# CORPORATE GOVERNANCE LISTING REQUIREMENTS: PROTECTING INVESTORS FROM FRAUDULENT FINANCIAL REPORTING

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**Abstract**

This paper analyzes the corporate governance listing requirements of major global stock exchanges to assess the level of investor protection from investment disasters, such as corporate fraudulent financial reporting (e.g. Enron, Lehman Brothers, Satyam, and Parmalat) and the 2008 financial crisis which destroyed over $1 trillion in market capitalization of U.S. companies. This investor protection issue is especially critical for emerging stock exchanges that are trying to attract foreign investors, such as in the United Arab Emirates (UAE) and Russia. This issue is assessed by comparing 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 to the listing requirements of the emerging stock exchanges in the UAE and Russia. The effectiveness of these corporate governance listing requirements in protecting investors is assessed by determining how they address ten common corporate governance factors which represent lessons learned from recent fraudulent financial reporting scandals. These ten factors have been divided into two groups of five. The first five common factors were the same ones found in a 2010 Commission on Corporate Governance report, sponsored by the New York Stock Exchange, to investigate the 2008 financial crisis. This paper has called them "structural" factors and labelled the other five common factors as "behavioral" factors. 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. The paper concludes with listing requirement suggestions to protect investors from these five "behavioral" factors. Investor protection from all ten factors is still needed as recent U.S. and global surveys have indicated that financial reporting manipulations are ongoing.

**Keywords:** Corporate Governance Listing Requirements, Fraudulent Financial Reporting, 2008 Financial Crisis

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## 1. 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.

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,

[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.

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. This paper is organized in the following major sections: corporate governance listing requirements, additional regulations in the U.S. and Europe, ten common corporate governance factors in financial reporting frauds and the subprime mortgage crisis, current trends, and conclusions.

## 2. Corporate Governance Listing Requirements

The Appendix presents details of the listing requirements of these major stock exchanges, juxtaposed with the ten warning signs of possible corporate fraud. For example, the UAE state owned, the listing requirements of Abu Dhabi Securities Exchange and Borse Dubai stock exchange (established by the Securities and Commodities Authority to be effective in 2010) have drawn from both the United States (U.S.) and the United Kingdom (U.K.) listing requirements. Since the UAE Borse Dubai stock exchange's goal is to become another major stock exchange by filling the '24/7' continuous, world trading gap between the U.K. and Singapore, the latter stock exchange's listing requirements for corporate governance have been included as well. Also, the Sarbanes-Oxley Act (SOX) requirements in the U.S. have been included as they were written to address several of the ten common fraud factors. The emerging Russia or RTS Stock Exchange listing requirements have focused upon the ten rules needed for major Russian companies to be included on its leading or most exclusive 'List A', as opposed to the less prestigious 'List B' (Derisheva, 2007).

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.

## 3. Additional Regulations in U.S. and Europe

History has shown that many financial regulation reforms were motivated by crises. For instance, the U.S. Securities Exchange Act of 1934, which established the Securities and Exchange Commission (SEC), followed the U.S. stock market crash of 1929. The Foreign Corrupt Practices Act of 1977, the SEC Practice Section, and the Financial Accounting Standards Boards (FASB) were all established following the classic U.S. financial reporting frauds of the 1960s and 1970s, such as National Student Marketing, Stirling Homex, Equity Funding, W.T. Grant, and Penn Central. History repeated itself with the passing of the Sarbanes-Oxley Act (SOX) in July 2002 after Enron, WorldCom, and other U.S. companies collapsed. SOX also created the Public Company Accounting Oversight Board (PCAOB) that establishes standards, performs quality reviews of auditing firms, and investigates and disciplines these audit firms and their employees. This Board is composed of five members, only two of whom can be certified public accountants (CPAs). Board members must serve full time and cannot receive payments, other than their retirement pay, from public accounting firms (Felo and Solieri, 2003).

History has also been repeating itself in Europe with various new regulations, following the collapse of Parmalat and Cirio. In the European Union (EU), the need to use international accounting standards became a priority after such financial reporting scandals. Starting in January 2005, International Financial Reporting Standards (IFRS) have been required for public EU companies. Both the IFRS and U.S. generally accepted accounting principles (GAAP) have been considered as forms of corporate governance. Both U.K. and Sweden have required the regular rotation of the lead partner on an audit but only Italy has required audit firm rotation every five years (Plender, 2004). Also, various U.K. securities laws have similar provisions to the major SOX requirements. For example, the Companies (Audit, Investigations and Community Enterprise) Act of 2004 required companies, their officers, employees, and auditors to provide information for the investigation of company accounts that may be defective.

## 4. Ten Common Corporate Governance Factors in Fraudulent Financial Reporting and the 2008 Financial

Various short sellers, fund managers, investors, and financial analysts have used corporate governance factors to help make their investment decisions (Anders, 2002; Bryan-Low and Opdyke, 2002; Mulford and Comiskey, 2002; Schilit, 2010 and 200). Company managers, board members, internal auditors and external auditors also need to analyze corporate governance factors, particularly for risk management strategies that attempt to detect and prevent fraudulent financial reporting and risky investments. Corporate governance factors have been leading indicators of financial reporting frauds in many recent cases as these factors occurred well before the stock prices of these fraudulent companies dropped to near zero (Grove and Cook, 2004; Cook and Grove, 2007). Furthermore, as noted by Sir David Tweedie (2007), Chair of the London-based International Accounting Standards Board, "The scandals we have seen in recent years are often attributed to accounting although, in fact, I think the U.S. cases are corporate governance scandals involving fraud." For example, many of Enron's corporate governance factors had surfaced by early September 2001 when Enron's stock price was still trading in the $30 to $35 range (off its all time high of $90 in the summer of 2000) before 30 November, 2001 when it dropped to near zero after exposure of its financial reporting fraud. Many corporate governance factors were also present when Parmalat's stock price was EUR 3.09 on 3 September 2003 before it dropped to EUR 0.11 on 22 December 2003 after exposure of its financial reporting fraud.

Corporate governance factors have also been present in the 2008 financial crisis. The first three of the ten fraud factors, all-powerful CEO, weak system of management control, and focus on short term performance goals, have all appeared to contribute to subprime mortgage problems in various investment banks. For example, CtW Investment Group, a union pension fund investment advisor to both private and public pension funds that have about $1.4 trillion in assets, has threatened to take action against both Citigroup and Merrill Lynch which cost shareholders $126 billion and $35 billion in 2007, respectively. CtW stated that the Audit and Finance Committees of both banks' Boards failed to prevent these banks from incurring excessive risks from these subprime mortgage investments and failed to monitor the former (fired) CEOs who designed and implemented those risky strategies (Reuters, 2008).

The magnitude of the 2008 financial crisis is demonstrated by the following subprime mortgage investment write-downs to date: $18 billion at Citigroup, $15 billion at Merrill Lynch, $15 billion at UBS, $11 billion at Morgan Stanley, and $2 billion at Bear Stearns. Total write-downs of subprime mortgage investments as of the end of 2007 totaled $100 billion with another $100 billion possible. CEOs at Citigroup, Merrill Lynch, UBS, and Bear Stearns all lost their jobs over subprime write-downs but the first two CEOs still received total severance packages of $95 million and $161.5 million, respectively! The following investment banks have turned to foreign governments' investment funds and wealthy foreign private investors in the Middle East and Asia for bailout financing:

- Citigroup: $22 billion as follows: $7.5 billion from Abu Dhabi Investment Authority, $6.8 billion from Government of Singapore Investment Corporation, and $7.7 billion primarily from Kuwait Investment Authority and Alwaleed bin Talal (a Saud Prince);
- Merrill Lynch: $12.2 billion as follows: $6.6 billion from Korean Investment Corporation, Kuwait Investment Authority and Mizuho Financial Group of Japan and $5.6 billion primarily from Temasek Holdings (controlled by the Singapore government);
- UBS: $11.5 billion as follows: $9.7 billion from the Government of Singapore Investment Corporation and $1.8 billion from an anonymous Middle Eastern investor;
- Morgan Stanley: $5 billion from the China Investment Corporation;
- Barclays: $5 billion as follows: $3 billion from China Development Bank and $2 billion from Temasek Holdings.

