Analysis of anglo-american corporate governance stemming

Business, Corporate Governance

Ted Seabrook, Phillips Exeter Academy's venerable wrestling coach during the 1960's when I was a student there, taught me an invaluable lesson that I have found applicable to a myriad of situations beyond the grappling mat. In describing how to bring a man down when, for example, the wrestlers begin in the down position and one finds himself on the top with the opponent beneath him, Seabrook admonished us that " a man is a table. To bring him down, therefore, all you need do is create an insecurity in one of the legs of the table.

Then, you apply force in line with that insecurity. " It was this image that came to mind as I began to collect my thoughts about what appeared to be the sudden, widespread failures of corporateaccountabilityas demonstrated by the recent demises of WorldCom, Enron, Tyco, Global Crossing, and the like: This was the result of unrestrained forces acting upon insecurities inherent in the system. The suddenness and widespread nature of the problem seemed to stagger investors’ faith in financial markets.

Investors globally began to ask, "[H] ow much confidence should...[they] place on companies' financial statements? " 1 Indeed, in the case of WorldCom, Karen Nelson, a professor of accounting at Stanford Graduate School of Business was quoted as saying, " Enron was all about complex partnerships and accounting for special purpose entities. But what WorldCom did wrong is something that's taught in the first few weeks of a core financial reporting class. That is why people are asking, given its basic nature and its magnitude, how could it have been missed. " 2 How indeed?

Prior to the recent spate of embarrassments, United States' Generally Accepted Accounting Principles (" GAAP") was viewed as the gold standard to which multinational {K0241737. 1} 1 corporations must conform in order to take the greatest advantage of the efficiencies of international financial markets. As a director of the Vorstung of Germany's Deutsche Bank pointed out to this author, after raising the bank's accounting standards from German mandated GAAP to International Accounting Standards, the bank's senior management determined it was worth spending around an additional $200, 000, 000 in order to comply with U.

S. GAAP so that the bank could be listed on the New York Stock Exchange. The managers realized that such a listing would unlikely have any marked effect on the liquidity of the bank's stock. Indeed they expected it to be thinly traded on the New York Stock Exchange. However it was their view that the bank's stock would always trade at a discount if it could not demonstrate that it had complied with the (perceptually) more accurate U. S. GAAP.

Now in light of Enron, WorldCom and other embarrassments, the effectiveness of U. S. GAAP, our corporate accountability system, and United States business ethics in general are all being questioned, with the consequent adverse effects on the prices of issues on public exchanges, and even the dollar approaching parity with the euro (although, admittedly, that may be attributable to other factors as well). Moreover, much like the return of a lesson unlearned from the bank runs of the early Great

Depression, a new paradigm of insolvency seems to be facing corporations: bankruptcy not caused by traditional financial problems, but rather by the loss of investor confidence. Yet for a long time before these events, there seemed to have been a sense that maybe the system was not quite right; that it needed improvement. In 1998 the New York Stock Exchange and the NASDAQ convened a Blue Ribbon Committee (the " BRC") to undertake a study of corporate governance, with particular emphasis on improving the effectiveness of corporate audit committees.

Yet the convening of this panel was less an affirmative response by the two exchanges to their own perceived need to tighten accounting procedures and investor accountability, than it was a response {K0241737. 1} 2 to a September 28, 1998 speech by SEC Chairman Arthur Levitt who excoriated the entire audit process as " a game of nods and winks" involving the analysts, the auditors and those in charge of the corporation's affairs.

Lamenting that " integrity may be losing out to illusion, he commented on various " hocus pocus" categories that were flagrant distortions of the financial reporting processes. Levitt then introduced a nine-point plan, two of the most important of which focused on the requirement that corporate audit committees takeresponsibilityfor their companies and " function as the ultimate guardian of investor interests and corporate accountability. " 3 The BRC released its extensive report in February 1999.

