CHAPTER 1

INTRODUCTION

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1.1 ACT LOCALLY, IMPACT GLOBALLY

In his farewell sermon to the congregation of Mount Olive Ministries in Milpitas, California, Pastor Michael Gibson urged the congregation to act locally and that every local act would have a global impact. Mike's message was directed at expanding the faith, but the process is much the same in governance, risk, and internal controls designed to improve financial, technical, and environmental

compliance. While there are global actions such as the Kyoto environmental accords, Basel II banking accords, and the International Financial Reporting Standards (IFRS) emerging as a global GAAP (generally accepted accounting principles), the vast majority of actions will occur at a local level. The cumulative effect of local actions, even though they seem insignificant, will be to improve governance, risk management, and compliance (GRC) on a global level. In short, there is no such thing as an isolated event in improving GRC. Unfortunately, this process also applies on the dark side as well. Local acts of fraud, corruption, censorship, intolerance, and other constraints on human rights do not occur in isolation. They impact us all, at least indirectly.

The process of improved GRC is and will continue to be irrevocable and irresistible. The market, political, social, and religious forces in play are all pointing in one direction. Although there is major resistance to improved GRC, ultimately the laggards will be compelled to fall in line or suffer financial, political, social, and environmental disasters and scandals that are viewed as more painful than the cure. The loss of reputation and the ostracism will also assert as great a pressure as the threats of criminal prosecution or civil litigation.

This book presents examples on national, regional, technical, environmental, and industry levels of success stories and failures in the GRC process. The goal is to provide a handbook that touches the current state, major trends, best practices, case studies, and benefits of getting there sooner rather than later.

The terms *governance*, *risk*, and *compliance* are in widespread use, and the distinctions are sometimes blurred. Internal controls and globalization are also included in many GRC-related discussions. A short explanation of each and their relationships to one another may help clear the air.

1.2 GOVERNANCE

(a) INTRODUCTION. Corporate Governance. Corporate governance addresses the processes, systems, and controls by which organizations, both public and private, operate. Governments often administer these processes and systems. The Latin origin of the word *governance* denotes steering, and governance typically includes the exercise of legal and regulatory authority and the use of institutional resources to manage organizations. It is also an area of economics that studies issues relating to the separation and segregation of ownership and control. Governance relationships include those between board directors, owners, managers, employees, suppliers, customers, regulators, and communities.

Corporate governance is the process by which an organization defends the interests of the stakeholders, which can include board members, company executives, employees, stockholders, suppliers, customers, and the community in which the organization operates. Governance refers to the relationship between those who govern and those who are governed. On a political level it is the relationship between the government and its citizens and includes three requirements:

(1) to know the present state, (2) to know where it needs to go, and (3) to know how it is progressing in the journey—somewhat analogous to what consultants call a gap analysis. It also involves three areas of decision making: who is governing, who is being governed, and what resources/assets are to be deployed in the process. The requirements and decision making apply to governments and corporations alike.

The Corporation. In 1794, Stewart Kyd created a definition of the corporation that is still valid today: "a collection of many individuals united into one body, under a special denomination, having perpetual succession under an artificial form, and vested by the policy of the law with the capacity of acting in several respects as an individual."[1] The notion of the modern corporation came into being in the aftermath of the stock market crash of 1929 and the Great Depression of the 1930s that started in the United States but quickly spread to Europe and eventually to most of the world. The scars of these two events have influenced all following generations and laid the foundations for government regulations and corporate governance. The pioneering work of Adolf Augustus Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Macmillan, 1932), continues to influence current thinking.

A corporation is an artificial legal entity, known as a juristic person under the law, which has a separate legal entity even though it is made up of a variety of other legal entities and real people. The corporation therefore has legal rights and obligations. Modern corporations typically have the following abilities and legal rights:

- Ability to access the courts (i.e., the right to initiate lawsuits and be the subject of lawsuits)
- Ability to hold assets separately from its members' assets (i.e., the right to a common treasury)
- Ability to hire and fire employees (i.e., the right to engage agents)
- Ability to enter into contracts (i.e., the right to a common seal)
- Ability to govern the corporation's internal affairs (i.e., and the right to make bylaws)
- Ability to transfer shares without impacting the existing corporation
- Ability to maintain a perpetual succession regardless of the withdrawal or removal of any of its members
- Ability to limit the liability of stakeholders[2]

The Corporation as a Legal Entity. Corporations are given a unique legal personality under the law in which shareholders own the corporation as a legal entity, but the corporation as the legal body owns the corporation's assets. Under the law, corporations have the same contractual rights as an individual and are capable, like an individual, of making contractual agreements, buying and selling real estate, and engaging in lawsuits.

While the corporation has its own existence and personality under law, it is only an abstraction and requires the actions of real people to operate. Therefore corporate law requires a board of directors to govern the organization, who delegate operational control to professional managers, typically under a chief executive officer (CEO). In some cases the CEO is also the chairman of the board of directors. The CEO-dominated corporate model evolved in the past 50 years in the United States and is sometimes referred to as the imperial CEO. In earlier times boards were dominant over corporate management, and now the pendulum is swinging again in the direction of greater board involvement and control at the expense of the CEO.

Under the law, there are three actors in corporations: directors, employees, and shareholders. Directors provide the oversight and stewardship over all corporate assets, both human and otherwise. Employees do the day-to-day work of managing the corporation's resources and assets. Shareholders provide the money in the form of risk capital and share risk equal to their investments. Shareholders' involvement in corporate operations is typically limited to interaction with the board, and not with corporate employees.[3]

The Corporation as an Economic Entity. The corporation is also an economic enterprise that exists to make profits, which are, in turn, ultimately shared with shareholders as dividends and rising stock prices. This economic entity replaces a wide variety of less efficient activities in the marketplace that would be conducted by individuals. Corporations increase efficiency by acting as independent holders of property rights that create contractual arrangements with other parties. This greatly reduces the costs and number of transactions for all those involved—customers, suppliers, employees, owners, government agencies, and so on. The separation of control and ownership, while improving efficiency, does mandate a governance framework to align corporate decisions with the corporation's economic capital and resources.

The Corporation as an Accounting Entity. Corporations are also accounting entities. Accounting is the process by which corporations identify, measure, and communicate information that impacts financial reporting. It is used by stakeholders to guide their judgment as to the current state and future prospects of corporations. Many corporate governance issues revolve around accounting-based information.

The Corporation as a Cultural and Socially Responsible Entity. Corporations are also cultural entities that often transcend national and regional borders. As global trade, politics, entertainment, media, the Internet, and other cross-border activities expand, corporations take on more of a cultural identity that is bigger than their traditional branding. Coke, Pepsi, Visa, Disney, Levi's, and IBM have been widely recognized brands in every region of the world for decades, and new names such as Apple/iPod, Yahoo!, and Google have become cultural phenomena that are growing in importance beyond traditional corporate branding.

The actions of these marquee global corporations are becoming as important as the actions of any of their home governments in shaping our lives, regardless of whether we are direct customers of their products. Consequently, the governance of these corporations takes on major significance and may trump national government regulations and regulators in shaping our economic growth and stability.

The latest example of this can be seen in the greening of corporate America. While the European Union (EU) and its resident corporations have strongly embraced improved environmental governance (discussed in detail in Part Five, our environmental compliance section), the United States has lagged in many critical areas due to the resistance of the central/federal government. (We should note that many U.S. state and local governments are taking proactive measures on their own, such as my home state of California.) Corporate America has now embraced green as good business and the socially responsible course of action—in spite of the lack of action on the federal government's part. This is counter to the notion that government should lead and that corporations are too market-driven to take such socially responsible actions. Toyota's visionary embracing of hybrid technology is one of the best examples. Toyota went to market with the Prius hybrid car even though there was no strong business reason to do so. Now all the laggards are chasing the Prius's success, and Toyota is poised to become the world's largest automaker. Toyota's leadership had little to do with stewardship or pressure from its home government in Japan.

(b) THE MORAL FOUNDATIONS TO TONE-AT-THE-TOP. Historically, investors in most companies were individuals ranging from the very rich to the working class. Over recent decades, however, institutional investors representing insurance companies, banks, investor groups, and mutual, hedge, and pension funds have become dominant players in the market. Institutional investors have been able to advocate for stronger corporate governance and oversight. While oversight has improved, it has not necessarily improved the voice of small investors. The growth of mutual funds and pension plans has given small investors at least an indirect voice.[4]

The need for institutional investors to access equity capital on a global level has increased the demand for improved governance, typically manifested through improved financial transparency, accountability, and representation of minority shareholder interests. The process has increased demand for what is commonly referred to as tone at the top—corporate boards and executives providing the stewardship, culture, and organization committed to corporate governance. Tone at the top, as the jurist said about pornography, is hard to define, but you know it when you see it. The fundamental issue around tone-at-the-top may come down to the basic ethics and morality of those in positions of corporate power. Dr. Rick Warren, in an interview by NBC's Tim Russert in the final *Meet the Press* of

2006, discussed the three requirements for good governance: freedom of religion, freedom of information, and freedom of markets. Dr. Warren is the author of the best-selling *The Purpose Driven Life* (Zondervan, 2002) and a Protestant minister. He argues that freedom of religion is key because it provides a moral foundation to governance and that without a moral foundation capitalism is pure greed. It is a profound notion and makes a lot of sense. If there is no moral and ethical foundation to the tone at the top, rules, regulations, and sanctions will ultimately fail. Morally bankrupt wrongdoers are typically too clever and powerful to be caught.