The only major investment banking company to avoid this subprime mortgage mess was Goldman Sachs whose CFO enforced a strong system of internal controls for risk management. Goldman Sachs either sold off or bought insurance on its subprime mortgage investments and avoided any investment write-downs. It maintained a net short subprime position with the use of derivatives and

benefited from the declining prices in the mortgage market. Thus, in 2007 Goldman Sachs earned a record $11.6 billion and was the only major investment banking firm to pay year-end bonuses which were approximately $20.2 billion with its CEO obtaining record CEO compensation for this industry at $67.9 million. Further supporting this point, the subprime mortgage crisis which is at the center of the debt predicament is 'the biggest failure of ratings and risk management ever' according to UBS (Grant, 2008).

The ten fraud (and corporate governance) factors represent common red flags that were leading indicators in many recent frauds and the 2008 financial crisis. These ten factors are elaborated with specific company examples and with corporate governance observations from Warren Buffett, the CEO of Berkshire Hathaway, a multi-billionaire investor worth over $40 billion, and the second wealthiest person in the U.S., after Bill Gates. Buffett (2003-2007) has included a corporate governance section in his recent annual CEO letters to shareholders. He served on 20 public company boards and has interacted with more than 250 directors over the last 40 years. However, he has only been asked to serve on one compensation committee of all these 20 boards since he has such tough, rigorous views on executive compensation, as opposed to the huge severance packages for the fired CEOs of Citigroup and Merrill Lynch.

Corrective guidelines to overcome these corporate governance weaknesses were derived from corporate governance listing requirements of major and emerging stock exchanges around the world in the U.S., U.K., Russia, UAE, and Singapore. For example, the similar NYSE and NASDAQ listing standards for corporate governance were approved by the SEC on November 4, 2003. Both the NYSE and NASDAQ required that all their listed companies adopt and discuss these listing standards. Also, listed foreign companies must disclose any significant differences from these corporate governance listing standards.

The following ten red flag factors for fraudulent financial reporting were also matched with regulations from SOX which posed remedies for the perceived ineffectiveness of corporate governance and external audits (Felo and Solieri, 2003). SOX was also applicable to more than 300 European companies that are dual-listed on U.S. stock exchanges since the SEC has required them to follow SOX for their U.S. listings. Also, there were currently about 1,300 foreign firms registered with the SEC, as opposed to only 500 firms in 1992, and the number of foreign firms listed just on the NYSE has grown from 332 to 424 in the last few years. The SEC's resolve to enforce SOX with these foreign firms has been reinforced by European cases of fraudulent financial reporting, i.e., Parmalat, Cirio, Ahold, and Adecco.

### *All-Powerful CEO*

The CEO is also the Chairperson of the Board of Directors. Insiders (senior company managers) on the Board have majority control and there is a failure of corporate governance.

Cullinan and Sutton (2002) found that the CEO and other senior managers were involved in 90% of the 276 companies cited by the SEC for earnings management or fraud in its Accounting and Auditing Enforcement Releases (AAERs) from 1987-1999. Beasley et al. (1999) found similar results in their study of AAERs from 1987-1997. Basilico et al. (2005) also found significant statistical differences for insider majority control of over 100 fraud companies in AAERs from 1986-2001 versus matched non-fraud companies. For example, the original CEO, usually the company founder, was also the Chairman of the Board at Enron, WorldCom, and Global Crossing. The Qwest Chairman of the Board who was the largest single Qwest shareholder, hand-picked the CEO. In Europe, Parmalat began as a family-owned meat company that grew into a global food giant. The CEO, who was the company founder, the Chief Financial Officer (CFO), and the company lawyer continued to run the corporation together as insiders controlled the Board of Directors even after it went public.

Concerning corporate governance for an effective board structure, Buffett (2005) observed: "true independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare." He looked for people whose interests are in line with shareholders in a very big way. All eleven of his directors each own more than $4 million of Berkshire stock. They are paid nominal director fees. No directors and officers liability insurance is carried, not wanting them to be insulated from any corporate disaster that might occur. Buffett (2007) summarized this independence issue: 'board members must be truly independent because many directors, who are now deemed independent by various authorities and observers, are far from that, relying heavily as they do, on directors' fees, often ranging between $150,000 to $250,000 annually, to maintain their standard of living.' Buffett wanted the directors' behavior to be driven by the effect of their decisions on their net worth, not by their compensation. He called this approach 'owner-capitalism' and said that he knows of no better way to create true independence for board directors.

All the major stock exchange listing requirements for corporate governance have emphasized an independent Board of Directors to help counter-balance an all-powerful CEO in order to help protect investors. For example, the NYSE required that its listed companies have a majority of independent directors and has defined independence as directors having no material relationships with the

company over the past year. To help promote more independent Boards, SOX Section 402 prohibited corporate loans to company officers and directors. SOX Section 1105 also gave the SEC the power to ban, temporarily or permanently, individuals from serving as officers or directors of public companies if the individuals have committed securities fraud, like Martha Steward and Frank Quattrone. Also, several large companies, like Disney and MCI, have separated the two jobs of CEO and Chairman of the Board but JPMorgan Chase shareholders rejected such a separation in May, 2013.

### *Weak System of Management Control*

The system of internal control (checks and balances, separation of duties, internal audit etc.) is so weak that senior management can override it anytime it wants. There is a failure of corporate governance.

A weak system of internal controls was almost always present in major fraudulent financial reporting cases, both in current and past frauds. Senior management encouraged such a weak control system so that it can be easily overridden to make the desired financial targets, preferably by subordinates without the specific knowledge of top management. For example, although Parmalat had reported profits each year, a report prepared by an independent auditor for prosecutors in Milan said that Parmalat only had one profitable year between 1990 and 2002. Also, Parmalat's CEO has admitted shifting over EUR 500 million cash from the company to other businesses. However, the independent Parmalat report put that number closer to EUR 1 billion cash and blamed the CEO. A Milan Magistrate close to the Parmalat case observed: "We need individuals and a culture that exercise controls" (Barber, 2004). Another example was the Swiss company Adecco, the world's largest temporary employee agency. It had a Board of Directors and three-person Audit Committee, composed of only Europeans. Meanwhile, 20% of total revenues were in the U.S. where the fraud occurred from overstated revenues, billing errors, lack of internal controls, and poor information technology security. Adecco had failed to exert proper control over its foreign subsidiaries.

This control problem has appeared to be timeless as the 2007 KPMG survey of 138 top corporate executives found that inadequate internal control was the primary contributor in the previous year to a fraud incident against their company. The survey found that a major contributor to fraud was management's override of internal controls. The lead partner for KPMG's Forensic practice concluded: 'Applying lessons learned from their efforts to implement controls over fraud risk could help boards, senior executives and other who have responsibility to manage the risk of fraud with early detection and prevention' (KPMG, 2008).

Concerning corporate governance for management controls, Buffett (2004) observed that many intelligent and decent directors failed miserably due to a "boardroom atmosphere." He elaborated: "It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his advisors are present and support his decision." To avoid these "social" difficulties, Buffett has enthusiastically endorsed the NYSE requirement that outside directors regularly meet without the CEO. Also, the NYSE required that every listed company have an Audit Committee of at least three members composed entirely of independent directors who must be financially literate. Furthermore, it has required that every listed company have an internal audit function.

All the major stock exchange listing requirements have emphasized a strong system of internal controls to help protect investors. Various exchanges, like the NYSE, have specifically cited the need for independent Audit Committees and internal audit functions. Since a strong internal control environment is critical to preventing fraud, SOX Section 404 required that both the CEO and the CFO discuss their firm's internal controls. Firms must also report on the policies and procedures in place to prevent fraud in their annual reports. CEOs and CFOs are required to state that establishing and maintaining the internal control structure is their responsibility and to provide an annual assessment of the effectiveness of those policies and procedures. In its recent Auditing Standard No. 5, the U.S. Public Companies Accounting Oversight Board (PCAOB), created by SOX, required that the external auditor give an opinion on the effectiveness of a firm's internal controls in addition to the required opinion on the fairness of the firm's financial statements.

### *Focus on Short Term Performance Goals*

The overriding performance goal is to 'make the numbers,' for each quarter and each year. More performance emphasis is given to revenue, or 'top-line' growth, than earnings, or 'bottom-line' growth.

Qwest's CEO was criticized by his own board for having a short-term focus on making the numbers, particularly double-digit revenue growth. For example, Qwest did quarter-end swaps of its fiber optic networks with other companies, such as Global Crossing and Enron, to make its quarterly double-digit revenue targets. Qwest also recorded thirteen months of advertising revenues from its telephone directories, instead of the normal twelve months, to make its annual revenue growth target one year. None of these swaps were disclosed to investors. To make its own revenue goals, the Dutch company Ahold recorded supplier rebates as revenues. Two German

firms rejected proposed mergers with Enron and Qwest, similarly citing aggressive revenue and earnings management accounting practices and huge off-balance sheet debt of these companies.

