Shodhshauryam, International Scientific Refereed Research Journal
© 2020 SHISRRJ | Volume 3 | Issue 1 | ISSN : 2581- 6306

Sarbanes-Oxley Act Analysis and Its Effects on Corporate Governance

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Abstract
After Enron and WorldCom, two once-respected firms, failed spectacularly, Congress passed the Sarbanes-Oxley (SOX) Act in 2002. In addition to being a fundamental legal reform, SOX marks a shift in regulatory approach by incorporating a wide range of corporate governance measures within federal securities law. Prior to SOX, the federal regime consisted of disclosure requirements rather than substantive corporate governance standards, which were left to state corporate law because they were seen to be within the states' purview (Romano 2005). This method is altered by SOX, which gives the SEC clear guidelines and restrictions. Nevertheless, a large number of the governance clauses governed by SOX are not actually novel solutions to issues or shortcomings in the corporate environment. Rather, these are essentially rehashed concepts put out by corporate governance entrepreneurs (e.g., additional independent members in the board and prohibition on accounting firms providing advisory services to auditing customers). It is highly anticipated by practitioners and scholars that SOX will reform ineffective governance procedures and initiate improved bonding and monitoring systems in corporate governance. According to SOX proponents, companies may see improvements in operational performance and company value as they strengthen governance. Empirical data, however, suggests that this could not be the case. Numerous studies have looked into SOX, its requirements, and how they affect firm value and corporate governance. This paper examines previous research on the topic and links SOX to a number of topics in corporate finance as well as market valuation, including accounting firms' productivity and efficiency, decisions about going public and going private, small businesses, lobbying strategies, risk, return, as well as market reaction, trends in corporate governance, global implications and comparisons, and symptoms and underlying issues. The results of research on SOX & its effects are conflicting and not entirely clear. We propose two further suggestions. First, rather than only addressing the symptoms, the government should update SOX rules to address the root causes of issues in the accounting and corporate governance domains if it is to continue taking a one-mandate-for-all approach to SOX. The three-step model demonstrates that SOX requirements have not addressed auditors' diligence and intellectual capacity to identify issues or their abilities to identify suspicious activities. Second, the government should remove the mandatory force of SOX regulations and switch to a "comply, otherwise explain" strategy if it has no imminent interest in changing them as the first option suggests. Because the existing "one-mandate-for-all" system is too expensive for certain businesses, particularly small businesses, they choose not to comply. However, rather than coming from SOX requirements, the advantages of adhering to them might come from improved governance frameworks, especially more vigilant shareholders and an increasingly engaged marketplace for corporate control following Enron's collapse.

Keywords : Sarbanes-Oxley Act (SOX), Corporate Firms, Accounting Scandals, Auditors, JOBS Act, (EGC), CEO, CFO, PCAOB.

Introduction

A federal law known as the Sarbanes-Oxley Act of 2002 created extensive financial and auditing standards for publicly traded corporations. The law was drafted by lawmakers to assist shield the public, workers, and shareholders from dishonest financial practices and accounting errors. Corporate officers, accountants, and auditors were held responsible for the new regulations. These regulations were additions and modifications to a number of statutes that the Securities and Exchange Commission (SEC) enforced, such as the Investment Advisers Act of 1940 and the Securities and Exchange Act of 1934 (Exchange Act). The Sarbanes-Oxley Act is enforced by the SEC. The Act's primary goals are to:

- Strengthen criminal penalties;
- Regulate accounting;
- Provide new protections; and
- Encourage corporate accountability.

The main goal of the Act was to control internal audits, financial reporting, and other business operations of publicly traded corporations. Nonetheless, certain clauses are applicable to all businesses, including nonprofits and private corporations.

Penalties for violating the Act's requirements were also introduced. Corporate governance and financial disclosure are key components of Act compliance.

By imposing new reporting requirements on public accounting firms and company executives, the Sarbanes-Oxley Act, or "SOX," significantly changed corporate financial reporting for publicly traded companies. It was put into effect in 2002 as a reaction to the many accounting scandals that occurred in the late 1990s and beginning of the 2000s. The U.S. economy lost thousands of jobs as a result of these scandals, which also cost shareholders billions of dollars. The act decreased corporate fraud and increased the reliability of financial information given to investors by enacting greater criminal penalties, stronger civil fines, and more stringent reporting requirements.

