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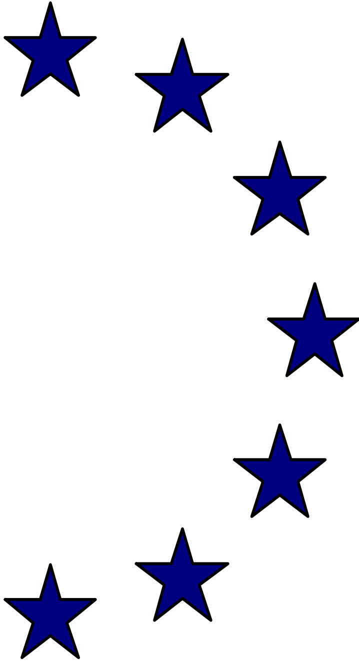

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Issues in corporate governance

by
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Issues in Corporate Governance

Abstract

The objective of this economic paper is to review issues and problems arising in the area of corporate governance from a broader economic perspective at a time when a series of major corporate accounting fraud scandals has renewed interest in the subject. The paper highlights the economic significance of corporate governance for resource allocation, investment decisions as well as financial market development. Effective information disclosure is then explored, as the basis for effective corporate governance control procedures. Potential barriers to disclosure, including complexities linked to innovative financial instruments, are highlighted together with incentives to distort information. The latter sections of the paper focus on internal and external safeguards for effective corporate governance. Issues relating to internal safeguards include management incentives, independent directors and shareholder control. In considering external safeguards, the analysis focuses on conflicts of interests and problems for outside company watchdogs, such as auditors, investment analysts and rating agencies.

Executive Summary

Recent accounting scandals have put corporate governance in the public spotlight. However, the interest in the subject can be traced back at least to the eighteenth century and economists such as Adam Smith. Indeed, there is probably little new in the current debate relating to financial malpractice, except for the scale of the financial and economic consequences which reflect the greater importance of finance in the modern economy. This paper reviews a range of matters, which have emerged in the context of recent corporate scandals, as well as efforts to address these issues. The objective is to examine them in a broad economic and financial context, and not only from a narrower regulatory perspective.

Corporate governance has significant implications for the functioning of the financial sector and, by extension, the economy as whole. Efficient resource allocation is supported by strong shareholder control rights, which facilitates investment in new growth activities and limits the scope for corporate over-investment. Investment decisions are further linked to corporate governance (and transparent markets) insofar as investors prefer to invest in properly supervised corporations and tend to avoid investing in obscure environments. In this way, the investor confidence generated by sound corporate governance arrangements and the protection of minority shareholders promotes the financial market development by encouraging share ownership and efficient capital allocation across firms.

Transparent financial reporting is essential to delivering effective corporate governance. Financial reporting supports investor confidence by providing information about the condition, performance and risk profile of the firm concerned. However, various factors can hamper effective disclosure, including (i) incomplete and unenforceable contracts; (ii) managerial advantages resulting from asymmetric information situations; and (iii) opportunistic managerial behaviour. Possible motives for providing misleading financial information are diverse and range from a desire to attract investors' capital to efforts for artificially depressing share prices prior to a management buy out. Complex financial innovations and off-balance sheet activities pose an additional challenge for financial disclosure, with derivatives a prominent example in this regard. Indeed, the opaqueness of credit derivatives markets is a growing concern for regulators and supervisors. A variety of enforcement mechanisms to ensure proper financial disclosure are available (e.g. accounting standards) but these mechanisms can only be effective in conditions of effective corporate governance procedures and financial literacy among the relevant company officials.