To guard against an undue focus on short-term financial performance for compensation packages, a total compensation package could be divided into fixed and variable components. For example, the variable component could be made up of several performance measures (Hilb, 2004):

1. long-term financial performance over three years,
2. comparative value indices (e.g. 50% Economic Value Added, 20% customer loyalty, 20% employee satisfaction, and 10% public image), and
3. functional performance assessments (20% board committee performance, 30% individual board member performance, and 50% corporate performance).

Similarly, Epstein and Roy (2002) have advocated that Kaplan and Norton's (2000) Balanced Scorecard approach be used to evaluate, not only company performance, but also board performance. One of the four strategic perspectives of the Balanced Scorecard was slightly modified as the customer perspective would be expanded to a stakeholder perspective for the board. The other three Balanced Scorecard categories remained the same: financial, internal processes, and learning/growth.

Concerning guidelines for executive compensation, Buffett (2006) stated: 'In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging.' He noted that when CEOs meet with boards' compensation committees, too often one side (the CEO) has cared much more than the other side about the pay package. The difference often has seemed unimportant to the board's compensation committee, particularly when stock option grants had no effect on earnings prior to 2006 under U.S. accounting rules. He observed that such negotiations often had a 'play-money' quality and said that directors should not serve on compensation committees unless they are capable of negotiating on behalf of the shareholders. Buffett noted that "CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. It would be a travesty if the bloated pay of recent years became a baseline for future compensation." The 2008 financial crisis with the bloated severance packages for fired and continuing CEOs reinforced this observation. Also, Buffett has argued that a red flag should exist if a company always does meet its quarterly and annual goals, like Enron did, since such performance ignores the reality of competitive environments and business cycles.

All the major stock exchanges have independent compensation committee requirements to help protect investors concerning these types of compensation problems. For example, the NYSE required that all listed companies have a compensation committee comprised solely of independent directors. This committee must have a written charter which includes objectives for CEO compensation and performance evaluation. Annual performance evaluations of the board and its committees are required. Also, the SEC has required an annual compensation committee report with specific disclosures from the board in proxy statements to shareholders.

SOX Section 302 required CEOs and CFOs to certify, in a written report, that they have reviewed all quarterly and annual reports filed with the SEC. They must state that, to the best of their knowledge, the reports present fairly the financial condition and operations of the firm and do not omit material information. Individuals can be fined up to $5 million and be sentenced to up to 20 years in prison for violating this requirement. This regulation helped prevent earnings manipulation by companies to meet the quarterly and annual earnings targets of financial analysts. Also, SOX Section 401(b) enabled the SEC to adopt Regulation G for the required disclosure and reconciliation of pro-forma financial measures to generally accepted accounting principles (GAAP). U.S. companies, especially technology companies, had been using pro-forma (non-GAAP) accounting to make short term revenue and earnings targets in their quarterly and annual press releases and conference calls. They are now required to reconcile any such pro-forma numbers to GAAP financial statement numbers in an 8-K report to the SEC.

### *CEO is Uncomfortable with Criticism*

When questioned by outsiders, like financial analysts during conference calls, the CEO is defensive and abusive to these outsiders. The CEO and/or senior managers, like the CFO, may even wind up lying to these outsiders.

Enron's CEO, Jeffrey Skilling, was uncomfortable with criticism. In a conference call with financial analysts, he called one financial analyst an 'asshole' when questioned about Enron's performance. Jim Chanos, who was the first hedge fund manager to question Enron's performance, called Skilling's conference call a disaster and the final piece of the puzzle. He began to short Enron's stock shortly thereafter while it was still trading around $70 per share. Also, Enron's CEO and CFO both repeatedly told financial analysts that Enron would never be liable for bank loans with its Special Purpose Entities (SPEs). However, there were credit triggers in the bank loan covenants that could and did make Enron liable for such loans. The two major credit triggers were Enron's common stock price falling below a certain level and Enron's credit rating falling to junk bond status.

Qwest's CEO criticized the Morgan Stanley financial analysts who questioned his company's

performance and who downgraded Qwest's stock from a buy to a neutral status. He said that they were 'not the sharpest knives in the drawer' and called their report 'hogwash.' He pledged never to talk to them again and terminated any future investment banking business with Morgan Stanley. Parmalat's CEO was uncomfortable with criticism from his new auditors and Italian bankers. Italian law requires audit firms to be rotated every five years. To mitigate this law, he moved 51% of Parmalat's operations and its questionable business practices to the Cayman Islands where the former lead audit firm had been rotated. Also, he shifted funds from Italian banks to a Bank of America account in the Cayman Islands.

Concerning guidelines for an effective board, Buffett (2006) commented: "When the CEO cares deeply and the directors don't, a necessary and powerful countervailing force in corporate governance is missing. Getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners - big owners. Twenty, or even fewer, of the largest institutions, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior."

Similarly, the U.K. or London Stock Exchange listing requirements could be used to enhance such institutional power to help protect investors. Rule E1 states that institutional investors (IS) should enter into a dialogue with companies based on the mutual understanding of objectives and Rule E2 stated that IS should avoid a box-ticking approach to assessing a company's corporate governance. Thus, if IS asked tough questions of a company's management, particularly the CEO, then, such executives should be more comfortable with criticism and additional tough questions from financial analysts, hedge fund managers, and other investors. Also, the UAE Article 12.2b stated that shareholder rights shall include the opportunity to efficiently participate and vote at general assembly meetings and the right to discuss the matters listed on the agenda and to ask questions thereupon to the directors and external auditor, who shall answer them to the extent that shall not be in any prejudice of the company's interest. More independent Boards of Directors, as required by all the stock exchanges, would also help protect investors.

### *Senior Management Turnover*

The CEO and/or other senior managers, especially the CFO, quit their 'dream jobs' to 'spend more time with their families.'

Enron's CEO, Jeffrey Skilling, resigned only six months after being promoted to his 'dream job', and called it a 'purely personal' decision, elaborating that he wanted to devote more time to his family. One investment fund manager, John Hammerschmidt, said: "That was the worst excuse I've ever heard. As soon as I heard that, I dumped my shares." Others, including Sherron Watkins, the Enron whistleblower, have speculated that Skilling knew that Enron's falling stock price would cause Enron's loan guarantees of its SPE partnerships to be exposed and then lead to Enron's bankruptcy. Similarly, Qwest's CFO resigned over one year in advance of its accounting problems surfacing and Parmalat's CFO quit nine months before it went into bankruptcy.

To help reduce senior management turnover, a competent, independent nominating committee of the Board of Directors could help select senior managers who are interested in the long-term success of the company and its shareholders. Buffett (2005) commented: "In addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company. In my 40 years of board experience, the great majority of these directors lacked at least one of these three qualities. As a result, their contribution to shareholder well-being was minimal at best and too often negative. They simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation."

A similar focus on a competent Board's nominating committee to help protect investors was the NYSE requirement that each listed company have a nominating/corporate governance committee comprised solely of independent directors. This committee must have a written charter which includes the criteria and responsibilities used to identify individuals qualified to become board members. Also, a version of the UAE requirement for directors could be used. Article 3.4 states that a director shall stay in office until he is succeeded, becomes deceased, resigns, or is dismissed via a Board of Directors' decision. A statutory requirement, similar to the SOX requirement on insider trading, could be used to increase investor protection. Senior management turnover would have to be disclosed on a company's website within two days and reported to the SEC in the same time.

### *Insider Stock Sales*

Senior managers, especially the CEO and the CFO, are selling their own company's common stock at current prices, rather than holding these shares for the long term. At the same time, they are saying that their company's stock is undervalued and has a great future.