The United States is a conflicted society as to the notion of tone-at-the-top. Survey after survey shows the great majority of Americans claiming to be Christians; evangelical Christians are a major political force in American politics; and until recently no major politician would run for office as openly agnostic or atheist. The conflict comes in the major disconnect between the claims of a moral and religious foundation to governance and actions that appear to be driven by pure greed. The late Kenneth Lay (Enron) and Richard Scrushy (HealthSouth) actually made their strong Christian convictions part of their respective defense arguments during their corruption trials. (Lay lost and Scrushy won.)

During the *Meet the Press* interview, Dr. Warren referenced a conversation he had with major leaders in China. He cautioned that they would ultimately fail in that they were embracing only one of the three requirements for corporate governance—freedom of markets. The rampant and growing corruption in the booming Chinese and Indian economies lends support to Dr. Warren's arguments that all three elements are essential.

The notion of a moral or faith-based governance is not unique to the West or to modern times. The Qur'an (the Holy Book of Islam) orders the faithful to follow the principles of shariah, which require ethical business behavior and see money as a vehicle for doing good. This is a guiding principle to 1.3 billion Muslims and can be seen in Islamic banking practices. (See our two related chapters: Chapter 43, "Islamic Finance," and Chapter 46, "Corporate Governance in Major Islamic Nations.") There are also several passages in the Old Testament warning against usury, immoral, and unethical behavior. China's Confucian philosophy calls on man to serve the good of society as the highest calling.

(c) CHRONOLOGY OF CORPORATE GOVERNANCE. There is a common misconception that corporate governance is a new concept, but its roots are as old as man. The basic concepts around corporate stewardship are 400 years old. More general concepts of governance are much older and have been debated for over 2,000 years. However, the following chronology does demonstrate a major escalation in activities in the past 10 years.

Year	Location	Event
500 B.C.	China	The Confucian Analects advocate moral government led by virtue and uniformity with the rules of propriety. The Book of Mensius advocates the rights of the governed to overthrow corrupt rulers.
31 B.C.	Rome	Although lacking some of the core characteristics of modern corporations, Roman citizens invest in business enterprises as shareholders. The government sanctions corporations.
A.D. 71	Global	The New Testament of the Bible (Matt. 25:14–30) argues that money sets us apart from the animal kingdom and makes voluntary exchanges ''more fair, less wasteful, and far more extensive''. Profit and money provide opportunities to glorify God by expanding our stewardship, meeting our needs and those of others, providing charity, and promoting the mission of the church in the world.
700	Global	The Qur'an (the Holy Book of Islam) orders the faithful to follow the principles of shariah, which require ethical business behavior and see money as a vehicle for doing good.
1600	United Kingdom and Holland	The East India Company introduces a Court of Directors, separating ownership and control.
1776	United Kingdom	Adam Smith in *The Wealth of Nations* warns of weak controls over and incentives for management.
1844	United Kingdom	First Joint Stock Company Act is enacted.
1899	Japan	The Commercial Law is enacted based on German commercial law.
1930	G10 nations	The Bank for International Settlements (BIS) is created to foster international monetary and financial cooperation—the world's oldest international organization.
1931	United States	Berle and Means publish their seminal work *The Modern Corporation and Private Property*.
1933, 1934	United States	The Securities Act of 1933 is the first act to regulate the securities markets, notably registration disclosure. The 1934 Act delegates responsibility for enforcement to the Securities and Exchange Commission (SEC).
1956	India	The Companies Act is enacted as one of the most comprehensive acts in the world.
1968	European Union	The European Union adopts the first company law directive.
1974	G10 nations	The Bank for International Settlements creates the Basel Committee to improve corporate governance and stabilize markets.
1977	United States	The Foreign Corrupt Practices Act (FCPA) is enacted to prevent bribery of foreign officials.
1985	France	Publication of the Vienot Report.

(*continued*)

Year	Location	Event
1985	United States and European Union	Five nonprofit accounting and auditing organizations form the Committee of Sponsoring Organizations (COSO) to eliminate fraudulent financial reporting.
1987	United States and European Union	The Treadway Commission reports on fraudulent financial reporting, confirming the role and status of audit committees, and develops the COSO framework for internal control, published in 1992.
1988	G10 nations	The BIS's Basel Committee issues the first Basel accord, mandating minimum capital requirements.
1990	United Kingdom	Polly Peck (£1.3 billion in losses), Bank of Credit and Commerce International (BCCI), and Maxwell (£480 million) business empires collapse, calling for improved corporate governance practices to protect investors.
1992, 1993	United Kingdom	The Cadbury Committee publishes the first code on corporate governance; in 1993, companies listed on United Kingdom stock exchanges are required to disclose governance on a ''comply or explain'' basis.
1994	South Africa	Publication of the King Report.
1994	United Kingdom	Rutteman (on internal control and financial reporting), Greenbury (on executive remuneration), and Hampel (on corporate governance) reports are published.
1995	Russia	The Russian Law on Joint Stock Companies is adopted.
1996	Russia	The Russian Law on the Securities Market is adopted.
1998	Germany	KonTraG is enacted to improve corporate governance.
1998	United Kingdom	Publication of the Combined Code.
1999	G10 nations	The Bank for International Settlements' Basel Committee releases its Basel II capital accord to improve internal controls (Pillar II) and transparency (Pillar III).
1999	Global	The Organization for Economic Cooperation and Development publishes the first international benchmark, the OECD Principles of Corporate Governance.
1999	India	Clause 49 is enacted to improve corporate governance, to go into effect in 2003.
1999	Italy	Preda Code is enacted to improve governance.
1999	Mexico	Code of Best Practices is enacted representing a first for Latin America and one of the first in the world.
1999	United Kingdom	Publication of the Turnbull guidance on internal control.
2001	European Union	The Lamfalussy report on the regulation of European securities markets is published.
2001	Russia	The Russian Law on Joint Stock Companies is significantly amended.
2001	United States	Enron Corporation, then seventh largest listed company in the United States, declares bankruptcy.
2002	Canada	The Ontario Securities Commission (OSC) enacts Bill 198—Multilateral Instruments 52-109 and 52-111 (called CSOX), which mirror U.S. Sarbanes-Oxley Act (SOX)'s Sections 302 and 404.

Year	Location	Event
2002	European Union	The Winter report on company law reform in Europe is published.
2002	Germany	Publication of the German Corporate Governance Code—KonTraG
2002	Russia	Publication of the FCSM Russian Code of Corporate Conduct.
2002	United States	The Enron collapse and other corporate scandals lead to the Sarbanes-Oxley Act (SOX).
2003	France	The Yearly Budget Law (LSF) and NRE Law are enacted to improve governance and regulatory disclosure.
2003	Spain	The Aldama Commission's report is issued to improve governance.
2003	United Kingdom	The Higgs report on nonexecutive directors is published.
2004	European Union	The Parmalat scandal shakes Italy, with possible EU-wide repercussions.
2004	United States and European Union	COSO updates its 1992 internal control framework with Enterprise Risk Management (ERM), also known as COSO II or COSO 2004.
2005	Russia	The Duma's Property Committee, Economic Development and Trade Ministry, and the Federal Services Agency enact and recommend several improvements in corporate governance.
2005	European Union	Over 7,000 EU corporations embrace the International Financial Reporting Standards (IFRS) as a means to improve and standardize financial reporting.
2006	Japan	New Corporate Law (called JSOX) goes into effect to improve corporate internal controls and governance.
2007	United States	Backdating stock options scandals impact over 140 U.S. corporations with the subversion of a pay-for-performance system designed to reform corporate compensation.
2007	United States	The U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) propose changes to the most controversial sections of the Sarbanes-Oxley Act with the goal of improving U.S. competitiveness in global markets.
2011	Global banks	Global banks are required to be live under new Basel II capital accords.

(d) COMMONLY ACCEPTED PRINCIPLES OF CORPORATE GOVERNANCE. Regardless of the national jurisdiction and local conditions, there are some principles and issues of corporate governance that have been widely embraced over the years.

Rights and Fair Treatment of Shareholders. Companies need to listen to shareholder concerns and respect their rights. This includes open and two-way communication and shareholders' involvement in general board meetings.

Roles and Responsibilities of the Board of Directors. Robust corporate boards need skilled and focused members possessing a range of experience and expertise. A healthy mix of independent members with strong credentials and internal members with company expertise is essential. It is best if the chairman of the board and the CEO positions are held by different people—a sound check and balance.

Ethical and Professional Behavior. Companies need a culture of compliance and ethics, not just a code of ethics. This flows down from the board and executives through a tone at the top and is reinforced through actions, not just words.

Financial Transparency and Disclosure. Companies need strong and well-documented processes and controls to consistently provide full transparency in financial reporting. Results need to follow accepted norms and best practices and be audited by independent internal and external experts. Internal and external auditors must be qualified and strong enough to provide brutally frank assessments without the fear of retaliation. It is also necessary to defend and encourage internal whistle-blowers, who often are the best means to uncover errors and fraud in financial reporting.

Internal Controls. Internal controls are a key component to all regimens to improve corporate governance in general, to reduce risks, and specifically to provide consistent financial transparency. Debates over the scope of internal controls have raged for decades, but most agree that internal controls that impact financial reporting fall within the scope of corporate governance. Some argue that policies, procedures, training, and whistle-blower protection impact internal controls as well. The Committee of Sponsoring Organizations (COSO) framework originally issued in 1992 and updated in 2004 is often the framework of choice for internal controls management. We argue in various chapters in this handbook that the quantification and prioritization of risks are key to successful internal controls in that higher control activities are deployed for areas with the highest potential financial impact, the greatest likeliness, and the highest level of difficulty in detection.

(e) MODELS OF CORPORATE GOVERNANCE. Anglo-American Model. This model typically gives priority to shareholder interests, which translates into strong pressure to innovate, compete, and grow profitability. The Anglo-American model places less emphasis on the interests of managers, employees, customers, suppliers, and the community in general. Ironically, this approach does not translate into proactive shareholder involvement in corporate governance. It is a more hands-off relationship in which a powerful CEO runs the daily operations of the organization and the board provides overarching stewardship. The U.S. scandals of the 1990s have added greater oversight to board responsibilities beyond their traditional stewardship.