At the heart of the corporate governance issue is the need for appropriate checks and balances between the investor (principal) and the company management (agent). The principal-agent problem can be managed by focusing on both internal company structures and external safeguards. Internal structures must deliver (i) carefully calibrated incentive structures for management as well as procedures for internal control, (ii) a strong watchdog function of independent directors (both on the company board and on the audit committee), and (iii) effective shareholder control – through easier voting procedures, granting investigative rights to minority shareholders, creating larger investors (through hostile takeovers, if necessary) and encouraging institutional shareholders to exercise their control rights towards management. External safeguards include the role of *audit firms* where various developments seem to have weakened their watchdog function. Close links between the audit firms and their clients can lead to various conflicts of interest, real or

perceived. A further issue in this context is the growing audit firm concentration as well as market barriers for smaller audit firms. All of these factors bode ill for the perception of audit quality and independence, although there is no hard evidence of a deterioration in audit performance. *Investment analysts* provide another external safeguard for the investor. Up to recently, these analysts seemed to have managed internal conflicts of interests well but more current investigations have revealed important abuses. In this respect, the recently concluded Wall Street Settlement is revealing. *Credit rating agencies* are a third external safeguard for investors but these have also been criticised for alleged conflicts of interests, a lack of transparency in the credit rating process and an oligopolistic market structure. A box looks also at EU initiatives in the area of corporate governance.

A number of conclusions can be drawn:

- In an age where the financial system has become simultaneously more complex and more accessible to the unsophisticated investor, it is essential that the challenge of effective corporate governance is addressed.

- Harmful incentive structures, conflicts of interests, and the absence of transparency seem to be key issues in addressing shortcomings in current corporate governance arrangements. In addition, the interests of minority shareholders have to be protected as larger investors may abuse their power. These problems can effectively be addressed by the use of forensic audits after major bankruptcies or suspected accounting frauds, by encouraging whistleblowers, by fostering of a process of diluting ancillary links between audit firms and their audit clients as well as between investment analysts and their clients. Greater transparency in the process of credit rating by the relevant agencies is also required. Other suggestions for reform include measures to tackle concentration in the provision of audit services, perhaps by lowering entry barriers.

- The significance of corporate governance is likely to increase in coming years as investors in maturing economies with a declining population may be required to seek higher-yielding investment opportunities in less-developed parts of the world economy. This will increase the need for good corporate governance and financial reporting practices, which apply at a global level. Thus, apart from broader stability concerns, the propagation of good corporate governance may well become a strategic policy goal for mature economies as a means to integrate emerging economies into the international financial system.

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1. Introduction:

A series of major corporate accounting fraud scandals in both the United States and Europe has renewed interest among academics and policymakers in issues of corporate governance and financial-sector integrity. The significance of corporate governance in the functioning of the financial sector had been enhanced in earlier years by developments such as: (i) the deregulation and integration of capital markets; (ii) the privatisation of formerly state-owned industries; (iii) the wave of hostile take-overs in the United States, particularly during 1980s; (iv) the South East Asia financial crisis, putting the spotlight on governance in emerging markets; and (v) the need for pension reform and the growing importance of private savings for retirement. Long before these developments, however, corporate governance had been already a topic of economic analysis. In his Inquiry into the Nature and Cause of the Wealth of Nations, Adam Smith noted the following when discussing public corporations:

> *"The directors of such [public] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. ... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."*[1]

Viewed from this perspective, there is little new in current problems of corporate governance relating to the financial misconduct of chief executive officers (CEOs), chief financial officers (CFOs), the negligence of non-executive board members as well as conflicts of interest among auditors and investment analysts. If there is a difference with the past, it seems to be in the scale of the financial and economic consequences that have stemmed from the more recent episodes of misconduct – which are significant by any historical standard as the life-savings of investors and pension fund holders have disappeared and many thousands of workers have been made unemployed. Moreover, corporate misconduct has tended to compound the negative effect on stock market values caused by the deflating technology bubble and has aggravated investor loss of confidence during the associated economic downturn.