Significant insider trading occurred at Enron in the last half of 2000 and the first half of 2001 before its stock crashed in the last half of 2001 and it went into bankruptcy. The former CEO (Ken Lay), the following CEO (Jeffrey Skilling), the general council, the CFO, and other chief executives all sold large blocks of stock and made $1.1 billion. In 2000, Lay made $66.3 million and Skilling made $60.7 million

from exercising stock options and selling the shares, roughly double the amounts the year before. Since the selling at Enron was prolific as the stock fell throughout 2001, one financial analyst at Thomson Financial, Paul Elliot, called such insider sales a "screaming red flag," and questioned: "If Lay and Skilling believed that the stock was undervalued and headed for $120, as they repeatedly told investors, then why were they cashing in so heavily?" Lay and Skilling have been convicted on numerous counts of conspiracy and securities fraud. Skilling served a prison term of 7 years but Lay died before he could appeal his conviction. Similar insider trading occurred at major U.S. telecom companies. For example, eight Qwest senior executives made $2.2 billion while still "touting" the stock price prospects at Qwest. The Qwest CEO has been convicted of numerous counts of insider trading and served a prison term of 5 years. Also, WorldCom's CFO immediately exercised and sold all his stock options as soon as they vested. He has also been convicted of insider trading and is serving a 25 year prison term.

Both Russian and UAE stock exchange requirements are relevant for investor protection here. Russian Rule 8 states that an issuer's Board of Directors shall pass a document on the use of confidential information about the issuer's activities, securities issued by this company, and transactions, which involve the above securities, since its disclosures can considerably influence the market price of the issuer's securities. UAE Article 14 (Appendix, Section 2) states that the required Governance Report shall state the transactions of the directors and their relatives in the company's securities during the period covered by the report.

Executive stock trades have become easy to follow in the U.S. From the mandate of SOX Section 403, the SEC required that such trades be reported electronically within two days and also posted on the company's website. The old requirement was 45 days. Managers often had an incentive to commit fraudulent financial reporting to receive bonuses and to profit from equity-based compensation. To reduce such incentives, SOX Section 304 required forfeiture of bonuses and profits from equity sales by CEOs and CFOs when firms restate financial statements from material non-compliance with financial reporting requirements as a result of misconduct. SOX Section 306 prohibits officers and directors from purchasing or selling company stock during blackout periods when employees are prohibited from selling their company stock in 401 (k) retirement plans while plan administrators are being changed, like Enron did. Also, SEC Rule 10(b) 5-1 has enabled executives to liquidate their holdings over a period of time under very limited circumstances.

### *Weak or Non-Existent Code of Ethics*

Company employees are encouraged to push their behavior and financial reporting to ethical and professional limits. The company's code of ethics (if one exists) is not taken seriously.

Parmalat unraveled quickly after it had trouble making a routine bond interest payment, prompting tougher scrutiny of its books by Italian regulators and its own auditors. A follow-up audit found that Parmalat's EUR 4 billion cash in a Bank of America account in the Cayman Islands did not exist. The auditors had sent the confirmation request to the bank through Parmalat's internal mail system where it was intercepted. Then, the written confirmation from the bank back to Parmalat's auditors was forged as were other supporting documents. The EUR 4 billion cash had just been fabricated to help cover up the CEO looting his company. Also, Parmalat employees were ordered to destroy documentation after the fraud surfaced but one employee turner over his computer and disks to investigators. Over fifty Parmalat employees, two former audit firms, and seven banks have been investigated.

A Fortune financial magazine reporter, Bethany McLean (2001), was the first to question Enron's value in the financial press. She noted that the use of the mark-to-market accounting method for pricing Enron's securities in illiquid markets with no fair value benchmarks was a red flag for fraudulent financial reporting. She said, "Enron often relied upon internal models which created serious potential for abuse." According to former Enron managers, salespeople used wildly optimistic assumptions about the forward price of commodities and other factors to value their contracts so profits would be inflated and their bonuses would be bigger. One power industry consultant said, "That's valuation by rumor. There's no way for those results to be taken seriously." In a home video at a retirement party for an Enron manager, Enron's CEO, Skilling, boasted that he could "add a kazillion dollars to the bottom line anytime" by using this mark-to-market method. Also, seventy-five Enron employees, including secretaries and sales representatives, were taken to an empty trading floor and told to act as if they were trying to sell energy contracts to businesses over the phone. Then, Wall Street analysts were given a tour of this operation but not allowed to ask any questions of these employees. In another example, Tyco's CFO said that he just forgot to include $12 million of loans forgiven by Tyco as income in his personal income tax return.

All the major stock exchanges' listing requirements have dealt with this ethics problem by requiring a code of ethics and related monitoring and communications procedures to help protect investors. For example, the NYSE required that its listed companies have a code of ethics and promptly disclose any waivers of the code. Also, CEOs must

certify annually that they are not aware of any company violations of NYSE corporate governance listing standards. CEOs must promptly notify the NYSE in writing if they become aware of any material non-compliance from these standards.

SOX Section 406 requires firms to disclose whether they have adopted a code of ethics for their CEO, CFO, and senior accounting personnel. Also, they have to file an 8-K report with the SEC whenever there is a change or waiver in the code. This rule was a reaction to Enron's Board twice waiving its conflict of interest policy to facilitate the establishment of the SPEs involving its CFO who ran them. SOX Section 407 required Audit Committees to establish procedures, like whistleblower hotlines, to receive and act on anonymous complaints concerning accounting, internal controls, and auditing. It made retaliation against whistleblowers a criminal act.

### *Independence Problems with the Company's External Auditors*

The company often pays the audit firm additional consulting fees that may exceed the audit fees. Using the same audit partner as the lead or engagement partner is often a condition for retaining the audit firm.

Italian securities laws require that a company change its external auditors every five years (Barber, 2004). Parmalat got around that requirement in two ways: 1) it initially had its lead audit partner change auditing firms, and 2) it subsequently switched 51% of its business to the Cayman Islands where the former lead audit firm had been rotated. Thus, the same audit partner had signed various parts of Parmalat's audits for the last twenty years. There were also independence problems with Enron's auditor, Arthur Andersen (AA). AA's consulting fees with Enron were $27 million, larger than its audit fees of $25 million. Many former AA auditors worked for Enron and Enron outsourced its entire internal auditing work to AA. AA was also the auditor of Qwest, Global Crossing and WorldCom and earned large consulting fees from those firms. The HealthSouth auditors charged about $1 million annually for audit fees while earning slightly less from performing janitorial inspections of HealthSouth's 1,800 health-care facilities.

All the stock exchanges have rules establishing Audit Committees that need to review the independence of external auditors. For example, the Singapore Stock Exchange Rule 11 states that the Board should establish an Audit Committee, consisting of three non-executive independent directors and having written terms of reference which clearly set out its authority and duties, including the review of independence and objectivity of external auditors. However, none of these stock exchanges, including the U.S. ones, specifically defined auditor independence or required auditor working paper retention like SOX has done.

SOX Section 508 requires that lead audit partners, but not audit firms, rotate off an audit engagement every five years. Also, a company is prohibited from hiring anyone who has worked for its audit firm during the one-year period preceding an audit. The prohibited jobs are CEO, CFO, Controller, Chief Accounting Officer, and equivalent positions. Section 508 also prohibits audit firms from designing and implementing financial information systems, providing internal audit services, and providing valuation and appraisal services to audit clients. Thus, only the major services of audit and income tax preparation may be performed by a firm's auditor. SOX Section 802 required that public accounting firms retain documents prepared to support their audit reports for at least seven years.

### *Independence Problems with the Company's Investment Bankers*

Favorable 'buy' recommendations from an investment banker's financial analysts may be a requirement for a company to do new business with an investment banking firm. Thus, the investment bankers' research may not represent an independent analysis of the company's investment potential.

The sell-side financial analysts who worked for the investment bank firms that earned significant fees from Enron and Parmalat had the same independence problems as the auditors. Typically, investment fees were much higher that equity research fees. As one example of independence problems, 17 of the 18 sell-side analysts following Enron still had buy recommendations the day after the CEO Skilling resigned, ignoring that warning sign. Also, one big investment banking firm fired a financial analyst for changing his investment rating to a 'sell' recommendation on Enron at $38 per share. Another big firm told its financial analysts to maintain a 'buy' recommendation for Enron no matter what. One of Parmalat's investment bankers upgraded its investment recommendation from hold to buy just before Parmalat went into bankruptcy, saying the current price of EUR 2.20 was attractive as Parmalat's restructuring was an appealing story.