More recently, following a number of dramatic failures, including Enron, and apparently responding to various Congressional initiatives that will have the effect of impinging upon the independence that public companies have traditionally enjoyed, the New York Stock Exchanged proposed, on June 6, 2002, detailed, stricter standards for its listing members. These standards adopted the recommendations of the BRC and expanded on them in certain important respects. Clearly the efforts of the BRC and the recent proposals of the New York Stock Exchange are moves in the right direction.

What neither proposal analyzes in methodological detail however, are the causes of these dramatic business failures. Absent such analysis it is naturally impossible to predict whether the problem has been properly addressed. Indeed, for example, if GAAP accounting is too antiquated for the current stresses and functionalities of modern business, putting more responsibility on audit committees and tightening rules of corporate governance will do little to address that fundamental problem.

Similarly, because CEOs in huge companies cannot possibly be aware of all their firms' financial transactions, it is not realistic to endeavor to solve the problems simply by requiring the CEO to certify that the financials are, in fact, accurate. 4 {K0241737. 1} 3 My approach in this thesis is a modest, but decidedly different, one than what has been taken thus far.

Rather than proposing axiomatic remedies to address specific problems that seem to have appeared in the recent cases, I suggest that the problems have arisen as a consequence of the forces arising from the imbalance of power in our corporate governance system, being unleashed upon the two fundamental weaknesses (or " insecurities" to return to the wrestling analogy at the beginning of this paper) intrinsic to the Anglo-American corporate governance structure; namely the unitary board of directors having conflicting obligations of oversight and management, and the incomplete contract that exists between shareholders and management in defining the parameters of management's authority and obligations, as stockholders' proxies to run the corporate entity.

While these weaknesses have existed since the joint stock company came into being with the original English East India Company model, the increasing extent and magnitude of the differential in power dynamics among the three groups ultimately responsible for guarding investor interest and providing for corporate accountability, specifically management, the outside auditors, and the Board of Directors represented by its Audit Committee, has reached the point where it is now overwhelming in favor of management, even after acceptance of the BRC's recommendations and the new proposals of the New York Stock Exchange. Because of this, I submit that it is only by making adjustments in some of the fundamental relations to this " three-legged stool" of corporate accountability as the BRC called it, that a more stable equilibrium in the balance of power among these groups may be achieved and thereby proper accountability restored within the system.

To put this problem another way, both the BRC and the New York Stock Exchange proposals, for example, do delegate new responsibilities to the Board of Directors through its Audit Committee and seek to require the Board to adopt a series of new and constructive protocols to buttress the meaningfulness of the company’s financial statements. However unless such delegation {K0241737. 1} 4 of responsibilities is accompanied by assignments of power, the rights sought to be assured to shareholders will likely prove as elusory as those in that famous " piece of paper" held by Chamberlain after his negotiations with Hitler at Munich guaranteeing " peace in our time. " What this thesis offers is a methodological analysis and approach to this growing problem of major international consequence. It focuses primarily on the narrow issue of power dynamics and its relationship to mandated disclosure.

A fundamental premise, not examined however, is that disclosure and daylight will ultimately have salutary effects upon corporate governance. Also not examined, is whether or not there may be fundamental problems in GAAP accounting, generally, which need to be addressed systemically. Further, I have not examined whether fundamental, statutory changes in corporate law might aid as well. Thus, I accept as given, for purposes of this paper, the systemic weaknesses of the basic unitary board concept, although I argue that an analysis of it is essential to understand the fragility of the disclosure process and, thereby, its susceptibility to the relative strengths of the three principal players.