The Coordinated Model. This model is prevalent in Europe and Japan. It also acquiesces to shareholder interest but gives priority to the interests of managers, employees, customers, suppliers, and the community in general. The coordinated model translates to innovation and profit growth on a more incremental level. Thus there may be slower growth in profits in the coordinated model, but corporations are less likely to suffer the failures in ethics and morality that occur in the Anglo-American model with its unrelenting demands for greater and greater profits.

The Family-Owned Company Model. In many Asian and Latin American countries, family-owned companies dominate. It is not unusual for a small number of powerful families to control a majority of public companies. Powerful families also control major corporations in Spain, France, and Italy. Notions of financial transparency that dominate corporate governance frameworks under the Anglo-American model are very difficult for family-owned companies to accept. Transparency is seen as exposing core business financials and strategies, which would benefit competitors and regulators, with few tangible benefits to the organization.

(f) AGENCY THEORY VERSUS STEWARDSHIP THEORY IN GOVERNANCE. Starting in the nineteenth century, laws were enacted in Western economies that enhanced and codified the ability of corporate boards to govern their enterprises without the direct and unanimous consent of shareholders. This was in exchange for statutory benefits such as appraisal rights. In the United States, the rights of shareholders have continued to decline as wealth and control became increasingly securitized into various corporate entities and government institutions. Corporate boards thus acted as agents for their principals, or shareholders.

American expansion after World War II through the emergence of multinational corporations saw the establishment of the managerial class. Accordingly, several Harvard Business School management professors published influential monographs studying the corporations' prominence: Myles Mace (entrepreneurship), Alfred D. Chandler Jr. (business history), Jay Lorsch (organizational behavior), and Elizabeth MacIver (organizational behavior). According to Lorsch and MacIver, "many large corporations have dominant control over business affairs without sufficient accountability or monitoring by their board of directors."

Eliot Spitzer, the newly elected governor of New York, took a very aggressive approach to ferreting out corporate wrongdoing when he was New York's attorney general. He has a portrait of President Theodore Roosevelt over his desk, and like President Roosevelt he feels that government has to take a leadership role as stewards of governance. At the beginning of the twentieth century, President Roosevelt introduced the notion that government had a stewardship responsibility over business and environmental matters. He undertook actions to

attack corporate monopolies and trusts and establish a system of national parks to protect the environment.

In the 1980s, agency theory came into prominence as an accepted approach to corporate governance—an organization is seen as a series of contracts. Agency theory has its limitations in the incomplete and asymmetric information between principals and agents. This means one party to a transaction has more complete or better quality information than the other party.

Agency theory argues that shareholder interests require protection by separation of incumbency of roles of board chair and CEO. Stewardship theory argues that shareholder interests are maximized by shared incumbency of these roles. Modern governance can be seen as a hybrid of both approaches.

Advocates of agency theory argue for greater monitoring and sanctioning of management, but there is evidence that greater monitoring has its limitations and may actually backfire. Here are some examples of agency theory versus agency reality:

Greater Board Independence

- *Assumption.* Increasing the number of independent board members improves corporate governance.
- *Reality.* Some of the greatest corporate scandals occurred in corporations with a high number of independent board members: Enron (80 percent), Tyco (65 percent), WorldCom (45 percent). Various analyses indicate no statistical relationship between board independence and firm financial performance.[5]

Pay for Performance

- *Assumption.* Compensation based on performance improves employees' contributions to the common good of their companies and/or society.
- *Reality.* Several studies suggest that good behavior is not motivated by compensation. The love of work and the good of the community are not reinforced by monetary rewards (e.g., blood donations drop when compensation is offered).[6]

Executive Compensation Transparency

- *Assumption.* With improved executive compensation transparency, employees are motivated by the potential to make such lofty salaries as they move up the corporate ladder.
- *Reality.* The disparity between employee and executive salaries has increased to such an extent that employees feel like suckers and have little loyalty to their organizations—feelings of exploitation reduce good behavior. The pay disparity between the average U.S. CEO and average

employee has increased from 25 times to 75 times over the past 30 years. When stock options are included, the disparity increases to over 200 times.[7]

INCREASED SUPERVISION AND MONITORING

- *Assumption.* Increasing the supervision and monitoring of employees will improve behavior.
- *Reality.* Employees want to act as agents and not as pawns. Various studies demonstrate that increased supervision decreases effort and loyalty.[8]

(g) SCANDALS DRIVE IMPROVEMENTS IN GOVERNANCE. History has demonstrated that improvements in governance and compliance typically come as a result of scandals. When the pendulum swings too far toward self-regulation, the freedom to act outside of the rules proves to be irresistible. The resulting scandals create a cry for increased regulation. In some cases the pendulum swings back too far in the form of excess regulation. The most recent scandals of the past decade are a case in point. This is in no way an exhaustive list, but captures one of the reasons you may be reading this book:

U.S. Savings and Loan Crisis of 1986 to 1995. Over 1,000 savings and loan institutions were closed, holding over $500 billion in assets and representing about half of the total number of savings and loans. Deregulation, changing market conditions, volatile interest rates, tax changes, and reduced regulatory capital have all been cited as causes of the crisis. According to Timothy Curry and Lynn Shibut, losses totaled over $80 billion, with public sector/taxpayer costs of $75 billion and private sector costs of $7 billion.[9]

East Asian Crisis of 1997. South Korea, Malaysia, Thailand, Indonesia, and the Philippines saw their economies severely hurt by the flight of foreign capital after property assets collapsed. This was caused in part by poor governance at a national and corporate level.

U.S. Corporate Crises of 2001–2002. The collapse of Enron and WorldCom, and the ensuing scandals and collapses of other corporations such as Arthur Andersen, Global Crossing, Adelphia, HealthSouth, and Tyco, demonstrated the weakness of corporate oversight, rating agencies, audit firms, and business press. The resulting losses impacted millions of investors and several thousand employees. The perceptions of white-collar crimes changed dramatically, with demands for and the realization of jail terms that were on a par with sentences of drug dealers, rapists, and murderers. The most notable include:

- *Enron.* Ken Lay died after he and Jeff Skilling were convicted along with two dozen lower-level participants in a scandal involving accounting tricks around off-balance-sheet arrangements; called the Republican scandal due to Bush ties.

- *Tyco.* In September 2005, former CEO Dennis Kozlowski and CFO Mark Swartz were sentenced to 8.3 to 25 years in prison and must pay $134 million in restitution to Tyco and fines of over $35 million each.
- *WorldCom.* In June 2005, a federal court awarded investors over $6 billion in settlements. The largest part of the payout will come from Citigroup ($2.58 billion) and JPMorgan Chase ($2.0 billion).
- *Adelphia.* In June 2005, John and Timothy Rigas were sentenced to 15 and 20 years in prison, respectively, for their role in looting the cable giant. The scandal drove Adelphia into bankruptcy.
- *HealthSouth.* In March 2005, former CEO Richard Scrushy, the first CEO charged under SOX, was acquitted of all charges related to a $2.7 billion earnings overstatement. He was later convicted of other fraudulent activities.

EU Scandals of 2001–2003. The Italian dairy giant Parmalat filed for bankruptcy in December 2003 after collapsing under about $18.1 billion of debt and is suing Citigroup, Bank of America, and former auditors Grant Thornton and Deloitte & Touche. Ahold, the world's third largest food distributor, lost two-thirds of its stock value in the EU's largest scandal. The scandal stemmed from accounting irregularities from a U.S. subsidiary, which overstated its income by $880 million in 2001 and 2002.

U.S. Post-Enron Scandals of 2003–2006. In March 2005, Time Warner, the world's largest media company, agreed to pay $300 million to settle federal fraud charges for overstating its Internet subscribers and revenues, leading to an August 2006 restatement of $584 million in advertising revenues. Fannie Mae paid $400 million in fines to the SEC; its losses total $10.6 billion, shareholder losses total $30 billion, 44 of 55 executives were out, and 29 may be forced to return bonuses (called the Democratic Party scandal due to close ties). Former Refco CEO Phillip Bennett was accused of hiding $430 million in debt in a post-SOX scandal. Grant Thornton is being sued over its auditing of the Refco initial public offering (IPO), which occurred in August 2005.

Financial Services Scandals of 2003–2006. The past few years have seen a wide variety of scandals:

- *Securities and Exchange Commission/National Association of Securities Dealers (SEC/NASD) and New York Stock Exchange (NYSE).* Fines of $8.5 million were levied against five brokerage firms for failure to preserve e-mail communications.
- *Credit Suisse First Boston.* Criminal charges were brought against CSFB investment banker Frank Quattrone for allegedly telling people to "clean up" files after learning about an investigation.
- *Riggs Bank.* The Albritton family lost control of Riggs Bank after various scandals and fines of $25 million.

- *BCCI.* The Bank of Credit and Commerce International (BCCI) scandal resulted in the Bank of England being sued by creditors for £1 billion ($1.8 billion).
- *Morgan Stanley.* Morgan Stanley paid a $50 million fine to settle allegations that it inappropriately steered customers into select mutual funds in exchange for secret commissions as regulators targeted the industry's controversial fee regime.
- *Morgan Stanley.* Morgan Stanley was ordered to pay billionaire financier Ron Perelman more than $1.4 billion in damages over the 1998 sale of his Coleman camping-gear company to Sunbeam.
- *Prudential Financial.* Prudential and a subsidiary agreed to pay $600 million in penalties to resolve government allegations of deceptive market timing in the trading of mutual funds.
- *China Construction Bank.* Chairman Zhang Enzhao pleaded guilty to bribery and faces life in prison.
- *Banca Popolare Italiana.* Consolidation of the banking sector in Italy has been spurred since a scandal involving BPI and others led to the resignation of Antonio Fazio.

