether they agreed or disagreed with each item. They were also asked to provide selected demographic information as well as information about the composition of their company's board of directors. The instrument was e-mailed to 24 public companies in the Organization of Eastern Caribbean States through the ECSE. Six responses were received. In addition to the survey, the author also conducted a detailed interview with one of the respondents. Clearly, it must be recognized that the small sample size has implications for the generalizability of the results documented in this paper. However, the paper makes no statistical inferences and the focus is on developing an understanding of critical corporate governance issues within the framework of the Sarbanes-Oxley Act.

## **RESULTS**

The results of this study are highlighted in Table 1 and Figure 3. Both exhibits are fairly self-explanatory. Summary observations derived from the exhibits and from the overall study are listed in the paper.

Table 1: Company Characteristics and Board Composition

	<b>Median</b>	<b>Mean</b>
Revenues (EC\$ million)	47	51
Total assets (EC\$ million)	270	480
Number of employees	181	173
Number of years operating as a public company	18	21
Number of members on board of directors	10	10
Proportion of independent directors	0%	19%
Ratio of audit to non-audit services	99:1	97:3
Proportion of share capital owned by board members*	8%	24%

\*This number is understated because many directors who do not own shares represent the interest of significant stockholders.

As seen in Table 1, public companies in the OECS are relatively small. Median total assets and total revenues of respondents are EC\$270 million and \$47 million respectively. A complex corporate governance regime like S-O could be disproportionately costly to such small entities. Furthermore, corporate boards in the region appear to be dominated by inside executive managers, executive managers of affiliates, and representatives of majority stockholders. The implication is that with the current composition of corporate boards in the region, the capacity for independent audit committee members is much lower than in more advanced industrialized countries. Thus, any requirement for more independent audit committees would have to consider this important constraint.

It seems plausible that the underlying reality of corporate governance in the OECS is more closely aligned with the stewardship perspective than with the agency

perspective. Insiders, affiliates, and shareholders make up 100 percent of the board in four of the six cases reviewed. An audit committee made up entirely of independent directors is infeasible under such circumstances, and would be less desirable than in situations with potential for greater owner-management conflict. Naturally, given the composition of corporate boards among OECS companies, the desirability of an audit committee comprising of independent board members would have to be judged within the context of the effectiveness of minority shareholder representation on the board of directors.

An intriguing observation with implications for auditor independence emerges from Table 1. The median ratio of audit to non-audit fees paid to auditors is reported as 99:1. This ratio (audit fees to non-audit service fees) is employed, at least implicitly, by the SEC and in S-O as a surrogate for auditor independence. Using the ratio as an indicator of independence, it appears that auditors in the region have been highly independent. While reform in the area of auditor independence may be needed (i) to sustain this seemingly high level of independence that exists in the region and (ii) to circumvent the appearance of an independence problem (an inherent risk in small,