I begin with an analysis of the weaknesses of Anglo-American corporate governance stemming from the stockholder's incomplete contract with management, and from the nature of the unitary board, and how these problems can have a paralyzing effect on accountability. I then look at the power attributes and weaknesses of the three principal players in the disclosure process; namely management, the external auditors, and the Board of Directors through its Audit Committee. After demonstrating the gross imbalance of power in favor of management, I analyze the exogenous vectors to which management is subject which impel disclosure and impel concealment. Following the analysis section, I look at some current examples of corporate audit committee charters and reports as examples of the results of the current process, and the likely {K0241737. 1} 5

inconclusive results that will follow from the current state of affairs, without adjustment to the imbalances of power. The fourth section discusses briefly other approaches used in Europe, and in particular Germany and the U. K. and why their approaches may or may not be applicable to United States governance. I next undertake an analysis of the BRC's and the New York Stock Exchange's proposed changes and, in the final section of this paper, make my own suggestions that address the imbalance of power dynamics still present even after such recommendations are adopted. I close with some overall observations and a final question. Analysis: Development of a Model 1. Systemic Weaknesses:

Boards of Directors under the Anglo-American model of corporate governance have two, primary functions which from any initial analysis, appear to be at odds with each other. First, the Board of Directors is the ultimate head of all executive decisions of a corporation. It is the final arbiter and deliberative body that sets corporate policy, determines and executes stratagems on behalf of shareholders, and is ultimately responsible for compliance with applicable laws. Second, the Board has ultimate responsibility for supervising proper governance of the corporation and assuring the accountability of the executive officers whom the Board has appointed to manage the day-to-day operations of the entity's assets.

In spite of such an inherent conflict, this structure works fine when a corporation is owneroperated and even when there is a small group of investors, venture capitalists, and the like who closely monitor and are a part of the day-to-day decisions of the entity. Once there is a separation of ownership from control, however, two results ensue. First, executives no longer have the same {K0241737. 1} 6 financial incentive as would an operator who is also an owner to increase the future value of the firm. The executive's incentives are defined by his contract. While this will be discussed in greater detail later in this paper, even so-called " incentive contracts" are tied to isolated factors that are intended to be indicia of what the shareholders would prefer; but such factors, obviously, cannot be precise instruments of shareholder interest in all circumstances.

Moreover, executives are normally chosen for the their creativity and entrepreneurial attributes which are necessary in order to maximize opportunities presented by the market from time-to-time. Thus, a broad spectrum of freedom of action is normally ceded to such executives. The practical problem, then, is to find a way to promote managerial freedom without jeopardizing their accountability to stockholders. This gap has been referred to as the " costs of agency" and the result of (necessarily) incomplete contracts. 5 As discussed in " Wearing Two Hats: The Conflicting Control and Management Roles of Non-Executive Directors6, an incomplete contract exists whenever the contracting parties are unable, ex ante to specify fully the actions to be taken in every possible future " state of nature".

Thus, results that are economically efficient are achieved where the organizational structure of a firm is such that those who ultimately have the final claims to an entity, have the ability to determine the actions of that entity; simply for the reason that the downside of any action taken that does not seek to maximize value will ultimately have to be borne by them. The degree by which separation of ownership from control effects of loss of control over such factors is another way to characterize this " agency cost", and the agency cost, in turn, is a consequence of the need to leave management contracts largely incomplete.

Historically, this problem, as well as the inconsistency of the two obligations of the Board of Directors, has been addressed through requiring detailed disclosure by management to the shareholder. The disclosure requirement, it is thought, will act as automatic checks on the Board vis {K0241737. 1} 7 a vis the shareholders, and on the chief executive officer, vis a vis the Board; the thinking being that if actions with which the shareholders or the Board may disagree are known, they may be overruled, or the offending party removed from office. This system of accountability through disclosure, in turn, has two essential parts to it. The first is the system of legally mandated shareholder rights that gives shareholders the ability to obtain information not otherwise readily available. The second is the automatic disclosure required to be provided by the executives and by the Board itself. 7 The basic flaws of the system are obvious. First, there is little incentive for the average shareholder effectively to monitor the activities of any large, public corporation.