None of the major stock exchanges have any corporate governance rules in this area to protect investors. However, SOX Section 501 enabled the SEC to create rules governing research analyst conflicts of interest and the SEC has been working with the Financial Industry Regulatory Authority (FINRA) to help protect investors. FINRA has been given the authority by U.S. federal law to discipline securities firms and their employees who violate its rules and federal securities laws. FINRA oversees and regulates U.S. stock exchange trading and 5,100 brokerage firms, including about 670,000 registered securities representatives. Its Rule Filings are not

effective until approved by the SEC. Concerning the independence of financial analysts, FINRA established several rules in 2004 following major U.S. fraudulent financial reporting scandals. For example, its Rule 1050 required that all persons who function as research analysts be registered with FINRA and pass a qualification exam and Rule 1022 required that supervisors of research analysts pass an additional exam. Rule 2711 prohibited a research analyst from participating in a road show related to an investment banking services transaction or communicating with current and prospective customers about that transaction.

Also, in December 2002, the twelve largest investment banking firms in the U.S. agreed to pay almost $1 billion in fines to end SEC and other investigations into whether they issued misleading stock recommendations and handed out hot new shares to obtain corporate clients' favor. These firms also had to pay an additional $500 million over five years to buy stock research from independent analysts and distribute it to investors. New York Attorney General Eliot Spitzer, the lead negotiator of the settlement, commented: "Hopefully, these rules will restore investor confidence by restoring integrity to the marketplace."

### *Questionable Business Strategies with Opaque Disclosures*

An opaque disclosure strategy may exist for the company's business model and related financial reporting. The well-known investors, Warren Buffett and Peter Lynch, have given the following advice: 'If you don't understand what a company does, don't invest in it. If management refuses to fill in holes and keeps investors in the dark, run!'

Stock market investors were questioning Enron's business strategies and opaque disclosures as Enron's stock price fell from $80 in February 2001 to $1 by November 2001. Short-selling positions increased from 2 million shares in August 2000 to 8 million shares by year-end 2000 to 33 million shares by October 2001 and 88 million shares by November 2001. Similarly, from year-end 1999 to year-end 2001, all three major telecom companies under SEC investigation had significant stock price decreases (WorldCom: $55 to $14; Qwest: $43 to $14; Global Crossing: $50 to $1). Also, Parmalat's stock price fell from a 52 week high of EUR 3.09 on September 3, 2003 to EUR 0.11 by the end of December 2003.

Questionable business strategies existed along with opaque disclosure strategies at these firms. For example, the Fortune magazine reporter McLean (2001) was the first business reporter to question Enron and commented: "How exactly does Enron make its money? Details are hard to come by because Enron keeps many of the specifics confidential for what it terms competitive reasons. The numbers that Enron does present are often extremely complicated…The inability to get behind the numbers combined with even higher expectations for the company may increase the chance of a nasty surprise… Seemingly basic questions, like the effects of lower natural gas prices and less volatility in energy markets on Enron's profits, are still unanswered."

Similarly, Qwest had opaque disclosures of its revenue recognition accounting methods for its fiber optic swaps and equipment sales. A prime example of intentionally opaque, complex financial reporting and disclosure came from Enron's related party transactions with special purpose entities (SPEs). As the short seller Chanos said, "We read the disclosure over and over and over again and we just didn't understand it - and we read footnotes for a living." Warren Buffet made a similar comment in his 2003 CEO letter to shareholders. An A.G. Edwards energy analyst, Michael Heim said, "I've never seen such complicated disclosures. It was hard to follow the movement of money." When pushed to reveal more, Enron management was uncooperative and pleaded confidentiality concerns. When its scandal became public, Enron was forced to add over $600 million in debt to its balance sheet from SPE off-balance sheet financing.

Parmalat used a similar SPE strategy to earn its nickname as "Europe's Enron." It created an elaborate network of related party transactions, using opaque subsidiaries in tax havens such as the Cayman Islands and Luxembourg to hide the declining state of its finances. One subsidiary was called Buconero, which means black hole in Italian. Both Enron and Parmalat had unnecessarily complex business structures with hundreds of interwoven SPEs, affiliates, shell companies, and off shore companies in tax havens. An independent auditor's report stated that Parmalat hid over EUR 13 billion in off-balance sheet debt. One investment bank did change to a sell recommendation for Parmalat in November 2002 (about one year prior to the bankruptcy) as it could not understand the need for such opaque and complex finances. Satyam was nicknamed "Asia's Enron" for doing similar financial shenanigans.

A similar strategy was used in the 2008 financial crisis with subprime mortgage investments which were moved off the balance sheet with "structured investment vehicles" (SIVs) to hide valuation and write-down problems. These institutions had about $400 billion of suspect securities hidden in these SIVs until discovered recently in investigations of the subprime mortgage mess. Many investment banks inappropriately borrowed short term money to buy long term assets, such as mortgage securities which had fallen in value. Lehman Brothers had hidden $50 billion of such short-term financing off its books in 2008 just before it went into bankruptcy.

To help protect investors, the major stock exchanges' listing requirements have attempted to deal with opaque disclosure problems by requiring

disclosures of a company's performance and prospects by an independent Board of Directors. Also, the NYSE can go further and issue a public reprimand letter for violation of any of its corporate governance standards before invoking the ultimate penalty of delisting. SOX Section 401(a) enabled the SEC to adopt rules requiring disclosure of all material off-balance sheet transactions and Section 409 required firms to report material changes in their financial condition on a rapid and current basis. Also, to increase timeliness and usefulness of financial disclosures, the SEC has required all publicly-listed companies in the U.S. to report their financial results in an online format using extensible business reporting language (XBRL) as of the 2012 reporting year.

## 5. Current Trends

One way to assess the effectiveness of the corporate governance listing requirements of major stock exchanges and related regulations, like SOX, is to look at current trends in financial reporting restatements by publicly-held companies. For example, approximately five years after Enron, WorldCom, Qwest, etc., corporate America still has many accounting errors. In 2007 1,172 U.S. companies filed financial restatements, down 15% from 2006 which was up 6.5% from 2005. In 2004 and 2003 there were only 600 and 500 such restatements, respectively. However, the pattern has been changing as the SOX requirements are fixing U.S. financial reporting for many investors. For the first time in a decade, companies of all sizes filed fewer restatements to correct accounting errors in 2007 than they did the previous year in 2006. Also, restatements at large U.S. companies (with market capitalization over $750 million) dropped from 2005 to 2006 by 26%. Similarly, midsize U.S. companies (with market capitalization between $75 million to $750 million) also dropped 13%. However, an increase in restatements (up 45%) from 2005 to 2006 came from the small or 'microcap' companies (with market capitalization less than $75 million) which tend to be less regulated in the U.S. by the SEC and SOX (Glass Lewis & Co. 2008). The SEC typically has investigated just large or mid size companies for earnings management and fraud in its AAERs. These lower numbers of restatements have had constant through the 2012 reporting years for companies.

Since the advent of SOX requirements in the U.S., initial public offerings (IPOs) have increased in the U.K., primarily from Russian and Chinese companies, while IPOs have decreased in the U.S. However, fraud has increased in the U.K. while recently decreasing in the U.S. as previously discussed. Also, a growing body of economic research has shown that the cost of equity capital varies with the regulatory and disclosure environment. When a foreign company has cross-listed on a U.S. exchange, it has incurred a significant reduction in its cost of capital and also has been given a valuation premium (often 30 per cent or more) over non-cross-listed companies from its home country. Conversely, when a foreign company has cross-listed on the London Stock Exchange, there has been no valuation premium nor has a reduction in the cost of capital occurred. These patterns have continued for over 15 years. The obvious explanation was that stricter enforcement in the U.S. has caused investors to view cross-listed company's financial results with greater trust and assign a higher valuation, i.e. deterrence works. Also, criminal enforcement of securities offences has been virtually unknown in the U.K. and civil insider trading cases have remained rare. Given the hidden costs of insider trading, maybe the time has come for the U.K. to do more enforcement (Coffee, 2008).

In 2005, National Ratings of Corporate Governance were established by the Russian Institute of Directors for 150 Russian companies, i.e. the majority of companies whose securities are traded on the Russian stock exchange. For the first half of 2004, only one company received a Class A rating for a high level of corporate governance while most companies (116) received a medium level of risk with a Class B rating for a positive level of corporate governance. However, the corporate governance of these companies has been improving. At the end of January 2005, a second set of ratings was done. The number of companies receiving a Class A rating increased to five and the number of companies receiving a Class B also increased compared with companies with Class C or D ratings (low or unsatisfactory levels of corporate governance, respectively).