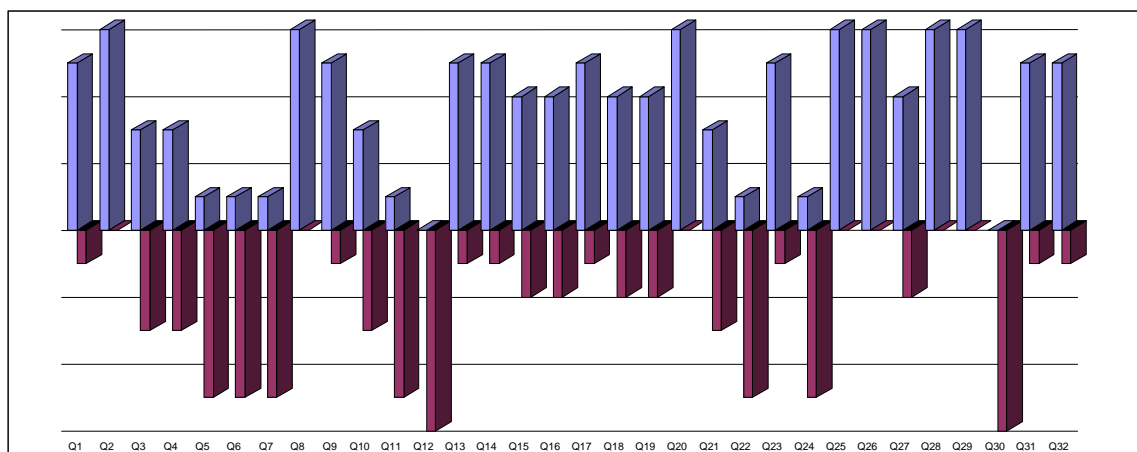


Figure 3: Summary of responses (refer to Appendix A for item descriptions)

tightly-knit societies), it can hardly be argued that such reform would be needed to stem an extant independence problem among public accountants in the region.

Results depicted in Figure 3 show several areas of strength, highlights areas need attention, and suggest an appetite for possible reforms in corporate disclosure, financial reporting, and auditing.

**Areas of strength include the following:**

- Board members' *compensation*
- *Independent board chairman*
- Board approval for *non-audit services* provided by auditors
- Functioning *audit committee* of the board
- *Audit committee's* access to information
- Audit committee effectiveness
- Functioning *internal audit unit*.
- *Audit unit* head reports to the board or board committee
- Respect for *auditor independence*
- *Non-employment* of *independent auditors'* employees
- *Disclosure of adjustments and corrections* identified by *independent auditors*
- *Off-balance sheet and related party* disclosures
- Financial statement and related *disclosures*
- *Real-time* disclosures
- *Infrastructure for real-time disclosures*
- Effective *internal controls*

- *Equitable treatment* of all shareholders

**Areas that need attention include:**

- Equity transactions by directors, officers, or shareholders with at least a 10% stake
- Process for dealing with officers/employers who commit a material violation of securities law
- Finance and accounting training for audit committee members
- Disclosure of contracts with independent auditors for non-audit services.
- Process for reporting and addressing complaints about overly aggressive or unethical accounting policies
- Reporting channels for complaints about aggressive or unethical accounting practices
- Independence of chair and other members of the audit committee
- Rotation of independent auditors
- Independent oversight for auditors of listed companies
- Attestation and certification of internal control.

**An apparent appetite for reform seems to exist for:**

- Independent oversight board for external auditors of public companies
- Fines and/or imprisonment for willful or negligent financial statement certifications that contain errors or fraud.
- Guidance for real-time reporting and disclosures (particularly real-time auditing)

## **DISCUSSION**

This discussion focuses on the three issues identified under the heading “appetite for reform:” (1) independent oversight board for external auditors of public companies; (2) fines and/or imprisonment for willful or negligent financial statement certifications that contain errors or fraud; and (3) guidance for real-time reporting and disclosures (particularly auditing).

### **Independent oversight board**

In the context of the OECS, the establishment of an independent oversight board is appealing from two important perspectives. The small nature of the island economies makes it challenging for the local accounting profession to monitor the quality and effectiveness of the independent auditors of listed companies. Because there are so few listed companies and independent auditing firms in each island, it seems plausible that stakeholders in the region and elsewhere would question the efficacy of a self-regulation regime in the accounting profession. A second reason why independent oversight is appealing has to do with some critical structural issues. CFOs are often recruited from public accounting, giving rise to highly cordial relationships between the CFO and the audit firms. The size of the islands and the relatively small core of professionals in accounting profession of each island make such relationships inevitable. Such close relationships extend well beyond the accounting profession to embrace a much broader class of professionals that includes CEOs as well as board members. In that context, an independent oversight board makes sense. However, it cannot be implemented at the

local level since a local oversight board would merely institutionalize the power and locus of control of the local professional community and call to question the board's independence. Therefore, any oversight board must be regional.