U.S. Stock Option Backdating Scandal of 2005–2006. Over 100 U.S. companies have been implicated in cheating on the dates that stock options were granted. It took some astute mathematicians to demonstrate that it was statistically impossible that options were always granted at the lowest levels for a given period. Several executives have been indicted, and several more have been forced to resign and repay their option gains. The *Wall Street Journal* estimates 2,000 U.S. companies may be drawn in. Silicon Valley is such a target of the investigations that the Federal Bureau of Investigation (FBI) has set up a temporary office in the area. Law firms are gearing up to handle the cases and looking to make a fortune in the process.

1.3 RISK

(a) INTRODUCTION. Definitions of risk typically refer to the possibility of a loss or an injury created by an activity or by a person. Risk management seeks to identify, assess, and measure risk and then develop countermeasures to handle it. This typically does not mean eliminating risk but rather seeking to mitigate and minimize its impact. Risk should not be viewed as inherently bad. All opportunities come with some degree of risk. An organization that is totally risk averse is not likely to be very attractive to investors and may be doomed ultimately to fail.

Just as risk and opportunity go hand in hand, risk, compliance, and internal controls go hand in hand. The process an organization, its internal auditors, its external auditors, and its regulators would typically follow to validate

the effectiveness of internal controls in controlling risk would include these elements:

- Identify business processes, especially those impacting financial reporting.
- Identify the risks associated with each process.
- Identify the internal controls used to mitigate the risks for each process.
- Create a hierarchy of business processes, risks, and controls.
- Identify the tests to be used in determining the effectiveness of the internal controls.
- Test the internal controls and publish findings.
- Provide an opinion as to the effectiveness of the controls.
- If the controls are found to be ineffective, recommend changes (remediations) and retest the controls.
- Create and maintain a documentation library of the processes, risks, controls, tests, findings, remediations, and so on involved in the risk/control process. This would include a risk/control matrix, process narratives, process flow charts, test procedures, and so forth.
- If the internal controls are found to be effective, business owners and external auditors sign off as part of a certification process.

The types of risks that impact companies vary depending on the home country location, industry, level of globalization, and many other factors. Banks worry about credit and market risks. Many firms worry about reputation and legal risks. Risks can be internally or externally based, but one area of risk impacts all companies: operational risk.

Banking is addressing operational risk in a big way with its new capital adequacy accords known as Basel II. Basel II defines operational risk as the risk of losses resulting from inadequate or failed internal processes, people, and systems or from external events. Although designed for banking, this definition holds true for any industry. Basel II describes seven major areas of operational risk:

1. Internal fraud
   - Unauthorized activities
   - Theft and fraud
2. External fraud
   - External security
   - Theft and fraud
3. Employment practices
   - Employee relations
   - Safe environment
   - Diversity and discrimination
4. Clients, products, and business processes
   - Suitability, disclosure, and fiduciary aspects

- Product flaws
- Improper business or market practices
- Advisory activities
- Selection, sponsorship, and exposure

5. Damage to physical assets
   - Disasters and other events
6. Business disruptions and system failures
   - Systems
7. Execution, delivery, and process management
   - Transaction capture, execution, and maintenance
   - Monitoring and reporting
   - Incomplete legal documentation
   - Customer account management

(b) COSO AND ENTERPRISE RISK MANAGEMENT. In 2004, the Committee of Sponsoring Organizations (COSO) published an update to its 1992 risk management framework. Known as Enterprise Risk Management (ERM), it added the concept of event management and recognized that controls will differ from the top of an organization down to its operational/local levels—a strategic versus tactical approach.

There are eight interrelated components that make up ERM. The eight components are based on an organization's management approach and processes. The components are:

1. *Internal environment.* New to ERM and not part of COSO 1992, this covers the tone at the top of an organization, and includes the philosophy around risk appetite, ethics, and in turn the environment in which they operate.
2. *Objective setting.* New to ERM and not part of COSO 1992, this covers the identification and prioritization of objectives. The goal is to have in place objectives that are in alignment with the organization to ensure that management has a set of risk management objectives that are in alignment with the company's overall mission and goals.
3. *Event identification.* New to ERM and not part of COSO 1992, this covers the management of internal and external events affecting achievement of an organization's objectives. The traditional thinking treated risks and controls as a static situation. The original framework did not distinguish between controls to manage recurring processes and controls for one-off events like natural and man-made disasters.
4. *Risk assessment.* Part of COSO 1992, this covers the analysis and rationalization of risks as to their likelihood and their financial impact, and the

nature of the controls needed as a basis for determining how risks should be managed. Risks are assessed on an inherent and a residual basis. Inherent risk management (sometimes called gross or absolute risks) assesses the consequence and likelihood of a risk occurring before any controls are taken into account. Residual risk management (sometimes called net or controlled risks) assesses the consequence and likelihood of a risk occurring after any controls are taken into account.

5. *Risk response.* Part of COSO 1992, this covers management's response to risk—avoiding, accepting, reducing, or sharing risk—developing a set of actions to align risks with the entity's risk tolerances and risk appetite. An important part of risk response is evaluating the cost versus benefits of the various risk management alternatives. It is impossible to eliminate all risks, and some countermeasures may be prohibitively expensive, especially for manual controls. Automating manual controls is usually a good option that lowers risks as well as auditing and related compliance costs.
6. *Control activities.* Part of COSO 1992, this covers policies and procedures established and implemented to help ensure the risk responses are effectively carried out. Auditors would typically test to determine if policies and procedures are being followed and whether they are effective in controlling risks.
7. *Information and communication.* Part of COSO 1992, but greatly expanded in ERM, this covers how relevant information is identified, captured, and communicated in a form and time frame that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.
8. *Monitoring.* Part of COSO 1992, but greatly expanded in ERM, this covers the entirety of enterprise risk management—how it is monitored and how modifications are made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.[10]

(c) INFORMATION TECHNOLOGY (IT) RISK MANAGEMENT. Risk management for information technology (IT) is a growing challenge as GRC requirements expand at an exponential rate and impact all areas of IT. The high turnover rates for chief information officers (CIOs) and chief technology officers (CTOs) are evidence of the increasing burden and stress placed on IT organizations. As pressure mounts on financial officers, they make ever greater demands on IT to improve the timeliness, accuracy, and cost of storage, archiving, encryption, searching, retrieval, consolidated financial reporting, dashboards, alerts, document and records management, e-mail and instant messaging controls, and so on.

The National Institute of Standards and Technology (NIST) has statutory responsibilities in the United States under the Computer Security Act of 1987 and the Information Technology Management Reform Act of 1996 to provide

IT guidelines for U.S. federal agencies. NIST's Special Publication 800-30 (*Risk Management Guide for Information Technology Systems*, July 2002) provides IT risk management recommendations that are a good foundation for any IT organization to follow. NIST's 800-30 stresses the important role risk management plays in protecting an organization's information assets. It warns that IT risk management should not be treated as primarily a technical process of IT, but as an essential control function that all business owners must support across any organization. Three basic processes are involved:

1. *Risk assessment.* This includes identifying and evaluating risks and risk impacts, and recommending measures to reduce risks.
2. *Risk mitigation.* This includes the prioritizing, implementation, and maintenance of the appropriate measures to reduce risks recommended in the risk assessment process.
3. *Evaluation and assessment.* This includes the continual evaluation process and the keys for implementing a successful IT risk management program.[11]

This is very much a balancing act in that absolute control measures are often cost prohibitive and require IT professionals to weigh the cost versus benefits of a myriad of options available to them. This process is complicated by the hundreds of software tool suppliers in the market promising to fix their GRC problems, conflicting demands from various parts of the organization, and a ratcheting up of requirements driven by litigation as much as by regulations.

Legal Discovery Demands on IT Risk Management. Legal discovery presents an especially difficult challenge. Most major lawsuits involve major requirements to produce electronically stored information (ESI). The United States, as potentially the most litigious society in history, is leading the charge. On December 1, 2006, the U.S. Supreme Court approved new Federal Rules of Civil Procedure to provide a standard for the legal discovery around ESI. The rules are important as they are bound to followed elsewhere and because American-based litigation will impact many non-American corporations doing business with the United States. They can be summarized:

- *Early attention.* Rule 26(a)(1) requires each party to show what information they have in their possession. Rule 26(f) requires the parties to come to a consensus as to what information will be in scope.
- *Form of production.* Rule 34(a) and (b) permit each party to request all types of electronically stored information—no ESI can be automatically excluded. Rule 26(b)(5)(B) requires parties to return or destroy privileged information that is uncovered in the discovery process.
- *Sanctions.* Rule 37 protects parties from being sanctioned for purging data as part of their normal operations.

- *Accessibility.* Rule 26(b)(2)(B) provides protection from prohibitively costly discovery requests. In the past, parties could make unrealistic demands to produce huge volumes of documents and records.

There are several other document and records management standards and guidelines that increase demands on IT risk management of ESI:

- Department of Defense (DOD) Directive 5015.2
- The United Kingdom's The National Archives (TNA)
- Germany's Document Management and Electronic Archiving (DOMEA)
- Australia's Victorian Electronic Records Standards (VERS)
- Canada's Electronic Records as Documentary Evidence
- ISO 15489, Information and Documentation on Records Management Guidelines
- The European Union's Model Requirement for the Management of Electronic Records (MoReq)
- The SEC's Section 19(b)(3)(A) and 19b-4(f)(6) to show all stock bids and offers

The cumulative effect of these higher standards and the growing complexity of litigation will be to substantially increase demands on IT risk management. Ironically, the give-and-take of lawsuits will drive the process ahead of regulations. In the United States, there are no hard-and-fast rules as to what is an acceptable response time to produce electronically stored information. As one party demonstrates the ability to produce ESI in a few days or weeks, the other parties will be under growing pressure to move as quickly or face losing their case before it begins.