In 2007, the Asian Corporate Governance Association (ACGA) produced its fourth survey of corporate governance in Asia in collaboration with the CLSA brokerage house. Five hundred eighty-two listed companies in eleven Asian-Pacific markets were rated on a corporate governance scale of one to 100 and, then, summarized by countries' stock exchanges using this scale. The derivatives trading scandal at China Aviation Oil, the Chinese state-owned jet fuel importer, and accounting frauds at several smaller Singapore-listed companies reduced that city-state's score, placing it level with Hong Kong as the ongoing number one and two rated stock exchanges. India was third and China was ninth. These surveys have raised awareness of good corporate governance practices in this region. For example, many Singapore companies have improved corporate governance practices, especially in promoting greater independence of boards and better communication with shareholders. Also, regional financial reporting and disclosures have improved while the independence of Audit Committees and political influence on regulatory action are still problematic. These corporate governance

improvements have helped offset the reluctance of equity investors to invest in listed companies in the region. Also, private equity investors have helped to improve corporate governance in listed companies since they had the patience and skill to work closely with management to improve their investment exit strategies.

## 6. Conclusions

This paper has assessed the corporate governance listing requirements of major global stock exchanges for investor protection against ten common corporate governance factors that facilitated fraudulent financial reporting as well as the 2008 financial crisis. This 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

Schilit (2010) discussed these five factors as facilitating earnings management and fraudulent financial reporting and Aljifri et.al. (2013) discussed disclosure issues relating to corporate governance. Also, the New York Stock Exchange (NYSE) sponsored a Commission on Corporate Governance after the 2008 financial crisis and this commission's report in September, 2010 cited the failure of these five corporate governance principles as lessons to be learned from the 2008 financial crisis (NYSE, 2010). 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

However, these five "behavioral" factors did not appear as often as the five "structural" factors (64% versus 98%) in the previously cited study of major financial reporting frauds of the 21st century (Grove and Basilico, 2011). Thus, the "behavioral" factors may not need as much investor protection as the "structural" factors. A 2013 study also reinforced the importance of the "structural" factors by concluding that "a poor tone at the top" is a strong predictor of aggressive or questionable financial reporting and investors should beware of such a poor tone at the top (King, 2013). The five "structural" factors are all related to senior management establishing a "poor tone at the top" and have contributed to excessive risk taking and poor company and related stock market performance in both U.S. and European banks during the financial crisis (Allemand et.al, 2013, Grove et.al, 2012, and Grove et.al, 2011).

Using a benchmarking approach where the best practices of corporate governance are taken from various entities, the UAE approach drew from the U.S. and the U.K. listing requirements in constructing its own listing requirements. A similar approach could be used here as specific listing requirements or statutory laws in various countries could be used as benchmarks by other countries to strengthen investor protection. Accordingly, excerpts from major stock exchanges' listing requirements for corporate governance and related SOX requirements were elaborated as guidelines to protect against each of the five "behavioral" factors as follows.

Concerning the factor, CEO uncomfortable with criticism, the London Stock Exchange listing requirements could be used to bolster investor protection. Rule E1 states that institutional investors should enter into a dialogue with companies based on the mutual understanding of objectives and Rule E2 stated that institutional investors should avoid a box-ticking approach to assessing a company's corporate governance. Thus, if institutional investors ask tough questions of a company's management, particularly the CEO, then, he/she should be more comfortable with criticism and additional tough questions from financial analysts, hedge fund managers, and other investors in conference calls and other meetings with investors. Also, assistance may come from the UAE Article 12.2b which states that shareholder rights shall include the opportunity to efficiently participate and vote at general assembly meetings and the right to discuss the matters listed on the agenda and to ask questions to the directors and external auditor, who shall answer them to the extent that shall not be in any prejudice of the company's interest. More independent Boards of Directors, as required by all the stock exchanges, should help in this area as well.

Concerning the factor, senior management turnover, a statutory requirement, similar to the SOX requirement on insider trading, could be used here to increase investor protection. Senior management turnover would have to be disclosed on a company's website within two days and reported to the SEC in the same time. Another aid would be the NYSE and NASDAQ requirements strengthening a company's nominating committee with all independent directors. Also, a version of the UAE requirement for directors could be applied here. Article 3.4 states that a director

shall stay in office until he is succeeded, becomes deceased, resigns, or is dismissed by a Board of Directors' decision.

Concerning the factor, insider stock sales, various SOX requirements could be used by all the stock exchanges to enhance investor protection. SOX Section 403 requires executive stock trades be reported electronically within two days and also posted on the company's website. SOX Section 304 requires forfeiture of bonuses and profits from equity sales by the CEO and CFO when firms restate financial statements from material non-compliance with financial reporting requirements as a result of misconduct. Also, a Russian stock exchange requirement could be used here. Rule 8 states that an issuer's Board of Directors shall pass a document on the use of confidential information about the issuer's activities, securities issued by this company, and transactions, which involve the above securities, since its disclosures can considerably influence the market price of the issuer's securities. Also, UAE Article 14 (Appendix, Section 2) states that the required Governance Report shall state the transactions of the directors and their relatives in the company's securities during the period of the report.

Concerning the factor, independence problems with external auditors, various SOX sections could be used by all the stock exchanges to help protect investors. SOX Section 508 requires that lead audit partners be rotated off an audit engagement every five years and no audit team member be hired by a company during the one year preceding an audit. An Italian law was much stricter in requiring that the entire lead audit firm, not just the lead audit partner, be rotated off an audit engagement every five years. SOX Section 508 also prohibits audit firms from designing and implementing financial information systems, providing internal audit services, and providing valuation and appraisal services to audit clients. SOX Section 802 requires that external auditors retain audit working papers for at least seven years. All the non-U.S. stock exchanges have rules establishing Audit Committees that need to review the independence of external auditors. For example, the Singapore Stock Exchange Rule 11 states that the Board should establish an Audit Committee, consisting of three non-executive, independent directors, and have written terms of reference which clearly set out its authority and duties, including the review of independence and objectivity of external auditors. However, none of these stock exchanges' listing requirements, including the U.S. ones, specifically defined auditor independence like the SOX Section 508 or required auditor working paper retention like Section 802. This problem is ongoing as 30% of the 1,000 leading U.S. public companies have used the same audit firm to audit their books for at least the last 25 years and 11% have used the same audit firm continuously for 50 years of more. Howard Schilit, a leading U.S. forensic accountant, observed: "When you're an auditor who's trying to protect a long-term relationship, you have to suck up to the client, and the client knows it" (Zweig, 2012). To date, the major U.S. audit firms have successfully lobbied against a SOX requirement to rotate audit firms.

Concerning the last factor, independence problems with investment bankers, SOX Section 501 enabled the SEC to create rules governing research analyst conflicts of interest and the SEC has been acting with FINRA to establish and enforce the independence of financial analysts. However, none of these major stock exchanges have any corporate governance rules in this area to help protect investors. One suggestion would be similar to the SOX Section 508 prohibiting auditors from performing non-audit services other than tax. A similar rule here would prohibit investment banking firms from providing investment research recommendations on client companies, like the FINRA Rule 2711. Thus, all these 'sell-side' financial analysts who work for the investment banking firms would be prohibited from providing such research and from going on road shows to promote client security offerings. In essence, the investment research on these client companies would be performed by the 'buy-side' financial analysts who do independent research primarily for institutional investors, similar to the New York Attorney General's settlement with the largest investment banks in the U.S.

Corporate governance observations from the very successful investor, Warren Buffett, were used to emphasize the importance of various fraudulent financial reporting factors. This paper has shown the potential of corporate governance listing requirements from various global stock exchanges for preventing fraudulent financial reporting and, thus, for protecting investors. Managers, board members, internal and external auditors, and government regulators should apply these corporate governance listing requirements and related recommendations of this paper to help reduce financial reporting fraud and other investment disasters, like the 2008 financial crisis.

A related strategy to help detect and prevent financial reporting fraud and other investment disasters was to strengthen risk management guidelines for companies, summarized as follows by Hilb (2004):

The task of the board and top management is to define an integrated, future oriented risk management concept. It should be integrated with the existing planning and leadership processes but not constrain entrepreneurial freedom. Such a risk management concept should give management the assurance to cope with daily risk and it should keep the responsibility for directing and controlling within the board. Boards should report annually to owners about their risk assessment and decision-making processes. At the board level, risk management deals with the

process of early detection, prevention, and management of dangers, as well as identification and effective realization of entrepreneurial opportunities. Thus, there must be the conscious exploration of risks where opportunities can be realized and in the prevention or reduction of risk, where the anticipated risk outweighs the expected gains. Risk management deals primarily with higher assurance in planning and a higher probability that company objectives are achieved.