The objective of this paper is to review issues and problems arising in the area of corporate governance by putting the subject in a broader economic and financial context. The remainder of the paper is structured as follows. Section 2 considers the economic significance of effective corporate governance standards for resource allocation, capital investment and financial market development. It includes also a box on corporate governance in transition economies. Section 3 explores issues relating to effective disclosure of corporate information, as being the basis for effective corporate governance control procedures. Disclosure barriers as well as incentives for distorting information are investigated, before information complexities, deriving from modern financial instruments, are discussed. The section, which includes a box on different forms of accounting techniques used to distort information flow and a second one on credit derivatives, finishes by debating the need for assuring the necessary mechanisms for information disclosure enforcement. Section 4 addresses problems related to the principal-agent relationship between company managers and

[1] Smith (1776)

shareholders by focusing on internal and external corporate governance safeguards. Internal safeguards deal with management incentives and procedures for internal control, independent directors as well as shareholder control issues. The section includes a box on conflicts of interests in the setting of executive compensation. External safeguards address conflicts of interests and problems for outside company watchdogs - like auditors, investment analysts and rating agencies. With respect to auditors, increased concentration in the provision of audit services is examined in conjunction with audit price, quality and independence as well as market barriers for smaller firms. Potential and actual conflicts of interests are the focus of the examination of investment analysts, which includes an assessment of the recent Wall Street Settlement. By looking at rating agencies, the paper considers the rationale for their existence, investigates their conflicts of interests and assesses growing calls for improved transparency. After exploring rating triggers, the section concludes with an analysis on rating agencies' oligopolistic market structure and the special US rating agencies designation procedures. A box on EU initiatives in the area of corporate governance is incorporated as well. Section 5 concludes.

2. The economic significance of corporate governance[2]

Resolving problems related to corporate governance is not merely of academic interest but is essential in addressing very practical difficulties in the functioning of the financial sector and, by extension, in the economy as whole. The analysis in this section considers the economic significance of corporate governance as a determinant of resource allocation, investment in companies and financial market development.

2.1. Resource allocation

A host of findings in the economic literature highlight the relevance of corporate governance for efficient resource allocation. For example, a lack of shareholder influence on business strategies has been found to render company management less

[2] For a survey of the empirical picture of corporate governance mechanisms and their effects on firm performance and economic growth see also chapter IV of Maher and Andersson (1999). It should be stressed that while corporate governance mechanisms have benefits, they also imply costs. It is important, therefore, to strike an appropriate balance in which context an economic welfare (or cost-benefit) analysis can be a valuable tool. The meta-rules for this kind of analysis are that (i) only individuals matter and (ii) all individuals matter equally. This leads to several surprising conclusions, and would therefore dissuade a mechanical application of the analysis' results. For example, a number of popular proposals fail the economic welfare test. In a static context, a fraudulent CEO does not necessarily cause any costs to society as a whole, as the two meta-rules oblige a disinterested analyst to treat shareholder losses on an equal basis with the wrong-doers gains. On the other hand, company chiefs resisting the establishment of internal control procedures as economic waste, tend to ignore the immediate benefits, such as employment for consultants hired to implement the relevant procedures. In contrast, economic projects and opportunities not pursued by a CEO due to heavy corporate governance procedures should be counted as economic costs. However, these factors have to be compared with (a) the costs coming from a lack of transparent and enforceable corporate governance rules, such as an entrepreneur finding it impossible to raise capital due to investor mistrust, or (b) a corporation's crashing share values due to an uncovered accounting scandal. Both, (a) and (b) affect current and potential investors, consumers and workers in a negative way. An efficient resource allocation and a reduced risk for outside investors willing to buy company shares has to be counted as a benefit, but the additional stress for managers and the reduced private benefits of control for wealth extracting dominant shareholders would be a minus in that analysis.

efficient in producing corporate growth. Emmons and Schmid (2001) find a connection between under-investment, company overstaffing and the worker co-determination model in Germany. Although employees on the supervisory board – having to approve major management decisions - cannot outvote shareholder-elected board members, their presence allows employees to put the public spotlight on unwelcome decisions. Employee representatives can create procedural delays, e.g. drawn-out consultations, which might stall restructuring efforts or inhibit takeover negotiations. Using a two time-period model, whereby incumbent labour in the second period does not oppose adding employees but might oppose layoffs, it is shown that management faces two possible risks. First, they might hire additional staff in the first period but suffer losses in the second period due to an unforeseen weakening in demand and be unable to make lay-offs. Alternatively, they might choose to under-invest in the first period to avoid a confrontation with employees over layoffs in period two and so miss opportunities for profit. The analysis concludes that companies with inadequate shareholder oversight deviate from their first-best strategy and pursue a sub-optimal investment and hiring path, thus lowering economic growth.