Key Roles in IT Risk Management. The key stakeholder roles in supporting information technology risk management can be summarized:

- *Senior management.* Senior management should ensure that the needed resources are applied to develop the capabilities to accomplish the company's strategic objectives. This includes evaluating risk assessments and incorporating the results into the company procedures and the decision-making process.
- *Chief information officer (CIO).* The CIO is responsible for the company's IT budgeting, planning, and performance, including the elements of its information security systems and assuring that decisions have an effective risk management foundation.
- *Information and system owners.* Information and system owners need to ensure that the appropriate controls are deployed to assure the availability, integrity, and confidentiality of the IT data and systems they are responsible for. It is essential that they understand and accept their role in the IT risk management process.

- *Functional and business managers.* The functional and business managers who purchase and use IT also have a critical role in the IT risk management process. They need to determine a variety of trade-offs between their users' demands and security requirements.

(d) QUANTIFICATION OF RISK. A major theme of this handbook is the criticality of quantifying risk. The original and revised COSO frameworks, while important contributors in improving corporate governance, lack a viable framework to quantify risk. Part of the problem stems from the overreaction that the U.S. Sarbanes-Oxley Act brought to the risk management process. Regulators and auditors, fearful of losing investor confidence, imposed draconian measures requiring the internal testing of controls and an independent retesting of the same controls by external auditors. Even though Section 404 did not mandate this level of micromanagement, in practice auditors tested all controls, regardless of the level of risk. If the audit community had considered a six sigma and statistical approach, they would have been able to apply simple quantitative models to measure and rationalize risk. The process could be as simple as applying three variable factors to all risks:

1. Financial impact
2. Likeliness of occurrence
3. Inability to detect

A simple 1 to 10 scoring would be applied to rate each risk. For example:

1. Financial impact = 10
2. Likeliness of occurrence = 6
3. Inability to detect = 6

In this example, the risk has a score of 22 out of a maximum possible of 30 and a minimum score of 3. Such a risk should be given much more attention than risks with very low scores. History has taught us that the Italian economist Vilfredo Pareto was right in developing his 80/20 rule. The good news is that in most cases, 20 percent of the total population of risks will represent 80 percent of the potential risks. Accountants knew this well when they developed the general rule of thumb known as the 5 percent rule. They would not focus on risks that impacted less than 5 percent of financial results. By doing so, they eliminated low-value activities and could focus on the significant few items representing the great majority of income and expenses.

1.4 COMPLIANCE AND INTERNAL CONTROLS

(a) INTRODUCTION. *Compliance* is a fairly straightforward concept of acting in accordance with established laws, regulations, protocols, standards, and specifications. The critical issue is around the cost of noncompliance, which can be civil,

criminal, reputational, financial, or market based. Corporate compliance typically includes compliance with external laws (enacted by legislative bodies) and regulations (created by regulatory bodies) and internal protocols such as policies and procedures.

Internal controls is a term in widespread use around financial reporting, but it can also be applied to technical and environmental compliance. The adoption of risk management frameworks like COSO (developed by the Committee of Sponsoring Organizations) in 1992 has given the concept of internal controls a great deal of attention. Several financial control regulations have embraced a COSO or COSO-like approach to internal controls. Internal controls typically include a process, affected by an organization's board of directors, management, business owners, and technology users, which is designed to provide reasonable assurance in achieving the following objectives:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Laws and Regulations. Compliance and internal controls are needed to meet a growing number of laws and regulations. As mentioned, laws are enacted by legislative bodies, while regulations are created by government agencies. For instance, the U.S. Congress passed the Sarbanes-Oxley Act in 2002. The act is quite short with few specific or actionable details. The law called on the Securities and Exchange Commission (SEC) to create a body of regulations to apply the law to public and private U.S. companies and to foreign filers in the United States. Section 404 is an example of a regulation created by the SEC to apply the Sarbanes-Oxley Act—a law. Typically regulations are much more detailed than their parent laws.

Standards. Compliance and internal controls are also to meet a growing number of internationally accepted standards. While standards do not have the force of law, many laws and regulations will reference acceptable standards. For example, the COSO risk management framework is referenced by the SEC as an acceptable framework for risk management. This is not at the exclusion of all other frameworks. The SEC also references the UK's Combined Code as an acceptable risk management framework.

(b) THE CASE OF SARBANES-OXLEY SECTION 404. The most controversial law, regulation, and standard of the past decade have been, respectively, the enactment of the Sarbanes-Oxley Act (SOX) by the U.S. Congress in 2002; the SEC's creation of a regulation over internal controls attestations as part of Sarbanes-Oxley, Section 404, in 2003; and the creation of Audit Standard Number 2 for Internal Controls, under Section 404, by the Public Company Accounting Oversight Board (PCAOB) in 2004. While the great majority of Sarbanes-Oxley has been very well received, this one section has created quite a flap. Ironically,

the law and even the regulation are not at issue. It is how the PCAOB decided to create Audit Standard Number 2 and how audit firms in turn decided to meet the audit standard. After the demise of Arthur Andersen and widespread fear of litigations by angry shareholders, audit firms were naturally very concerned over their survival and tended to err on the side of caution by testing controls even for processes that were of low value and not critical. This was also a self-serving approach, as it resulted in a doubling of audit fees compared to the pre-Sarbanes-Oxley era.

The relationship of the U.S. law to the SEC regulation and to the PCAOB audit standard demonstrates how well-intentioned measures to improve GRC by legislators and regulators can backfire. The SEC continues to struggle with defining guidelines that strike a balance between good governance and the cost of compliance. The controversial audit standard of Section 404 is being fundamentally rewritten as Audit Standard Number 5 and a companion audit standard to rely on the work of others. This is due to widespread criticism. Other evidence of the unforeseen consequences can be seen in the two-year delayed implementation of Section 404 for smaller companies and foreign filers.

Critics claim that Section 404 has damaged entrepreneurship by denying access to capital markets and driving initial public offerings (IPOs) offshore. As we discuss in our U.S. corporate governance chapter (Chapter 66) and in the section on globalization of capital markets in this introductory chapter, the truth is not this simple. Defenders of the regulations claim that the United States continues to attract global capital because of higher corporate governance standards. Private equity firms have enjoyed major increases in activities, but it is difficult to argue that this is direct result of higher U.S. compliance costs. In the year from October 31, 2005, to October 31, 2006, over 2,000 buyouts occurred globally with a value over $500 billion—up from $291 billion in the prior year.[12]

One of the worst unforeseen consequences of the law, the regulation, and the audit standard has been on small and midsize enterprises (SMEs), typically under $700 million in public float. The cost of compliance was never calibrated for the little guys. Legislators, SEC officials, and PCAOB audit authorities never seemed to grasp that small companies could not afford the large overhead and bureaucracy required to comply with the law, the regulation, and the audit standard.

Maybe the most valuable lesson of the U.S. experience is that GRC overreactions are bound to create unforeseen and unwanted consequences. While most reforms are scandal or crisis driven, it is essential that political, legal, and business leaders calm public fears and ponder their actions carefully. The intent of the U.S. Congress and President George W. Bush was to restore investor confidence after a series of highly publicized corporate scandals hurt thousands of employees and millions of investors. It was not their intent to add a heavy regulatory burden on companies, especially smaller companies. Greater emphasis on improved board governance, transparency, and accountability would produce better results than

improved internal controls. This can be seen in the high World Bank governance scores achieved by Canada, Australia, Germany, and the UK (described in the next section) with their strong board governance codes and without an equivalent to Audit Standard Number 2.

The disconnect between the intent and the reality of Sarbanes-Oxley can be seen in the SEC's original estimate of its costs. In its final ruling on Section 404, the SEC estimated the act would require about one full-time equivalent (FTE) internal resource and about one-half FTE external resource. With minimum costs running over $5 million for most larger companies, the SEC estimate looks very naive in hindsight. It was apparent after the first year of audit activities that the SEC had terribly underestimated the internal and external costs of complying with the act, yet there was little action by the SEC or PCAOB to address the excessive costs.

The U.S. experience teaches us that there must be an active two-way communication of *all* stakeholders from the legislative process down through the regulatory process and finally to the standards process. The circle of stakeholders is larger than one might imagine and should include business owners of the processes audited. Business owners understand better than any auditor the risks associated with the business processes within their span of control. They should be the first stop in determining the level and nature of controls and audit test procedures. These business owners need to represent the entire spectrum of business activities, from the very large global firms to the small entrepreneurial firms that are the engine of growth in much of the world.

Because boards and executive management were slow to grasp the huge impact on their organizations, they did not instill in their business process owners a sense of ownership with regard to compliance. In the early days, it was looked at as yet another regulatory pain in the neck. With the proper tone-at-the-top, management training, and reorganization, American companies could have been much more proactive in pushing back on what is now seen as many silly compliance requirements with little impact on financial reporting.

Banking's Basel II accords are not a bad role model to follow in the laws to regulations to standards process. The banking industry has had about eight years to prepare for the new minimum capital requirements developed by the Bank for International Settlements' Basel Committee. The accords do not have the force of law and are being adopted by national legislative action. Unlike Sarbanes-Oxley, the accords are not designed for midsize or smaller banks and do not take a one-size-fits-all approach. They have been well thought out and actively discussed for years. Unlike Sarbanes-Oxley with its punitive sanctions, the accords provide financial incentives for improved compliance—lower capital costs. The major rating agencies have published position and white papers describing Basel II best practice frameworks. This is not to say that all banks are prepared for or happy with the demands of the accords, but at least they should know what is coming at them.