Act creation and history

The Sarbanes-Oxley Act (SOX), enacted in the United States in 2002, is a federal law designed to enhance corporate governance and strengthen accountability in financial reporting to protect investors from corporate fraud. Although SOX is a U.S. regulation, its principles and implications have influenced corporate governance globally, including in India. In the wake of high-profile corporate crime cases, the Act aimed to restore investor confidence and enhance the accuracy of financial reporting by publicly traded corporations. The act bears the names of its sponsors, U.S. Representative Michael Oxley (R-Ohio) and U.S. Senator Paul Sarbanes (D-Md.). When he signed the act into law on July 30, 2002, former US President George W. Bush referred to it as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."

Corporate scandals at the beginning of the twenty-first century played a major role in federal lawmakers passing the Sarbanes-Oxley Act. One of the biggest, most prosperous, and most inventive businesses in the US was the energy company Enron Corporation. Enron collapsed in less than two years around 2000 as the company's dishonest business practices and the illegal actions of its executives were exposed. When word broke of WorldCom's own dishonest accounting methods, the telecom behemoth was enmeshed in a controversy. In 2002, the business declared bankruptcy and was fined $750 million by the SEC. • Tyco

International, a security systems firm, had a financial controversy prior to the Act; its chief executive officer (CEO) was sentenced to 25 years in prison, and its chief financial officer (CFO) was sentenced to five years in prison due to criminal accusations in the case. The former CFO and CEO of the corporation were found guilty of breaching various business laws, falsifying business records, and stealing hundreds of millions of dollars from the company.

In order to supervise and control public accounting firms that audit public businesses, SOX also established "Public Company Accounting Oversight Board (PCAOB)"a new quasi-government organization. Below are summaries of some of the most prominent accounting controversies.

The Sarbanes-Oxley Act brought about a thorough overhaul of public accounting firms' auditing procedures and corporate accounting practices. The number of restatements in both 2005 and 2006 makes the initial effects of SOX quite visible. Restatement increased by 66% to 1,600 in 2005 and reached a peak of 1,784 in 2006, shortly after the internal audit over financial reporting obligations was initiated. Restatement gradually decreased after 2006, hitting a record low of 711 during 2009. Please be aware that restatements that are 4.02 were more serious than those that are not. 4.02 Restatements indicate that the previously submitted financial statements are considered untrustworthy due to inaccuracies that were found to be material.

Opponents of the measure have claimed that SOX has caused more harm than benefit, despite the fact that many supporters of the bill maintain that it was required to address the corporate accounting crises. Congressman Paul Ryan & Arkansas Governor Mike Huckabee spearheaded the effort, claiming that SOX was unnecessary and that the high expenses of complying with the rules put American businesses at a disadvantage compared to their international rivals. They used the fact that, in the year after the implementation of SOX, the number of public businesses deregistered from public markets increased to bolster their arguments.

The JOBS Act, which was passed in April 2012 in response to these critiques, established a new class of businesses known as emerging growth companies (EGC) in order to offer some relief to recently listed public companies. Unless its gross revenues surpass $1.235 billion, it issues more than $1 billion in not convertible debt during a three-year period, or it becomes a large-accelerated filer, an EGC is free from SOX 404(b) over a period of five years. With fewer financial disclosures in yearly reporting and an exemption from external auditors' internal control attestation requirement, the EGC class aimed to reduce the cost of SOX compliance.

The Main Elements of the Sarbanes-Oxley Act

The eleven sections listed below are the main parts of the Sarbanes-Oxley Act:

Title 1. The Public Company Accounting Oversight Board (PCAOB)

Title 1 created the PCAOB, a nonprofit with the mission of supervising public accounting firms that offer audit services to publicly traded corporations. By inspecting audit workpapers and monitoring adherence to particular SOX components, the PCAOB improved the calibre of audits conducted by public accounting firms.

Title II. Independence of the Auditor

Title II helped lessen potential disputes of interest among audit clients and set the requirement for the independence of external auditors. The mandatory turnover of audit partners & the restriction on particular non-audit services offered to audit customers are highlights.

Title III. Corporate Responsibility

Senior executives are held accountable for the completeness and accuracy of their company's financial reporting under Title III, a civil requirement.

Title IV. Enhanced Financial Disclosures

Pro forma data, corporate officer stock transactions, and off-balance sheet transactions are all subject to stricter reporting obligations under Title IV. To further enhance a business's financial reporting procedure, an internal control structure must be put in place.