These ten fraudulent financial reporting factors should be controlled for improved risk management and individual high-risk areas need to be monitored closely. For example, the SEC has reported that over 50% of the financial reporting frauds and earnings management cases that it detected involved revenue recognition practices. Such risk management guidelines could be summarized for investors in the Governance Report required by the corporate governance listing requirements of the UAE stock exchange (Article 14)[2]:

The Governance Report is an annual report of corporate governance practices signed by the Chairman of the Board of Directors and submitted to the Authority on an annual basis or on request during the accounting period covered by the report. The Governance Report shall be inclusive of all such information as set out in the required authority approved form, including in particular: 1) requirements, principles, and application methods as necessary for corporate governance, 2) violations as committed during the financial year together with the reasons and the method to remedy and avoid the same in the future, and 3) composition of the Board of Directors, according to the categories and terms of office of its members, determining the remunerations of General Manager, Executive Manager or CEO as appointed by the Board of Directors.

This Governance Report required by the UAE. Authority has six approved sections: governance practices, transactions of directors in securities, composition of the Board of Directors, external auditor's fees, Audit Committee, and general information. The governance practices section could be expanded to require a summary of how a company's risk management strategy dealt with these ten common factors of fraudulent financial reporting, how any violations of corporate governance are related to these ten factors, and what corrective actions had been taken to protect investors. Such individual company actions and trends on a micro-level could then be compared to recent country or regional actions and trends on a macro-level of corporate governance for benchmarking analyses.

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. 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. 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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APPENDIX A

SEASONED STOCK EXCHANGE LISTING REQUIREMENTS (SUMMARIZED) MATCHED WITH THE TEN COMMON CORPROATE GOVERNANCE FACTORS ASSOCIATED WITH FINANCIAL REPORTING FRAUD

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 1 | All powerful CEO | Majority of independent directors (no material relationships over the past year after adoption of corporate governance listing standards). | Sec. 402 - Corporate loans prohibited to officers and directors.<br><br>Sec. 1105 – SEC given power to ban, temporarily or permanently, individuals who have committed securities fraud. | Rule A1 - Every company should be headed by an effective board, which is collectively responsible for success of the company.<br><br>Rule A2 - Clear division of responsibilities at the head of the company between the running of the board (Chairman) and the executive responsibility (CEO) for the running of the company's business. No one individual should have unfettered powers of decision.<br><br>Rule A3 - Board include a balance of executive and non-executive directors (independent) such that no individual or group of individuals can dominate the decision-making. | Rule 1 - Effective board to lead and control company.<br><br>Rule 2 - Independent board (comprised of at least 1/3 independent directors).<br><br>Rule 3 - Clear division of responsibilities at the top of the company (board) and executive responsibility - balance of power and authority, such that no one individual represents a considerable concentration of power (role of Chairman and CEO separate and disclosure of relationship between Chairman and CEO).<br><br>Rule 4 - Formal and transparent process for appointment of new BOD (nomination committee). |

APPENDIX A

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 2 | Weak system of management control | Outside directors regularly meet without the CEO.<br><br>Audit Committee with at least 3 members that are independent directors and financially literate.<br><br>Required internal audit function. | Sec. 404:<br><br>CEO and CFO to discuss their firm's internal controls (IC).<br><br>Firms must report on the policies and procedures in place to prevent fraud in their annual reports.<br><br>CEO and CFO required to state that they are responsible for establishing and maintaining IC structure and provide annual assessment of IC effectiveness.<br><br>External audit must give an opinion on effectiveness of a firm's IC. | Rule C2 - Board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.<br><br>Rule C3 – Board should establish formal and transparent arrangements (Audit Committee) for considering how they should apply the financial reporting and internal control procedures and for maintaining an appropriate relationship (independence) with the company's auditors. | Rule 12 - Board should ensure that the management maintains a sound system of internal controls to safeguard the shareholders' investments and the company's assets.<br><br>Rule 13 - The company should establish an internal audit function that is independent of the activities it audits. |

APPENDIX A

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 3 | Focus on short-term performance goals | Compensation committee comprised solely of independent directors.<br><br>Compensation committee required to have a written charter including objectives for CEO compensation and performance evaluation.<br><br>Annual performance evaluation required for BOD and its committees. | Sec. 302:<br><br>CEO and CFO to certify: they reviewed annual report filed with SEC (to the best of their knowledge reports present fairly the financial condition, operations, and no material omissions).<br><br>CEO and CFO can be fined up to $5 million and sentenced up to 20 years for violating certification requirements. | Rule 4:<br><br>BOD form inner managerial resources and remuneration (compensation) committee.<br><br>Principles and criteria used to assess rate of remuneration.<br><br>Disclose essence of the contracts signed: selection criteria, regular assessment of activities carried out.<br><br>Remuneration committee shall be comprised of independent directors and if necessary non-executive directors. | Rule 5 - Formal assessment of board and board member effectiveness.<br><br>Rule 7 - Formal and transparent policy on executive remuneration. No director involved in deciding his own remuneration (remuneration committee).<br><br>Rule 8 - Level of remuneration should be attractive but not excessive. Large proportion of executive directors' compensation link rewards to corporate and individual performance (long term incentives encouraged).<br><br>Rule 9 - Clear disclosure in annual reports of remuneration policy. |

APPENDIX A

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 4 | CEO is uncomfortable with criticism | None applicable. | None applicable. | Rule E1 - Institutional shareholders (IS) enter into dialogue with companies based on the mutual understanding of objectives. IS avoid box-ticking approach to assessing a company's corporate governance.<br><br>Rule E2 - Institutional shareholders responsible for considered use of votes. | None applicable. |
| 5 | Senior management turnover | Nominating/corporate governance committee comprised solely of independent directors.<br><br>Nominating committee create written charter with criteria used to identify board members. | None applicable. | There should be formal, rigorous and transparent procedures for the appointment of new directors to the board (nomination committee). | None applicable. |

APPENDIX A

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 6 | Insider stock sales | None applicable. | Sec. 403 - Executive trades reported electronically in 2 days and posted on company's website.<br><br>Sec. 304 - Forfeiture of bonuses and profits from equity sales by CEO and CFO when firms restate financial statements from material non-compliance with reporting requirements due to misconduct.<br><br>Sec. 306 - Officers and directors prohibited from trading company stock during blackout periods when are employees prohibited from selling company stock in 401(k) plans while plan administrators being changed. | None applicable. | None applicable. |

APPENDIX A

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 7 | Weak or nonexistent code of ethics | Required code of ethics and prompt disclosure of any waivers of the code.<br><br>CEO required to certify annually not aware of NYSE listing standard violations.<br><br>CEO required to promptly notify NYSE in writing if become aware of material non-compliance with standards. | Sec. 406 - Disclose whether adopted code of ethics for their CEO, CFO, and senior accounting personnel. File 8k report with SEC when change or waiver in code.<br><br>Sec. 407 - Audit Committee establish procedures, like whistleblower hotlines, to receive and act on anonymous complaints concerning accounting, internal controls, and auditing. Retaliation against whistleblowers is a criminal act. | Rule A5 - Board supplied in a timely manner with information appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.<br><br>Rule D1 - Dialogue with shareholders based on the mutual understanding of objectives.<br><br>Rule D2 - Board use the annual general assembly meeting to communicate with investors and to encourage their participation. | Rule 6 - Board members provided with complete, adequate and timely information prior to board meetings and on an on-going basis. |

APPENDIX A

(CONTINUED)

| Fraud Factor | | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 8 | Independence problems with external auditors | None applicable. | Sec. 508:<br><br>Lead audit partners rotate off an audit engagement every 5 years.<br><br>Prohibited from hiring anyone who has worked for its audit firm during 1 year period preceding an audit (positions include CEO, CFO, Controller, CAO, and equivalent positions).<br><br>Audit firms prohibited from designing and implementing financial information systems, providing internal audit, valuation, appraisal services to audit clients.<br><br>Sec. 802 - Public accounting firms retain audit documents at least 7 years. | Rule C3 – Board establish Audit Committee to consider financial reporting and internal control procedures and for maintaining independence with the company's auditors. | Rule 11 - Board establish an Audit Committee (consist of 3 non-executive independent directors) which reviews independence and objectivity of external auditors. |