1.5 GRC AND GLOBALIZATION

(a) INTRODUCTION. *Globalization* can be viewed as activities that increase cross-border activities such as trade, communication, treaties, travel, and compliance protocols. For our purposes, we will measure globalization as total trade (imports plus exports) as a percent of gross domestic product (GDP). By this measure, globalization is increasing in all regions and for several decades. Governance at a cross-border and national level can be looked at as an overarching umbrella that applies to a variety of frameworks and regulations that are utilized by companies and other organizations, and then implemented at a granular level via internal controls and other compliance activities.

One of the most popular arguments for improving governance, risk management, compliance, and internal controls is that doing so will open up new markets and increase growth. A related argument is that improved governance is needed to play in a global marketplace. Our evaluation indicates that some of the fastest growing economies are laggards in improved governance, but that most of the global economies are leaders in governance and compliance.

This handbook provides essays for the top 75 percent of global GDP for purchasing power parity (PPP), comprising 16 nations from the United States to Australia. We looked at their growth in GDP, their governance ratings by the World Bank, and their level of globalization as measured by total trade as a percent of their GDP. (See Exhibit 1.1).

GDP is typically measured at either market exchange rates or PPP. We believe PPP is a better means to measure average volumes of inputs and outputs and to measure living standards. PPP is better at capturing the true value of nontradable goods and services. John Hawksworth uses the example of a haircut to make the point, noting that a haircut costing $20 in New York can be had for less than $1 in China. PPP adjusts for these differences to capture the true purchasing power.[13] So a person with $1 in China has parity with a person with $20 in New York.

Using trade as a percentage of GDP, Germany, Canada, Spain, France, and the UK are the most globalized economies among the top GDP nations, while India, Brazil, China, Indonesia, and the United States are the least.

It may seem ironic that the United States would be grouped with the least globalized economies, but it is reaching a milestone in 2007 when imports are expected to exceed federal spending for the first time in history. The slowness of the United States to adopt the International Financial Reporting Standards (IFRS) and the Basel II accords in banking, as well as U.S. rejection of the Kyoto environmental accords, are reminders that the United States is not as globalized as one might think.

(b) GLOBALIZATION OF CAPITAL MARKETS. Capitalism is on the march everywhere around the globe, even in societies such as China and Vietnam that still embrace Communism with its central planning. The combination of expanding

capitalism and global trade require global capital markets to fund infrastructure and other improvements. Global financial markets, in turn, require harmonized regulations. The largest U.S. equity exchanges are now publicly traded entities. This is also the case for most of the world's equity exchanges. Major exchanges are also in the process of mergers and acquisitions. Both of these developments would have been unthinkable a generation ago. Exchanges are now subject to the same regulations as their member firms, and the cross-border merger and acquisition activities are accelerating the push for a convergence and harmonization of regulations.

Former SEC chairman Harvey L. Pitt argues that the globalization of capital markets is making it less important where stocks are listed and more important where shares are traded.

Globalized capital markets will require some degree of regulatory harmonization. Pitt describes the three regulatory areas that require harmonization:[14]

1. *Equivalence.* Equivalence encourages regulators to create regulations and standards to address common concerns. The international adoption of the International Financial Reporting Standard (IFRS) is one of the best examples of this process. The U.S. rules-based generally accepted accounting

GDP Rank	Country	GDP (Purchasing Power Parity)	Cum. GDP %	Total Imports & Exports	Trade as % of GDP	GDP Growth Rate %
	World	**$60,630**	**100%**	**$20,630**	**34%**	**4.7%**
1	United States	$12,310	20%	$2,655	22%	1.9%
2	China	$ 8,883	35%	$1,384	16%	10.2%
3	Japan	$ 4,025	42%	$1,002	25%	2.6%
4	India	$ 3,666	48%	$ 189	5%	8.4%
5	Germany	$ 2,480	52%	$1,817	73%	0.9%
6	United Kingdom	$ 1,818	55%	$ 856	47%	1.9%
7	France	$ 1,794	58%	$ 917	51%	1.2%
8	Italy	$ 1,667	60%	$ 741	44%	0.1%
9	Russia	$ 1,584	63%	$ 370	23%	6.4%
10	Brazil	$ 1,536	66%	$ 193	13%	2.3%
11	Canada	$ 1,111	67%	$ 683	61%	2.9%
12	South Korea	$ 1,101	69%	$ 437	40%	4.0%
13	Mexico	$ 1,064	71%	$ 466	44%	3.5%
14	Spain	$ 1,033	73%	$ 544	53%	4.0%
15	Indonesia	$ 870	74%	$ 146	17%	5.6%
16	Australia	$ 636	75%	$ 223	35%	2.7%

Source: Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, ''Governance Matters V: Governance Indicators for 1996–2005'' (September 2006).

EXHIBIT 1.1 GDP VERSUS TRADE VERSUS GDP GROWTH

principles (GAAP) are at odds with the principles-based approach of the IFRS. The U.S. system will eventually have to give way in order for the United States to remain a competitive player.

2. *Reciprocity.* Reciprocity encourages regulators to create mirror-image regulations and standards based on markets of interest.
3. *Transparency.* Transparency requires more complete financial disclosure and accountability. As we will cover in our 16 national and four regional corporate governance essays/chapters, the drive for transparency and accountability is virtually universal. No major economy is defending opaqueness and poor accountability.

The major rating agencies and audit firms are also playing a role in the globalization of capital markets by imposing best practice frameworks regardless of regulatory requirements. Banking is at the forefront of this phenomenon. While the Basel II accords only technically apply to very large global banks (over $250 billion in consolidated assets or over $10 billion in foreign exposure), rating agencies will punish smaller firms for not voluntarily complying. Many non-U.S. corporations have already felt the sting of Section 404 of the Sarbanes-Oxley Act as well. Rating agencies and auditors have come to expect SOX-like controls in areas of access and change control, segregation of duties, and documents and records management. There is now a bias in their thinking and actions in favor of higher standards, even though local regulations do not mandate them. Auditor fears of company-ending lawsuits and prosecutions are very real and not paranoia. Besides the one-count conviction that destroyed Arthur Andersen, the world's largest and most prestigious audit firm, major governance-related scandals typically include litigation against the auditors involved. Rating agencies were humiliated by their failure to see the pending disaster at Enron and other highly rated firms that crashed and burned, so their raising the governance bar is a natural defensive action.

Insurance companies are playing a role as well, insisting on proof of good corporate governance in order to secure the most favorable rates for corporate directors and officers (D&O), errors and omissions (E&O), and other types of professional liability policies. Several major pension funds from a variety of countries created a charter requiring global standards for environmental, social, and governance frameworks. These 32 funds are worth over $2 trillion, which is more money than is managed by all the world's hedge and equity funds.[15]

The debate continues in the United States as to whether overly costly regulations have hurt U.S. competitive markets and driven capital to other markets. This has been a popular argument in the United States for the past few years, but the globalization of financial markets may be the major factor, not the costs of U.S. regulations. As corporate governance improves in other markets, it is natural that companies will look to go public in their home markets. Cross-border trading

has become easier, reducing the prestige of listing on the large U.S. exchanges; and private-equity buyouts are growing in popularity on a global basis, not just in the United States.[16] Our 16 national and four regional corporate governance chapters demonstrate a virtually universal commitment to improved governance, so the benefits of a U.S. listing are bound to diminish.

(c) GOVERNANCE, TRADE, AND GROWTH. The World Bank describes six categories of governance and has evaluated over 200 countries against these standards. Its approach makes a lot of sense.

1. *Voice and accountability* measures the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
2. *Political stability and absence of violence* measures the perceptions of the likelihood that the government will not be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism.
3. *Government effectiveness* measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
4. *Regulatory quality* measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
5. *Rule of law* measures the extent to which agents have confidence in and abide by the rules of society, in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence.
6. *Control of corruption* measures the extent to which public power is prevented from being exercised for private gain, including petty and grand forms of corruption, as well as so-called capture of the state by elites and private interests.

We created a score based on an average of the six elements of governance and then placed each of the 16 nations in one of four quadrilles, with 1 the best and 4 the worst. (See Exhibit 1.2.)

The arguments about the benefits of improved governance are rather academic. To illustrate the point, take a look at some of the countries with the worst governance ratings. Only those holding power in these areas would advocate joining this list. The prestige and panache of joining the first quadrille of nations is very compelling. The social, political, and economic benefits are surely obvious.