Clearly, the existence of an independent oversight board creates several expectations, particularly in the light of the S-O Act. For example, many in the region might view the PCAOB as an attractive model. However, there are important caveats that must be considered before drawing such a conclusion. First, the PCAOB is very well endowed and it is expected that, as a cornerstone of corporate transparency in the U.S., it will continue to be well funded. This funding makes it possible to recruit some of the best talents in corporate America to serve on the board and staff of the PCAOB. Funding and staffing of a regional replica of the PCAOB would be a significant challenge. While the staffing issue could be partially addressed through the use of visiting scholars and internships, this staffing model would have to be supported to a core of more permanent staff to facilitate the long-term continuity and direction of the board. Second, the PCAOB has the authority to create its own accounting and auditing rules—a situation that could neutralize the rule-making authority of both the FASB and the AICPA. The PCAOB has already indicated its intent to do so. Furthermore, it has the power to adopt any rules that it considers appropriate. In the context of the U.S., this could very well imply the adoption of certain international accounting standards.

These powers of the PCAOB are largely inconsistent with the private-sector accounting rule-making model that has existed in the U.S. since the birth of the accounting profession. Such powers would also be inconsistent with the accounting regulation and oversight regime that currently exists in the region. Naturally, this would

create important conflicts with the accounting profession in the Caribbean. Such conflicts would be challenging to resolve because while the region has an umbrella Institute of Chartered Accountants, the by-laws of the local institutes and applicable laws in each island determine how the accounting profession is regulated. Thus, the concept of an independent oversight board forces the region to address the issue of a more unified, legally recognized accounting profession. This issue is fraught with complicated questions, including what would be the minimum qualifications for admission to a regional institute of chartered accountants and what role would the U.W.I. play. Experience has shown that these are highly contentious, emotionally-charged issues. For example, in the context of the role of U.W.I., Margaret Mendes a UWI lecturer, has called for a government sponsored inquiry into the process of determining entry into the accounting profession. Her key argument is an apparent preference in Jamaica for international qualifications as a basis for entry to the profession and the failure to actively develop a coherent regional certification regime for the accountancy profession despite the high cost and “the educational, social and psychological effects of a system which tells students that their own national curriculum is of no value and requires them to master a great deal of material that is not relevant at the workplace.”<sup>7</sup>

### **Certifications containing errors and fraud**

There is no doubt that a requirement for management to certify the “truth” and “fairness” of the financial statements is consistent with the intent of both the pre-Sarbanes-Oxley financial reporting environment in the U.S. and the current practice

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<sup>7</sup> Margaret Mendes. The Case for an Inquiry into the Jamaican Accountancy Profession. Working Paper, UWI-Mona, page 2.

regime in the region. However, S-O is much more explicit in that regard than what is generally practiced in the region. S-O requires explicit certifications of both the financial statements and the efficacy of the internal control system. Willful or negligent certifications are punishable through significant fines and imprisonment. Furthermore, CEOs and CFOs who issue negligent or fraudulent certifications could be required to refund certain incentive-based compensation, bonuses, and profits from equity transactions. Research has shown that such incentives are significant explanatory factors in financial statement fraud cases. Indeed, the AICPA has recognized financial incentives as a class of highly important red flags that should be examined in assessing the risk of fraudulent financial reporting. Certifications and the related enforcement regime could in general reduce pressures and incentives to commit financial statement fraud. While most of the research in the area of financial statement fraud has been conducted in the U.S., there is no reason to believe that the same results with respect to incentives could not be replicated in the Caribbean context. However, there is one major issue with regard to certification in the context of S-O that may negate its efficacy in the region. The statute of limitations under S-O is a grand total of five years or two years after the fraud was discovered, whichever comes first. Considering the closeness of the region's small island economies and tight nature of relationships among members of the professional class, S-O's statute of limitations may not work in the region.

Financial statement fraud--one of the hazards that is expected to be minimized by S-O--feeds on collusion. Collusion was a key characteristic in recent cases such as Enron, WorldCom, Global Crossing as well as older cases such as MiniScribe, Regina, and several S&Ls. Collusion is most likely in tight knit communities. Concealment of

collusive behavior that cheats stakeholders is also most feasible such situations. Furthermore, the wheels of justice and auditing/investigation cycles are much slower in the region than in the U.S. Therefore, a replica of the S-O statute of limitations could very well neutralize the value of certifications as a broad approach to fraud risk mitigation.