APPENDIX A

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | | | |
|---|---|---|---|---|---|
| | | NYSE and NASDAQ (similar requirements) | Sarbanes-Oxley Act | United Kingdom (London) | Singapore |
| 9 | Independence problems with company's investment bankers | None applicable. | Sec. 501 - SEC to create rules governing research analyst conflicts of interest (SEC has not acted on this section). | Rule E1 - Institutional shareholders avoid a box-ticking approach to assessing a company's corporate governance.<br><br>Rule 2 - Institutional shareholders responsible for considered use of their votes. | None applicable. |
| 10 | Questionable business strategies with opaque disclosures | NYSE issue public reprimand letter, list red flag next to stock ticker, or delist for violation of corporate governance standards. | Sec. 401(a) enabled SEC to adopt rules requiring disclosure of all material off-balance sheet transactions and debt.<br><br>Sec. 409 requires firms to report material changes in financial condition on a 'rapid and current basis.' | Rule C1 - Board present a balanced and understandable assessment of the company's position and prospects. | Rule 10 - Board present a balanced and understandable assessment of the company's performance, position and prospects.<br><br>Rule 14 – Board communicate with shareholders.<br><br>Rule 15 - Encourage shareholder participation at annual meetings and allow opportunity to communicate views on various matters. |

APPENDIX B

EMERGING STOCK EXCHANGE LISTING REQUIREMENTS (SUMMARIZED) MATCHED WITH THE TEN COMMON CORPORATE GOVERNANCE FACTORS ASSOCIATED WITH FINANCIAL REPORTING FRAUD

| | Fraud Factor | Matched Stock Exchange Listing Requirement | |
|---|---|---|---|
| | | Russia | United Arab Emirates |
| 1 | All powerful CEO | Rule 1 and 2 - Form Board comprised of at least 3 independent directors.<br><br>Rule 5 - Form a collegial executive body (management board). | Article 3.1 - Management shall be undertaken by a BOD.<br><br>Article 3.2 - Independent directors comprise at least 1/3 of BOD while the majority of directors shall be non-executive directors, who shall have experience and technical skills to the best interest of the company.<br><br>Article 3.3 - Position of Chairman of the BOD and company's manager and/or managing director may not be held by the same person. |
| 2 | Weak system of management control | Rule 3:<br><br>Form Audit Committee responsible for the appraisal of the joint stock company's auditorship seekers, assessment of the auditor's report and the issuer's internal control procedures, and for the making of improvement proposals.<br><br>Audit Committee comprised of independent directors<br>If not possible to be all independent directors, may use director other than non-executive director (board members other than one-man executive body and/or members of the issuer's collegial executive body). | Article 8 - BOD establish an internal control system and perform an annual review; disclose results of the review.<br><br>Article 11 – BOD may delegate some of its authority in managerial matters to the management, in which case, clear instructions shall be given as regards the management's authorities and particularly in relation to the circumstances in which the management shall obtain BOD approval before taking any decisions or entering into any obligations on behalf of the company. A written list of tasks and authorities maintained by the BOD and those delegated thereby upon the management shall be compiled and regularly revised. |

APPENDIX B

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | |
|---|---|---|---|
| | | Russia | United Arab Emirates |
| 2 | Weak system of management control (continued) | Rule 6 - Internal documents drafted that specify: functions of the board members, collegial executive body, sole executive body, and managing company and provide information on issuer's securities holding and issuer's securities sale and/or purchase.<br><br>Rule 9 - BOD shall pass a document on the issuer's financial and economic activities and internal control procedures. Adherence to these procedures monitored by a special department, which shall pass the information on the detected violations to the auditing committee. | |
| 3 | Focus on short-term performance goals | Rule 4:<br><br>BOD shall form an inner managerial resources and remuneration (compensation) committee.<br><br>Must specify with respect to BOD and collegial executive principles & criteria used to assess rate of remuneration, essence of the contracts signed, selection criteria and regular assessment of activities carried out.<br><br>Remuneration committee shall be comprised of independent directors and if necessary non-executive directors. | Article 6.1b – BOD form a remuneration committee.<br><br>Article 7 - Remuneration committee shall create a system in which to compensate BOD. |

APPENDIX B

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | |
|---|---|---|---|
| | | Russia | United Arab Emirates |
| 4 | CEO is uncomfortable with criticism | None applicable. | Article 12.2b - Shareholder rights include opportunity to efficiently participate and vote at general assembly meetings and the right to discuss the matters listed on the agenda and to ask questions thereupon to the directors and external auditor. |
| 5 | Senior management turnover | None applicable. | Article 3.4 - Director shall stay in office until he is succeeded, he deceases, resigns or is dismissed via BOD. |
| 6 | Insider stock sales | Rule 8 - BOD shall pass a document about use of confidential information about issuer's activities, securities issued by this company, and transactions, which involve the above securities, since its disclosure can considerably influence the market price of the issuer's securities. | Article 14 - Governance Report shall state the transactions of the directors and their relatives in the company's securities during the period covered by the report (Appendix, Government Report Form, Section 2). |
| 7 | Weak or nonexistent code of ethics | Rule 9 - BOD shall pass a document on the issuer's financial and economic activities and internal control procedures. The adherence to these procedures shall be monitored by a special department, which shall pass the information on the detected violations to the auditing committee. | Article 5.1 - A newly appointed Director shall be given an induction tour of the company, provided information to ensure his understanding of the company's activities and affairs and full awareness of his responsibilities. Management provide BOD and its ad-hoc committees with timely information to enable informed decisions and efficient performance. |

APPENDIX B

(CONTINUED)

| Fraud Factor | Matched Stock Exchange Listing Requirement | |
|---|---|---|
| | Russia | United Arab Emirates |
| 7 Weak or nonexistent code of ethics (continued) | | Article 5.3 - Majority of directors can request the opinion of independent consultant relating to company's affairs.<br><br>Article 4.4 - Director shall adhere to loyal behavior taking into consideration the company's and shareholders' interests. Comply with applicable laws, regulations, decisions, company's articles of association and bylaws.<br><br>Article 5.6 – BOD set forth written rules in relation to the dealings of the company's directors and employees in securities issued by the company or associated companies.<br><br>Article 5.7 - Management implement development schemes as necessary for all directors to enhance their knowledge and skills to ensure their efficient participation in the BOD.<br><br>Article 5.8 - Once appointed, every director shall disclose to the company the nature and dedicated times for, his positions in public companies, other significant obligations.<br><br>Article 13 - Professional conduct rules adopted by the company as to fit its objectives and purpose and comply with the applicable laws and regulations. Directors, managers, employees and internal auditors must comply. |

APPENDIX B

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | |
|---|---|---|---|
| | | Russia | United Arab Emirates |
| 8 | Independence problems with external auditors | Rule 3 - Shall form an Audit Committee responsible for the appraisal of the joint stock company's auditorship seekers, assessment of the auditor's report and the issuer's internal control procedures efficiency, and for the making of improvement proposals. | Article 6.1A - BOD comprised of at least 2 independent directors, and the Chairman of the Board is not to be a member.<br><br>Article 9:<br><br>Audit Committee must consist of at least 3 non-executive directors, a majority independent, and one financial expert.<br><br>No prior audit partner of the external auditor may be a member of the Audit Committee until one year after departing as partner from the audit firm.<br><br>Audit Committee is to recommend an external auditor to the board and monitor independence.<br><br>Article 10 - External auditor should be nominated by the board based upon competence, reputation, and experience and Audit Committee's recommendation and external auditor no relation to the company or any directors. |
| 9 | Independence problems with company's investment bankers | None applicable. | None applicable. |

APPENDIX B

(CONTINUED)

| | Fraud Factor | Matched Stock Exchange Listing Requirement | |
|---|---|---|---|
| | | Russia | United Arab Emirates |
| 10 | Questionable business strategies with opaque disclosures | Rule 7 - BOD shall pass a document which determines rules and approaches for the disclosure of the issuer information.<br><br>Rule 10 - The issuer's articles of association shall ensure that announcement about the general shareholders' meeting shall be made not later than 30 days before it is held, unless the law prescribes longer. | Article 8.6 - BOD ensure disclosures made by the company provide useful, high level, non-misleading information to investors and full adherence to disclosure rules.<br><br>Article 12.2a - Shareholders right to necessary and accurate information to enable them their rights without discrimination, provided that such information, including any information relating to the company's plans before voting thereon or any other information, are exhaustive, accurate, and regularly and timely submitted and updated. |