As mentioned, we did find a direct correlation between governance and globalization by measuring quadrilles for both. In general, the leaders in good governance were also those with the highest trade activities. This makes sense,

World Bank Six Elements of Govemance	US	China	Japan	India	Gemany	UK	France	Italy	Russia	Brazil	Canada	Mexico	Spain	S. Korea	Indonesia	Australia
Quadrille	1	3	1	3	1	1	1	2	3	2	1	2	1	1	3	1
Score	84.3%	35.6%	83.3%	45.6%	88.1%	88.1%	83.6%	68.3%	29.5%	49.8%	92.3%	48.9%	83.3%	70.2%	27.5%	91.5%
Voice and Accountability	88.9%	6.3%	74.9%	55.6%	93.7%	92.8%	92.3%	77.3%	25.6%	57.0%	95.2%	54.1%	87.0%	68.1%	40.6%	94.7%
Political Stability /No Violence	48.6%	39.2%	80.2%	22.2%	67.0%	59.4%	58.5%	52.8%	18.9%	40.6%	78.8%	36.3%	60.4%	60.8%	9.0%	73.6%
Government Effectiveness	91.9%	52.2%	84.7%	51.7%	90.4%	94.3%	90.0%	71.8%	38.8%	55.0%	95.7%	57.4%	89.5%	78.9%	37.3%	94.7%
Regulatory Quality	93.1%	44.6%	85.6%	41.1%	90.1%	94.1%	80.2%	76.2%	43.6%	55.0%	95.0%	62.4%	87.6%	71.8%	36.6%	96.0%
Rule of Law	91.8%	40.6%	89.4%	56.0%	93.7%	93.2%	89.9%	64.3%	21.7%	43.0%	95.2%	39.6%	85.0%	72.5%	20.3%	94.7%
Control of Corruption	91.6%	30.5%	85.2%	46.8%	93.6%	94.5%	90.6%	67.5%	28.1%	48.3%	94.1%	43.8%	90.1%	69.0%	21.2%	95.1%

World Bank Six Elements of Govemance	Iraq — 2005	Iraq — 2002	North Korea	Iran	Somalia
Rank: 203 Ct.	202	N/A	194	72	203
Quadrile	4	4	4	4	4
Score	3.7%	1.5%	9.3%	21.6%	2.0%
Voice and Accountability	9.2%	0.5%	0.5%	9.7%	1.9%
Political Stability /No Violence	0.0%	5.2%	41.0%	16.0%	5.0%
Government Effectiveness	1.4%	0.5%	0.5%	26.3%	0.0%
Regulatory Quality	5.9%	0.0%	0.5%	6.9%	0.0%
Rule of Law	0.5%	1.9%	10.1%	29.0%	0.0%
Control of Corruption	4.9%	1.0%	3.4%	41.4%	5.0%

Source: Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, ''Governance Matters V: Governance Indicators for 1996–2005'' (September 2006).

EXHIBIT 1.2 WORLD BANK SIX ELEMENTS OF GOVERNANCE: MAJOR GDP ECONOMIES AND LOWEST RANKING ECONOMIES

as globalized economies are very interdependent on one another. Some of the fastest growing economies lag in improving compliance. (See Exhibit 1.3.)

We did not find a direct correlation between growth and governance. China, India, and Russia are among the fastest growing major economies in the world, but lag in improving governance. (See Exhibit 1.4.)

Country Quadrille Rank	World Bank Governance (Six Elements)	Globalization (Trade as % of GDP)	Average	Standard Deviation*
United States	1	1	1.00	0.00
China	3	4	3.50	0.71
Japan	1	2	1.50	0.71
India	3	4	3.50	0.71
Germany	1	2	1.50	0.71
United Kingdom	1	1	1.00	0.00
France	1	2	1.50	0.71
Italy	2	2	2.00	0.00
Russia	4	4	4.00	0.00
Brazil	3	4	3.50	0.71
Canada	1	1	1.00	0.00
Mexico	3	3	3.00	0.00
Spain	1	2	1.50	0.71
South Korea	1	2	1.50	0.71
Indonesia	4	4	4.00	0.00
Australia	1	1	1.00	0.00
Average	**1.94**	**2.44**	2.19	0.35
Standard deviation	**1.18**	**1.21**		

*Standard deviation under 1 suggests a strong correlation.
Source: Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, ''Governance Matters V: Governance Indicators for 1996–2005'' (September 2006).

EXHIBIT 1.3 WORLD BANK GOVERNANCE VERSUS GLOBALIZATION

1.6 GROWTH OF GLOBAL TRADE

At this point, you may be asking yourself: What does this have to do with me? The answer comes in the World Trade Organization's 2005 statistics expressed in a chart of the growth in global trade versus production. Exhibit 1.5 shows that global trade has consistently grown at about twice the rate of production for more than 50 years. In short, very few of us will operate in isolation; we will need to navigate our way through a maze of laws, regulations, and standards no matter where we live and no matter what type of enterprise or organization we are involved with.

The growth in global trade is not restricted to a few regions. Ironically, North America has one of the lowest growth rates in both imports and exports from 2000 to 2004, as shown in Exhibit 1.6.

1.7 SIMPLE SUGGESTIONS TO IMPROVE GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE (GRC)

(a) TAKE A HOLISTIC APPROACH TO GRC. Organizations. An expensive and painful approach to the subject of governance, risk management, and compliance (GRC) is to treat it in a piecemeal and disjointed fashion, as a series of unrelated

Country Quadrille Rank	GDP Growth Rate	World Bank Governance (Six Elements)	Average	Standard Deviation*
United States	3	1	2.00	1.41
China	1	3	2.00	1.41
Japan	3	1	2.00	1.41
India	1	3	2.00	1.41
Germany	4	1	2.50	2.12
United Kingdom	4	1	2.50	2.12
France	4	1	2.50	2.12
Italy	4	2	3.00	1.41
Russia	1	4	2.50	2.12
Brazil	4	3	3.50	0.71
Canada	3	1	2.00	1.41
Mexico	3	3	3.00	0.00
Spain	3	1	2.00	1.41
South Korea	3	1	2.00	1.41
Indonesia	2	4	3.00	1.41
Australia	3	1	2.00	1.41
Average	**2.88**	**1.94**	2.41	1.46
Standard deviation	**1.09**	**1.18**		

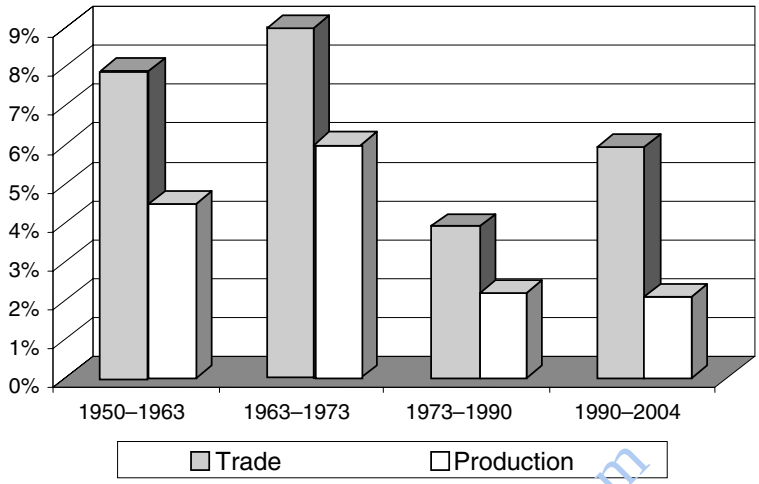
*Standard deviation under 1 suggests a strong correlation.
Source: Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, ''Governance Matters V: Governance Indicators for 1996–2005'' (September 2006).

EXHIBIT 1.4 WORLD BANK GOVERNANCE VERSUS GDP GROWTH RATES

tasks, and as an unfair and added cost with few tangible benefits—a necessary evil to doing business. A more sensible approach is to accept improved governance as a strategic imperative and key to the growth and prosperity of all organizations. This entails setting the example at the top of the organization and then having all managers take ownership to the process. Once this occurs, the lower-level activities of risk management and the internal controls to meet laws, regulations, and standards will start to fall into place.

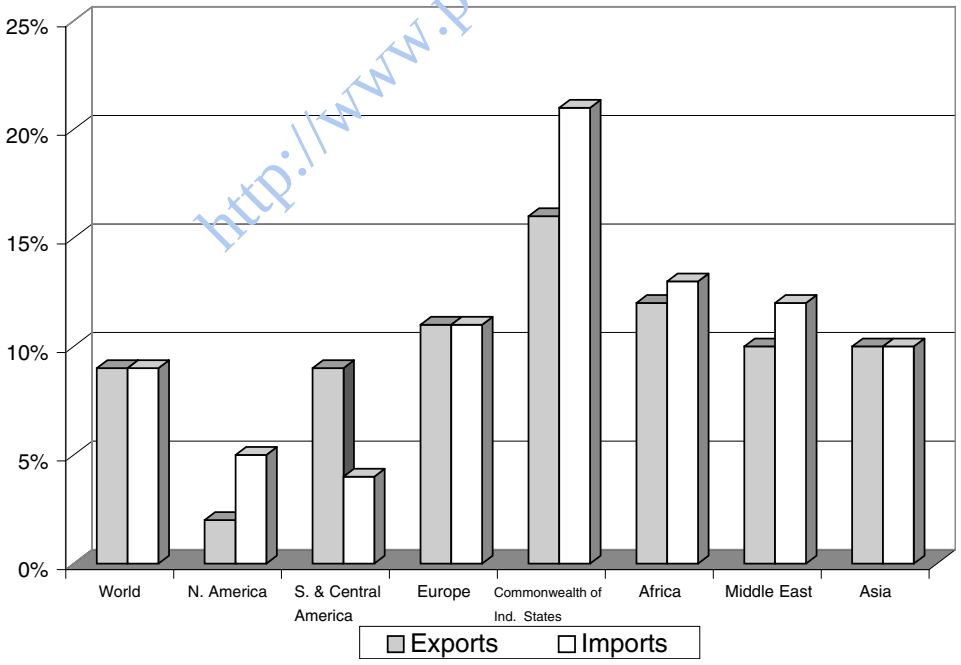
It is natural for companies to complain about the cost of complying with regulations and best practice frameworks. Many of the loudest critics fail to mention that the high costs of compliance are caused by decades of neglect, mergers and acquisitions, and the shortsightedness of their management. The internal control improvements forced by regulations will ultimately make organizations more efficient and therefore more profitable.

Regulators. Regulators have not always done a good job of considering the costs versus benefits of laws and regulations they create and administer. While there are some good efforts underway to harmonize regulations and standards, there are still far too many local variations in place to protect the parochial interests of governments and industries. Protectionist regulations typically fail



Source: World Trade Organization, 2005 International Trade Statistics.