Title V. Conflict of Interest Analysis

Title V mandates disclosure of any known conflicts of interest and offers a code of conduct for security professionals. Restoring investor trust in the securities industry's reporting role is the aim of Title V.

Title VI. Authority and Resources of the Commission

The United States is granted Title VI. Professionals can be censured or prohibited from acting as brokers, advisors, or dealers by the Security and Exchange Commission (SEC), which has control over them. Restoring investor trust in the securities sector is the aim of Title VI.

Title VII. Research and Documents

The Comptroller General and SEC were tasked under Title VII to produce studies on the effects of 1) public accounting firm consolidation, 2) credit reporting agencies, 3) securities violations, and 4) enforcement actions. This research sought to determine whether investment banks were involved in the accounting crises of the early 2000s, in which investors were not informed of the true financial status of public firms and earnings were misrepresented.

Title VIII. Accountability for Corporations and Criminal Fraud

Employees who falsify, modify, or trash accounting reports in an effort to obstruct an examination of a company's financial records may face special criminal penalties under Title VIII, which also offers whistleblower protections.

Title IX. Strengthening Penalties for White Collar Crime

Title IX is a criminal clause that increases the monetary fines and length of incarceration for white-collar financial offenses.

Title X. Tax Returns for Corporations

It is advised by Title X that the CEO sign the business's corporate tax return.

Title XI. Accountability for Corporate Fraud

Corporate fraud, altering corporate accounting records, or impeding official proceedings are now considered criminal offenses under Title XI. The consequences for these acts are likewise strengthened. Additionally, it enables the SEC to halt business payments or transactions that are deemed to be significant or out of the ordinary.

To make the structure of the act easier to understand, the following table places each title into one of the following categories: Auditor, Corporate, Financial Reporting, or Regulator.

Multiple subsections that describe the Act's particular rules are included in each section of the Sarbanes-Oxley Act. The seven sections listed below are crucial for auditors and business officers to comprehend. The essential elements in each of the seven categories are reviewed in detail in this article.

1. Section 302: Corporate Responsibility for Financial Reports
2. Section 401: Disclosures in Periodic Reports
3. Section 404: Evaluation of Internal Controls by Management
4. Section 409: Real Time Issuer Disclosures

5. Section 802: Criminal Penalties for Altering Documents

6. Section 806: Sarbanes Oxley Whistleblower

7. Section 906: Corporate Responsibility for Financial Reports

A comprehensive summary of all sections

Section 302. Corporate Responsibility for Financial Reports

The Chief Executive Officer (CEO) & Chief Financial Officer (CFO) must attest to the accuracy of the company's internal controls and its financial report in this section. The certification attests to the fact that the officer has read the report and that no material facts are false. Additionally, the financial statements accurately depict every facet of the issuer's financial situation for the time periods included in the report, according to the officer's understanding of them.

The officers are also tasked by Section 302 with creating and preserving an atmosphere that is conducive to effective internal controls. Within ninety days following the report, company officers had to have assessed how well the issuer's internal controls were working. The officers are also required to notify any serious flaws in the internal control system's architecture and functioning that would compromise the issuer's capacity to gather, process, compile, and report financial data to its audit committee and external auditors. The firm's officers are also required to report to the auditors any significant flaws in the internal control system and any fraud, whether significant or not, involving the management of the company or staff members who play a crucial part in the functioning of internal controls.

Section 401. Disclosures in Periodic Reports

The financial disclosures mandated by Section 13 according to Securities Exchange Act of 1934 are improved by this section. Disclosure of all significant accurate adjustments determined by the public accounting firm is required. Additionally, the issuer's relationships with unconsolidated entities, including material off-balance sheet transactions, arrangements, obligations, and contingent obligations, may have a material impact on the company's financial condition, operations results, capital expenditures, liquidity, capital resources, or significant components of the issuer's revenue or expenses, either now or in the future. Furthermore, pro forma data cannot include any false information or leave out any important details that would make the information deceptive to investors.

Section 404. Evaluation of Internal Controls by Management

Section (a), Section (b), and Section (c) comprise Section 404 of SOX. The main goal of section 404 is to increase the accuracy of a company's financial reporting by requiring management to evaluate how well its internal controls for financial reporting are working. Let's talk about each section's specifics.