### **Real-Time Reporting**

Real-time reporting is intended to reduce information asymmetry. However, if real-time disclosures (RTD) are unaudited and there are no independent guidelines on RTDs, there is the possibility that real time disclosures could become a vehicle for exacerbating moral hazards that information asymmetry creates. For example, a manager might decide to disclose good news real-time and defer the reporting of bad news, or vice versa. The manager could then act to leverage the market reaction to his/her selective disclosures. Another potential issue relating to RTD is that it can potentially institutionalize a second class of financial disclosures, which could become a lot more potent in terms of the immediacy of market reaction. While the market might react more quickly to this information, it is much more subject to manipulation by executive management and other corporate insiders since it's unaudited and there are no reporting/disclosure guidelines.

A second issue related to real-time disclosures is technological. Effective information technology is a necessary prerequisite for real-time reporting of financial data unless management is satisfied with press releases that merely describe notable events. Depending on the scope of RTD, there is usually a need for complex IT

applications that include some degree of intelligence to support real-time audits of reported information. This technology may not be available to many listed companies in the OECS.

## **CONCLUSION**

The Sarbanes-Oxley Act is broad and complex. It reduces fuzziness in the area of corporate governance and clarifies many issues relating to the responsibility for financial reporting and disclosure. As such it could serve as a benchmark for corporate governance reforms in the OECS. S-O has a very broad reach/scope that could easily extend to entities operating in the OECS and other Caribbean states. Cautious adoption of many of the S-O corporate governance requirements could help the region preempt the potential implications of the act for public companies, regulators, and governments in the region. The preliminary benchmarking study reported here should be refined and extended. Future corporate governance reform in the region could benefit from similar benchmarking studies.

## Appendix A Survey of Corporate Governance

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***Please indicate with a checkmark whether you agree or disagree with each statement listed below?***

1. Members of my company's board of directors are <b>compensated</b> at a rate that is commensurate with the market value of their service to the company.	Agree ___ Disagree ___
2. My company's board of directors has an <b>independent chairman</b> (one who is <b>not</b> the chief executive or other officer of the company)?	Agree ___ Disagree ___
3. If directors, officers, or shareholders with at least a 10% stake in my company should be involved in <b>equity transactions</b> in my company's share capital, then they must report those transactions to the regulatory authorities in my country in a timely manner.	Agree ___ Disagree ___
4. If my company or any of its officers/employers commits a <b>material violation of securities law</b> , the company has a process in place to report and remedy the violation.	Agree ___ Disagree ___
5. If one of our employees believes that my company has an overly <b>aggressive or unethical accounting policy</b> , we have a designated person within the company that the employee may contact.	Agree ___ Disagree ___
6. In my company, the designated person that employees contact to convey incidents of <b>aggressive or unethical accounting practices</b> does not report to the chief executive officer either directly or indirectly through the organizational hierarchy.	Agree ___ Disagree ___
7. My company has a process in place to avoid victimization of employees who report <b>aggressive or unethical accounting practices</b> to appropriate channels.	Agree ___ Disagree ___
8. My company has a process to ensure <b>equitable treatment of all shareholders</b> , including minority and foreign shareholders.	Agree ___ Disagree ___
9. The board of directors of my company has a functioning <b>audit committee</b> .	Agree ___ Disagree ___
10. All members of the <b>audit committee</b> of my company's board have received formal training in finance and accounting.	Agree ___ Disagree ___
11. The chair of the <b>audit committee</b> of my company's board has no direct stakeholder interest in my company (e.g., <i>shareholder, major customer, major vendor, officer or employee</i> ).	Agree ___ Disagree ___
12. Most members of the <b>audit committee</b> of my company's board have no direct stakeholder interest in my company (e.g., <i>shareholder, major customer, major vendor, officer or employee</i> ).	Agree ___ Disagree ___
13. The <b>audit committee</b> of my company's board is effective	Agree ___ Disagree ___
14. The <b>audit committee</b> of my company's board has timely access to information they need to execute their duties.	Agree ___ Disagree ___
15. My company has a functioning <b>internal audit</b> unit.	Agree ___ Disagree ___
16. The head of my company's <b>internal audit</b> unit reports to the board of directors or a committee of the board.	Agree ___ Disagree ___
17. My company currently discloses in its published financial statements all material adjustments and corrections identified by our <b>independent auditors</b> ?	Agree ___ Disagree ___
18. My company has a process in place to provide reasonable assurance that <b>independent auditors</b> are not fraudulently influenced, coerced, manipulated or misled by our employees, officers, directors or agents.	Agree ___ Disagree ___
19. My company has a policy of <b>not</b> hiring the current partners or employees of our <b>independent auditors</b> to fill its officer positions.	Agree ___ Disagree ___