EXHIBIT 1.5 GROWTH IN GLOBAL TRADE VERSUS GLOBAL PRODUCTION



Source: World Trade Organization, 2005 International Trade Statistics.

EXHIBIT 1.6 ANNUAL GROWTH IN TRADE, 2000–2004

and cause more harm than good. The goal should be to create a cross-border level playing field based on best standard frameworks that facilitate economic growth and prosperity. The OECD Principles, the IFRS/global GAAP, and the Kyoto and Basel II accords are all examples of movements in the right direction.

(b) MAP PROCESSES TO CONTROLS TO AUDITED REGULATIONS. Organizations. In order to avoid redundant compliance activities, it is critical to create a matrix that captures the relationships among business processes, the risks associated with processes, the internal controls deployed to mitigate the risks, the tests used to validate the effectiveness of the controls, and finally the regulations to which the internal controls apply. The example of accounts payable illustrates the point.

The accounts payable process covers the activities to pay suppliers for the goods and services they provide a company. One of the many risks associated with the accounts payable process is that a buyer and/or a payables accounting clerk would commit fraud by setting themselves up as a supplier to the company. The control to prevent this is typically known as segregation of duties (SOD). Most financial governance regulations (Sarbanes-Oxley, OECD Principles, Basel II, etc.) contain requirements to prevent violations in segregation of duties. The tests auditors use would include testing access and change controls in the accounts payable application software for the existence of detective and/or preventive controls. By mapping the process, risk, control, audit test, and regulations, an organization can avoid redundant compliance costs by using one control and audit test for multiple regulations. This will also help organizations make the business case for standardizing and automating the control and testing process.

Regulators. Regulators should publish a matrix with the mapping of the common processes that most companies will have to deal with in their compliance activities, including the acceptable tests for each regulation. Regulators should maintain and publish recommended best practices and lessons learned to assist organizations in improving their compliance performance.

(c) RATIONALIZE AND PRIORITIZE RISKS. Organizations. Even the smallest organization can implement a process to rationalize and quantify risks. It can be as simple as creating a scoring system for three or more variables of risk such as economic impact (severity), likeliness of occurrence (frequency), and ability to detect (discovery). Such a system requires a consensus from the audit committee down to the business owners of each organization. Those risks and controls with the highest risk scores would obviously receive the greatest level of effort and should be the first candidates for process and technology improvements.

Regulators. As we discuss in our COSO and operational risk chapters, it is time to revisit the effectiveness of any risk framework that does not provide the means to quantify risks.

(d) INCREASE CONTROLS STANDARDIZATION AND AUTOMATION. Organizations. Manual controls are, by nature, costly and ineffective. Automated controls lower costs and lower risks. Process improvements go hand in hand with automation. It makes little sense to automate inefficient and nonstandardized controls. Auditors will typically want to review manual controls every quarter, because manual controls are only as good as the person handling them. Auditing manual controls is more labor intensive and less effective than auditing automated controls. Automated controls do not have to be overly complex, either. The company can start with a good document and records management system, and then expand to automated work flows to control key business processes that have the greatest impact on financials or the greatest threat of fraud.

Regulators. While regulators and external auditors are not supposed to be technology experts, they need to increase their understanding of the many compliance automation tools that have been available for years. This is not to say that they are advocates for overly complex and expensive technology solutions, but they should be advocates for basic tools that are readily available and affordable in the marketplace. Tools to control document and records management and the audit operations, segregation of duties, financial consolidation, and application controls have been around for some time and will continue to drop in cost. In some cases, regulators and auditors have a conflict of interest in recommending these solutions, in that the tools will reduce the need for audit services. Fully automated controls with remote-view-only access could eventually make much of the on-site audit activity a thing of the past.

(e) CREATE AN INTERNAL CONTROLS GRADING SYSTEM FOR STOCKS. Organizations. Organizations should accept improved internal controls as a strategic competitive advantage and not as simply a cost of doing business. Regardless of the regulatory requirements, improved internal controls are a sound investment that will lower costs and improve decision making.

Regulators. The debate continues as to the cost versus benefits and effectiveness of measures to improve internal controls. Investors do need protection against organizations that lack effective internal controls. In the United States the system is punitive, with material weaknesses charged against wrongdoers but nothing rewarded to those who have excellent internal controls. It is a simple pass/fail system in which there are no tangible rewards for excellence. The same companies that have not undergone expensive internal control assessments are listed alongside those that have failed assessments (material weaknesses or financial restatements) or have not yet taken them at all. In the United States, nonaccelerated and foreign filers were not required to meet Section 404 requirements through 2006. There is no simple means to know the compliance status of a listed company.

A simple internal controls grading system for publicly traded companies may provide at least a partial answer. (We also include this recommendation

in our U.S. corporate governance chapter.) In such a grading system, those companies that have excelled in meeting tough internal controls requirements over an extended period would receive the highest score. Those with internal controls issues would receive lower grades. Smaller or start-up companies would be given the ability to opt out of the process and be given an "X" grade. A company's internal controls grade would appear next to its stock symbol, making it easy for even a casual investor to decide among offerings based on their internal controls scores.

A more complex grading system would require a cross-border consensus around acceptable internal controls standards and frameworks—a commonsense version of Sarbanes-Oxley that quantifies risk and seeks controls for the significant few and not the insignificant many. It would include generic and industry-specific best practice internal controls frameworks. Such a system would also require a consensus around breaches in internal controls, sometimes called material weaknesses. Ideally, all publicly traded companies would be graded on the same basis.

1.8 WHY READ THIS BOOK: THE CASE FOR GOOD GRC

Surveys have indicated for many years that investors will pay a stock premium for companies that are well governed. It makes sense that a lower-risk investment is seen as a safe haven. If the safe haven also has a good track record of stability and profit growth, the premium will increase. The size of the premium is very market dependent, with greater premiums in more poorly governed markets. McKinsey and Company's 2002 survey showed premiums ranging from 11 percent in Canada (the best-governed country, according to our World Bank data) to 40 percent in developing markets.[17] The premiums also wax and wane based on the scandal cycles—typically increasing after investors witness Enron-type collapses, but decreasing during boom times due to short memories.

Well-governed companies have other advantages beyond premium stock prices. They can typically access capital at lower costs than their poorly governed competitors. The major rating agencies (Fitch Ratings Ltd., Moody's Investors Service, and Standard & Poor's) are more focused on good governance, risk, and compliance management in their company assessments. In some industries they are holding companies to higher standards ahead of the regulators. (The impact of rating agencies on operational risk is discussed in two of our chapters: Chapter 14, "Operational Risk Management (ORM) Best Practices," and Chapter 17, "Operational Risk Management in Financial Services.") In the United States, privately held companies thought that they were immune to the Sarbanes-Oxley Act until they found banks and insurers looking for them to meet the higher standards in order to receive the most competitive rates of financing and insurance.

Well-governed companies will typically attract and retain higher-level talent. Employees would rather brag to their family and friends about the good deeds and reputations of their employers than apologize about their publicly embarrassing misdeeds and failures.

Some of the benefits of good governance are:

- Greater access to capital markets
- Lower cost of capital
- Ability to attract and retain higher-caliber talent
- Higher-quality and more timely decision making
- Greater ability to respond to and recover from crises and disasters
- Improved operational efficiency and lower operating costs
- Fewer conflicts and lower stress levels
- Improved community and industry reputation

1.9 ORGANIZATION OF THE HANDBOOK

Corporate Governance. Part One provides high-level overviews of corporate governance. It includes an evaluation of the effectiveness of the COSO framework, corporate tax problems caused by the dual book system, the importance of the internal audit function, the need to control outsourced processes, the importance of consolidation and reconciling financial statements as part of the period end process, and the issues around stock options. Part One concludes with two chapters on fraud and corruption—an introduction to the subject and the means to fight the problem.

IT Governance. Part Two provides high-level overviews into information technology governance, including a general discussion about IT governance, the International Standards Organization (ISO) standards impacting IT, and the role of Control Objectives for Information Technology (CobiT).

Operational Risk. Part Three provides four chapters on operational risk. It begins with an introduction to best practices in operational risk management, followed by discussions of six sigma as a good practice to control operational risk, quantitative tools that can be deployed to control operational risk, and measuring the effectiveness of operational risk programs.

Technology and Tools. Part Four provides a survey of the technology and software tools available to improve governance, risk management, and internal controls. It includes the following tools: enterprise search and automated testing, audit operations applications, segregation of duties, database management, and product life cycle management (PLM). It concludes with an introduction to eXtensible Business Reporting Language (XBRL).

Environmental Governance. Part Five provides national, regional, and material environmental guidance, with chapters covering materials (e.g., the European Union's Reduction of Hazardous Substances/Waste Electrical and Electronics Equipment directives), China, the European Union, India, Latin America, and the United States.

Industry Governance. Part Six covers a variety of industries that have unique governance requirements, including electronics (homologation), Internet

commerce (privacy versus security), logistics, transportation, pharmaceuticals, the public/government sector, retail, supply chain, and telecommunications.

Financial Services Governance. Part Seven covers the unique challenges facing the financial services industry with chapters on insurance, Islamic finance, operational risk in banking.

Regional and National Guidance. Our final section provides high-level introductions to corporate governance in the top 16 GDP nations, capturing 75 percent of global GDP as measured by purchasing power parity (PPP); Islamic nations; and the regions of Africa, Latin America, Southeast Asia, and the European Union.

Supplemental Chapters. We have also included a web link to six supplemental chapters and case studies: banking in China, Malaysian insurance, South African banking, bad behavior in Australian banking, and measuring effectiveness and performance of GRC in the United States.

Notes

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10. See COSO's Executive Summary, "Enterprise Risk Management—Integrated Framework," September 2004.
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17. McKinsey and Company, "Global Investor Opinion Survey," 2000 and 2002.