There are no exceptions to Section 404(a), which is applicable to all public issuers. Management must assess the operational efficacy of the business's internal controls for financial reporting in order to comply with this provision. The internal control system of the business needs to be recorded and reviewed every year. The company's Form 10-K then reports the findings of the management's yearly evaluation of internal controls.

Public issuers are required by Section 404(b) to hire an outside auditor to verify and document management's evaluation of internal controls. Recall that while section 404(a) requires management to conduct an internal assessment, section 404(b) calls for an impartial auditor to determine the accuracy of management's assessment of the organization's internal controls. The Public Company Accounting Oversight Board (PCAOB) sets guidelines that independent auditors must adhere to when reporting on the company's internal controls. The auditor's assessment of the controls is presented in the audit report portion of Form 10-K. More background and information on this part can be found at the American Institute of Certified Public Accountants (AICPA). More details on creating a thorough SOX testing program may be found in SOX Testing: How to Build a Well-Rounded Testing Program.

Certain organizations are exempt from Section 404(b) under Section 404(c). In particular, companies that are not large-accelerated filers or accelerated filers are exempt. Another name for this group of businesses is non-accelerated filers. Additionally excluded are emerging growth corporations (EGC). An organization must have less than $75 million in public float, or the value of shares held by the public, in order to be eligible as a non-accelerated filer. If a company does not surpass specific benchmarks, the SEC grants it EGC status for the first five years following its initial public offering.

Section 409. Real-Time Issuer Disclosures

According to this clause, issuers must notify investors in almost real-time of any significant changes to their financial situation or any actions that are required or beneficial to safeguard investors.

Section 802. Criminal Penalties for Altering Documents

The penalties for the corporation and its auditors were increased under this section. In order to obstruct, hinder, or influence any legal inquiry into the issuer, anyone found to have altered, destroyed, mutilated, concealed, or fabricated papers or tangible things suffers a fine and a potential prison sentence of 20 years.

This clause extended the time that auditors had to keep any audit and review workpapers. According to the original regulations, any accountant conducting an audit on a securities issuer was required to keep its audit or review workpapers for at least five years following the conclusion of the fiscal year during which an audit or review was finished. The retention time was extended to seven years by the final rule, nevertheless. A fine and up to ten years in prison are the consequences of breaking the record retention regulations.

Any documents that serve as the foundation for the audit or review of the issuer's financial statements are referred to as workpapers. A document must meet the following requirements in order to qualify as a workpaper:

1. documents produced, transmitted, or obtained in relation to the audit, review, and
2. any records containing financial information, opinions, analyses, or conclusions pertaining to the audit or review.

Section 806. Sarbanes Oxley Whistleblower

Workers of publicly traded companies who provide proof of fraud or aid in the investigation of scams against the company's shareholders by a federal regulatory body, law enforcement agency, member of Congress, a congressional committee, or an individual with supervisory body over the employee are further protected under Section 806. The restrictions against relationships with employees were also broadened under Section 806.

Organizations who penalize against whistleblowers may face legal action from the SEC under this clause. Commission Rule 21F-17(a) reinforces this provision by forbidding any action by an individual or organization to prevent another person from reporting a potential securities violation to the SEC immediately. Severance agreements and non-disclosure agreements (NDAs) may be illegal under federal law if they expressly forbid employees from bringing up issues with the SEC directly.

Section 906. Corporate Responsibility for Financial Reports

The Sarbanes-Oxley Act's Section 906 mandates that public businesses include particular certifications from the CEO and CFO in every period report that includes financial statements. According to the certification, the data in the financial statement accurately depicts the company's financial situation and operational outcomes in all relevant respects. False statements in these certifications can result in a fine of up to $1 million & a maximum jail sentence of 10 years. Additionally, an officer might be subject to fines of up to $5 million & 20 years in prison if they knowingly certify a fraudulent financial report.

To ascertain if the financial statement accurately depicts the state of the company's finances, the CEO and CFO should exercise a reasonable amount of due diligence. The officials ought to conduct a thorough examination of the accounting record & speak with the staff members of the company who created it. People who should be contacted about the financials' preparation include Chief Accounting Officer (CAO), Risk Management Officer (RMO), General Counsel, and Chief Investor Relations Officer. Personnel from the external audit team or the company's principal audit partner may also be consulted.

The Management Discussion & Analysis (MD&A) section of financial report, any important accounting policies, recognized financial trends, the state of the company's internal controls, and any important internal audit procedures should all be discussed by the CEO and CFO. Examining the sub-certifications of important players in the business's financial reporting procedure is another recommended step. The steps taken by both the CEO and the CFO to examine the company's financial report should also be documented.