Not only is it extremely expensive for shareholders to launch initiatives (as shown by the exorbitant costs of hostile takeover bids and the like) but the economic benefits inuring to such a shareholder from such monitoring function can, because of such shareholder's relatively small percentage ownership of the overall corporation, only marginally benefit that shareholder. On the other hand, the disincentive to engage in any monitoring activities by such a shareholder is increased by the fact that all other shareholders who have not incurred such costs obtain exactly the same proportional increase in the value of their stockholdings through that shareholder's efforts, while having a " free ride" withrespectto the cost of the monitoring activity.

" Hence, each shareholder has an incentive to free ride and it becomes irrational for an individual shareholder to devote resources to becoming better informed and to voting intelligently. " 8 Additionally, this analysis may begin to give one the sense that the accountability of the executive to the Board is different in kind and scope than the accountability obligations of the Board to the shareholders. These protections become further diluted by a recognition that stockholders are not the only ultimate residual claimants to a corporation's assets, such that the theoretical unitary goal of " maximizing return to shareholders" cannot be the sole objective function either of the executives or {K0241737. 1} 8 of the Board. Because of that, each may often act in ways contrary to the " interest of the shareholders.

" By way of example, various studies have shown that numerous non-shareholder constituencies influence corporate decisions. These include customers, labor, senior debt holders, and the like. 9 Further, the general law of fiduciary duty as well as various state statutes throughout the United States provide that when a corporation is " insolvent," officers and directors are required to act in the best interest of creditors, rather than of shareholders. For this very reason, there is no requirement under Delaware law (or the law of any other jurisdiction of which this writer is aware) that the filing of a bankruptcy petition requires a shareholder vote.

Indeed, under Section 1107 of the Bankruptcy Code, a corporation whose management continues in control of the company's assets operating its affairs after filing a bankruptcy petition is required, with only one exception, to represent the interests of creditors. The only exception is with respect to a plan of reorganization that the company files. And, with respect to the plan of reorganization, it is at that point that in addition to representing the interests of creditors, management may also represent the interest of the " company. " Obviously, the " company" is something other than the shareholders although it may include the shareholders in the concept.

One may attempt to argue that such a change in director and managementloyaltyis only fair in these cases because it occurs under an extreme situation, namely when the company is " insolvent. " The problem, however, is that there are at least three definitions of insolvency; thus, one is never certain when " insolvency" commences or occurs. 10 Finally, the goal of " shareholder" welfare is not by itself equivalent to the concept of share price maximization. Markets systematically under value certain long-term expenditures, particularly expenditures that may fall into the categories of capital investment or research and development spending. This excessive short-term focus yields a form of market myopia that may encourage, therefore, management to view its obligations to increase the share price rather than deal {K0241737. 1} 9 with a more elusory concept of " shareholder value".

This tendency, of course, is enhanced when management's own contracts provide bonuses based upon increases in the per share price. 11 To summarize the foregoing analysis, the incomplete contract that exists between the shareholders and the executive managers of a firm afford the managers a broad range of discretion. The necessary incompleteness of such a contract, as well as the natural conflict between the selfinterest of the managers and the differing interests of the shareholders provides the opportunity for executives to act in a manner not necessarily in the best interests of shareholders.

Further, there is often the opportunity and, in certain circumstances, the obligation, for management to act in the interests of other parties. Thus the obligations of management to shareholders become weakened and unclear as well as diverted, in certain respects and instances, by obligations to other parties. Further, it is impracticable for individual shareholders themselves to undertake meaningful monitoring activities of management. While this obligation is delegated to the Board, the Board itself is riddled with the same conflicting obligations as has management. Further, the Board, as the commander in chief of operations, is not clearly objective in its supervision of its own policies.

Against this backdrop of these weaknesses inherent in the corporate governance structure, let us now turn to analyze the dynamics of power within the accountability system itself. I propose to do this in two parts. First, I shall analyze the attributes and vulnerabilities of the three primary players in the disclosure process in order to evaluate their relationship to each other and their ability to control reporting outcomes. Second, I shall focus on the forces impelling management towards concealment as well as those forces impelling management towards disclosure; since it is management, as will be shown, who have the decided advantage in determining the context of the disclosure process.