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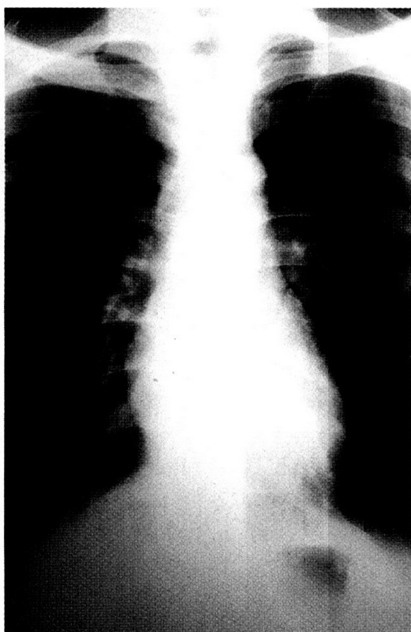
On Corruption and Accounting: No Panacea for a Modern Disease

By Bert J. Zarb

If technological advancement is the hallmark of progress in modern society, then corruption is its bane. Along with prosperity and progress, globalization acts as an agent of change in international trade. This increased internationalization of business has propagated the dark side of domestic practices as well as raised the specter of corruption. Globalization has turned companies into global institutions; it has challenged daily economic life and national identity; and it has created a persistent movement toward cultural and business homogenization.



The tentacles of corruption have touched several sectors of society. Accounting, on both the national and international level, has not escaped unscathed. Although corruption is a social malaise that engulfs development and ravishes the fabric of society, steps can be taken to curb it. Adopting a set of universally accepted financial accounting standards, striving toward a high level of economic development, observing the cultural construct of uncertainty avoidance, operating within a country's legal system, and mandating the use of audit committees could be ways to fight corruption. The recent accounting scandals show how businesses of all sizes, in any location, are vulnerable to the malevolent intentions of corrupt individuals who create chaos and seek personal enrichment at great cost to others, leaving a legacy of financial ruin.

Corruption takes many forms, including bribery, fraud, illegal payments, money laundering, smuggling, extortion, and nepotism. Although fighting corruption covers an array of issues and occurs on many fronts, there is no panacea; the struggle to stop it entirely—or at least curb it—is one of Sisyphean proportions.

Defining and Justifying Corruption

Perhaps one of the first problems of corruption is defining what it really is. Some of the definitions found in the literature focus on the abuse of public roles and resources for private gain. Others suggest that distinguishing between public and private corruption is difficult, and that the reasons for engaging in corrupt activities have become so ingrained in the system that nobody talks about them. While corruption's effect on the economic performance of a country varies with that country's individual conditions, its negative effects either force governments to intervene where they should not, or impede governments from promulgating laws and implementing policies.

Scholars have defined corruption based on rules and laws because of the stability, universal application, and relative precision that formal laws and rules offer. At times, however, laws are broken and lose their legitimacy. Consequently, the issue becomes whether corruption should be described in terms of its social significance rather than its nominal meaning. The literature is replete with studies showing that classifying specific actions alone ignores the place of morality and justice in a society. Corruption can also be seen as "the abuse of public roles or resources for private benefit" by appreciating that the terms "abuse," "public," "private," and "benefit" are subject to considerable dispute and interpretation.

An interesting strand of literature purports that corruption enhances economic efficiency. The argument goes that this is because corruption might not affect the short-run efficiency of an

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economy if all it does is transfer economic rent from a private party to a government official. In the long run, however, expectations of bribery clearly wreak havoc on the number and types of contracts put up for bid, how contracts are awarded, and the speed or efficiency with which public officials perform their work in the absence of bribes.

Corruption can also be seen to increase economic efficiency when enterprises are allowed to avoid restrictive regulations or confiscatory taxes. Some proponents of this line of reasoning claim that, ethical considerations aside, corruption actually reduces costs by cutting bureaucratic red tape and making public officials more flexible. Other scholars have shown that corruption could play an efficiency-enhancing role, the suggestion being that the size of bribes paid by different economic agents could reflect their different opportunity costs and also achieve "Pareto-optimal" allocation. This has led to the coining of the term "efficient grease." Other studies have suggested that if bribes "grease the wheels of commerce," then initiatives by governments and other organizations to combat corruption in international trade would be counterproductive.

Weapons to Fight Corruption

The impact of corruption on business in particular and society in general is such that it diverts resources from productive to nonproductive sectors, and enriches a few of the rich at the expense of everyone else. Apart from increasing risk and the cost of doing business, corruption damages investor confidence, stifles economic growth, and deters foreign direct investment. International financial reporting standards, an increased economic development, the cultural construct of uncertainty avoidance, an effective legal system, and active audit committees are among the weapons that can be used in the fight against corruption. ❑

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emerging trends

Governance Changes Resulting from the Sarbanes-Oxley Act

Lead directors are becoming standard in boardrooms, and active CEOs and COOs are becoming reluctant to serve as directors, according to a recent study of boards of directors for S&P 500 companies conducted by the executive recruiting firm Spencer Stuart.

Despite calls for more independent chairmen, less than 10% of all S&P 500 boards have independent chairmen. The CEO is still chairman on 71% of S&P 500 boards, and on 140 boards where the CEO is not chairman, 67% are not independent. On the other hand, boards recognize the need for lead (also called presiding) directors. A total of 94% of all S&P 500 boards now have a lead director, compared with 85% last year; only 36% of companies reported having this board position in 2003.

Active Senior Executives Continue to Decline Director Positions

Given the increasing time commitment required for board service and a perception by some of greater financial and professional risk, recruiting active CEOs or COOs as directors is becoming more difficult, although companies prefer them. Active CEOs on average now serve on less than one outside corporate board, down from two in 1998. Active CEO/COOs account for 32% of new board appointments, down from 53% in 2000. Spencer Stuart concludes that because of this, boards are increasingly turning to either retired CEOs or active executives at the next level down (e.g., division and subsidiary presidents) for directors.

A long-term trend toward boards with fewer directors continued during the year. The average board size in 2005 was 10.7 directors, as compared to 12 in 1998. Two-thirds of S&P 500 boards now have between nine and 12 members.

Women Underrepresented

Twelve percent of boards still have no women. While 20% of newly appointed directors are women, the total number of women on S&P 500 boards remains the same as last year, 15%. Fifty-eight S&P 500 companies, or 12%, have no women on their board. A total of 43% were technology firms, and the state with the highest number of boards without women was California, with 29%. Sixty-two percent of boards without a woman director had annual revenues below $4 billion.

Board Composition

The survey shows that the most visible result of SOA in terms of board composition was an immediate increase in the number of new independent directors. Although appointments of new directors increased immediately after the passage of SOA, they have generally returned to traditional levels. Annual appointments of new independent directors rose from 278 in 2001 to 401 in 2002, 393 in 2003 and 443 in 2004. In 2005 the number of newly appointed directors dropped by almost 25%, to 333.

A total of 98% of boards have identified at least one financial expert, up from 91% last year and 21% in 2003. S&P 500 companies identified 908 financial experts on 468 boards in 2005, compared with 832 in 2004 and 146 in 2003. The percentage of designated financial experts on boards has increased to 18% of all board

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