Despite their apparent similarities, section 302 while section 906 differ in that the former is a civil provision as well as the latter is a criminal provision.

Governance of Companies and Sarbanes-Oxley

Enhancing corporate governance by giving public company executives more accountability for financial reporting was one of SOX's main goals. In order to hold business executives responsible for inadequate financial reporting, Title III, IV, IX, X, and XI imposed a number of additional criteria. Additionally, new and harsher sanctions for executives who intentionally commit fraud or behave in bad faith encourage business leaders to keep a careful eye on their financial reporting and make sure investors are receiving accurate, trustworthy information.

Section 302 of Title III required the Chief Executive Officer (CEO) or Chief Financial Officer (CFO) to attest to the accuracy of the company's internal controls and its financial reporting. Executives were held directly accountable for misleading financial reporting once SOX was passed, and they were no longer able to overlook issues with their organization's financial reporting system. Companies were now held personally responsible and subject to civil fines if their financial statements were false, deceptive, or misleading to investors. In order to further assess the performance of the company's internal controls, select external auditors, and guarantee that the financial reporting is accurate & devoid of major errors, this section also mandates the establishment of an independent audit committee.

Corporate governance was further improved by Title IV, Enhanced Financial Disclosures, which required executives to attest to the efficacy of their organization's internal control system. There are no exceptions permitted, such as for EGCs or small reporting firms. Section 404(a) of Title IV, which all issuers must abide by, requires executives to actively participate in and fully comprehend their organization's internal controls regarding financial reporting. Some of the biggest changes were brought about by Title IX, White Collar Penalty Enhancement. Like Section 302, Section 906 mandates that the Chief Executive Officer (CEO) & Chief Financial Officer (CFO) provide particular certifications on the financial statements of the business. Section 906 enhanced criminal sanctions for any fraudulent claims related to these certifications, which is the most crucial thing to comprehend. Penalties include up to 10 years in prison and a fine of up to $1 million. An officer might be fined up to $5 million & imprisoned for up to 20 years if they knowingly certify a fraudulent financial report.

The subject of criminal offenses was carried over into Title XI, Corporate Fraud Accountability, which extended criminal penalties to include anybody acting in bad faith. Anyone engaging in corporate fraud, altering company financial records, or impeding official processes faces criminal consequences in the form of fines, up to 20 years in prison, or both under this clause, which applies to more than just the CEO & CFO.

When taken as a whole, titles III, IV, IX, and XI work together to improve corporate governance and financial reporting. These new requirements contribute to better financial reporting through a combination of new criminal penalties, enhanced civil penalties, and mandatory certifications.

Principal Advantages of Sarbanes-Oxley (SOX)

Many more benefits for investors were brought about by the 2004 introduction of SOX. For investors or the public at large, public companies' financial reporting has improved in accuracy, dependability, and transparency. Improved corporate governance, increased regulatory monitoring, and a greater focus on putting internal control systems into place and evaluating them were the main factors that propelled the improved financial reporting. Describe SOX controls. More details on locating pertinent controls with a business's internal control structure may be found in Best Practices for Determining Your Scope.

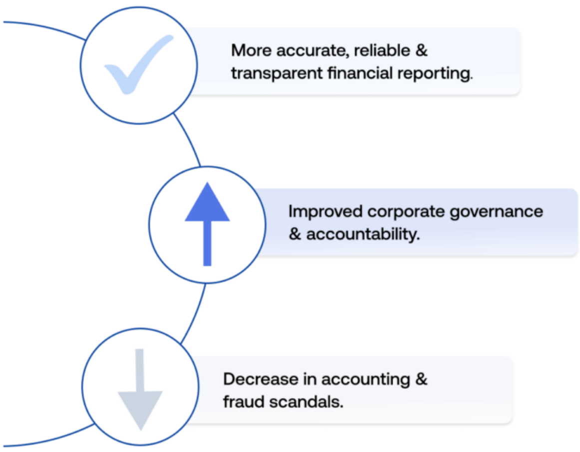
Because of its emphasis on enhancing audit standards, putting in place an efficient internal control structure, and having external auditors certify that framework, Section 404 of SOX is regarded as the foundation of SOX. When SOX was passed in 2002, the idea of internal control of financial reporting wasn't new. The Committee of Sponsoring Organizations of the Treadway Commission (COSO), which was established in