20. In my company, the board of directors or a committee made up of board members must pre-approve contracts (explicit or implied) with our <i>independent auditors</i> for <b>non-audit</b> services.	Agree ___ Disagree ___
21. My company discloses in our published financial statements all contracts with our <i>independent auditors</i> for <b>non-audit</b> services.	Agree ___ Disagree ___
22. My company has a policy of periodically rotating <i>independent auditors</i> (i.e., require a different auditor after a certain number of years).	Agree ___ Disagree ___
23. I support the concept of an <i>independent oversight board</i> for external auditors of <b>public</b> companies.	Agree ___ Disagree ___
24. My country has or is considering the creation of an <i>independent oversight board</i> for external auditors of <b>public</b> companies.	Agree ___ Disagree ___
25. My company <i>discloses in its published financial statements</i> all material off-balance sheet transactions and other relationships with unconsolidated entities	Agree ___ Disagree ___
26. My company's corporate governance framework ensures <i>timely and accurate disclosures</i> on all material matters regarding the corporation, including the financial position, performance, ownership, and governance.	Agree ___ Disagree ___
27. My company publishes <i>real-time reports</i> on events and transactions that materially affect its operating results and financial position.	Agree ___ Disagree ___
28. My company has the necessary information technology to support <i>real-time</i> reporting.	Agree ___ Disagree ___
29. The <i>internal control system</i> (including security and control of information systems) at my company is effective.	Agree ___ Disagree ___
30. My company provides shareholders and other stakeholders with periodic reports, signed by a senior officer, <i>certifying</i> the effectiveness of its <i>internal control system</i> .	Agree ___ Disagree ___
31. My company provides shareholders and other stakeholders with periodic reports, signed by a senior officer, <i>certifying</i> that published financial statements contain no material misstatements.	Agree ___ Disagree ___
32. Regulatory authorities in my country should impose mandatory fines and/or prison terms for willful or negligent financial statement <i>certifications</i> that contain errors or fraud.	Agree ___ Disagree ___

33. How many members (directors) are on your company's board of directors? \_\_\_\_\_
34. What proportion of your company's board of directors is made up of persons with no direct interest in your company (e.g., shareholder, major customer, major vendor, officer or employee)? \_\_\_\_\_
35. What is the relative proportion of audit and non-audit fees you pay to your independent auditors for services they perform for your company? \_\_\_\_\_% audit \_\_\_\_\_% non-audit
36. What proportion of your company's capital stock is owned by the board of directors as a whole? \_\_\_\_\_
37. Please provide us with the following demographic information:

Company Name:	Your e-mail:
Head office location:	Your phone number:
Web site:	Total sales: _____ Total assets: _____
Your name:	Total employees: _____
Your title:	Number of years since going public: _____

Thank you for completing this survey. Please note that your name and individual responses will not be used in analyzing and reporting results. If you would like to receive a summary of the results, please send an e-mail to Professor Thomas G. Calderon at [tcalderon@uakron.edu](mailto:tcalderon@uakron.edu), call 330 972.6099, or fax 330 972-8597.