1985 and supported the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative that examined the primary causes of fraudulent financial reporting, is best known for its work on the topic of using internal controls to monitor and enhance financial reporting. This idea dates back to the early 1980s. More information about the COSO framework & internal controls may be found in Foundations of the COSO Framework: The Fundamentals for Integrated Internal Controls. It compelled businesses to invest time and resources in creating an efficient internal control system by mandating that CEOs and CFOs review and assess their organization's internal control system on an annual basis. More capable internal audit divisions were established to carry out year-round inspection and evaluation of internal controls in order to assist executives in assessing the internal control environment. Additional information about internal audit departments & their responsibilities may be found in Internal Audit 101: All You Need to Know. Additionally, this part requires external auditors to evaluate the efficacy of a company's internal control architecture, with limited exceptions for smaller issuers. A certified audit opinion regarding internal controls, which indicates that there are misstatements or omissions in the financial accounts, and significant repercussions for the company's leaders and board of directors would follow a failure.

As was previously mentioned, SOX improved corporate governance by requiring executives to certify financial reports and by imposing new criminal penalties in addition to increasing civil penalties. This stopped business leaders from disregarding or denying their organization's financial reporting procedure. Executives of a corporation were now subject to both civil and criminal liability if their financial statements were erroneous, either as a result of deliberate fraud or incompetence.

Overall financial reporting was also enhanced by heightened regulatory monitoring and increased federal authority. The SEC can freeze business transactions or payments that are deemed to be significant or out of the ordinary under Title XI. Additional whistleblower rights are offered to employees under Title VIII. Numerous accounting problems that occurred before and even after SOX were exposed by internal whistleblowers. Companies find it more and more difficult to conceal fraud from investors and the public as a result of the expanded statutory safeguards for these whistleblowers.

Key Benefits of the Sarbanes-Oxley Act



Relevance of SOX in India

India, with its growing global business presence, especially in IT and financial services, has companies listed on U.S. stock exchanges. These companies must comply with SOX requirements. Additionally, the act's principles have influenced Indian corporate governance laws and practices.

Key Provisions of SOX which are already discussed

1. Section 302. Corporate Responsibility for Financial Reports.
2. Section 404. Management Assessment of Internal Controls.
3. Section 806. Protection for Whistleblowers.
4. Section 802. Criminal Penalties for Altering Documents.

Indian Context: SOX-Influenced Regulations

India's corporate governance framework aligns with SOX through:

1. The Companies Act, 2013. Mandates independent directors, audit committees, and internal control mechanisms.
2. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. Strengthens corporate governance for listed entities.
3. Clause 49 of the Listing Agreement. Introduced corporate governance norms, including CEO/CFO certification of financial statements.

Examples of SOX in Action in India

- Infosys. As a company listed on NASDAQ, Infosys complies with SOX requirements, including stringent internal controls and financial disclosures.
- Wipro. Another Indian IT giant listed in the U.S., ensuring SOX compliance through robust internal control systems and regular audits.

Comparative Table: SOX vs. Indian Corporate Governance Laws

Aspect	**SOX (U.S.)**	**Indian Framework**
Applicability	U.S.-listed companies, including foreign firms	Indian companies (Companies Act, SEBI norms)
Internal Controls	Mandatory under Section 404	Mandated under Companies Act, 2013
Whistleblower Protection	Section 806	Companies Act, 2013 (Section 177)

Audit Committee	Independent audit committee	Required for listed companies
Certification of Reports	CEO/CFO certification (Section 302)	CEO/CFO certification (Clause 49)

Impact of SOX on Indian Companies

- Enhanced Transparency. Indian firms with U.S. listings have adopted stricter controls, improving trust among global investors.
- Compliance Costs. High costs for SOX compliance (e.g., audits and reporting) have impacted profitability for smaller firms.
- Cultural Shift. Emphasis on ethics and accountability in corporate governance.

Challenges

- High Compliance Costs. Maintaining SOX standards is resource-intensive.
- Global Coordination. Indian firms need to align with both Indian and U.S. regulations.

Conclusion

While SOX is a U.S. law, its influence on Indian corporate governance is significant. Indian companies listed in the U.S. or with global operations adopt SOX-compliant practices to ensure transparency, accountability, and investor confidence. The alignment of Indian laws with SOX principles reflects India's commitment to global governance standards.

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