A study by Gugler et al. (2001) shows that legally defined shareholder rights are associated with superior company performance. Utilising a measure on over- and under-investment (i.e. the ratio of a firm's returns on investment to its cost of capital) and assuming that a firm maximises shareholder value if the corporation invests up until the point where marginal return on investment is higher or equals its cost of capital, aligns the interest of shareholders and managers. Empirical analysis confirms that this alignment of interests is more likely in countries with a relatively effective corporate governance environment.[3] The analysis also shows that, in a system designed to protect shareholder interests, concentrated ownership achieves higher returns than a more dispersed ownership distribution, presumably because shareholders with large individual holdings have a greater incentive to supervise management. In contrast, in a system with weak shareholder protection, concentrated ownership allows a dominant shareholder group to exploit minority shareholders. In consequence, few companies in either of these environments tend to have dispersed ownership structures. Only especially attractive investment opportunities or a demonstrable commitment by the original owners in the sense that they would not follow expropriation practices is able to attract disperse ownership in corporations situated in low-investor protection countries. The relation between corporate governance and over-investment of surplus cash is also explored in Richardson (2002). In this case, evidence is found of pervasive over-investment and limited surplus-cash distribution to external stakeholders in many companies. Firms having more independent non-executive directors seem to be able to reduce over-investment.

Good corporate governance can be seen as facilitating corporate restructuring, as companies turn more quickly to new areas of growth or declare bankruptcy when management fails to invest resources profitably. For example a paper on the Japanese experience by Peek and Rosengren (2003) focuses on the misallocation of credit by banks. The analysis highlights the incentive for a bank to pursue a policy of forbearance with a problem borrower so as to avoid reporting impaired loans as non-performing. To this end, the bank may prefer to make available sufficient credit to the affected firm for outstanding interest payment on the existing loans. Thus, due to inadequate corporate governance structures in both the bank and the company concerned, bankruptcy is avoided, necessary corporate restructuring is postponed –

[3] In this context, the authors conclude that legal systems of English origin seem to be better at protecting shareholders.

with implications for efficiency in the economy as a whole. Bertrand and Mullainathan (2003) find that managers in environments with weak takeover laws prefer to enjoy a quiet life. Their study suggests that the respective companies increase worker wages (especially those of white-collar workers), shy away from closing down old plants while hesitating as well to invest in new ones, causing an overall decline in productivity and profitability in affected firms.

More broadly, as the economic growth process can be destabilising for dominant interest groups, good corporate governance is needed to prevent incumbent managers from lobbying governmental authorities for protectionist policies. For example He et al. (2003) point out that dominant companies can add to a countries economic growth and symbolise its technological advancement, but growing economies demand a rejuvenation of entrenched structures as new firms emerge to provide innovative and more efficient business practices. From this viewpoint, the continued dominance of a few firms over a long period could be a sign of stagnation. To test this hypothesis, corporate stability indices are constructed for a large cross section of countries over a twenty year period and are assessed against standard measures of economic growth. The findings suggest that countries whose corporate sectors are relatively less stable tend to enjoy faster growth, even when correcting for factors such as initial per capita GDP, level of education and capital stock. In addition, greater turnover in the ranks of top corporations is associated with faster productivity growth in developed countries and faster capital accumulation in developing countries. When trying to identify the sources of corporate stability the authors identify government size and the development of the banking sector as being positively correlated with greater stability, while stock market development and openness to the global economy are negatively related.[4]

In sum, the thesis underlying most of these findings is that inadequate corporate governance structures generate a company management less responsive to market developments. The consequence is a delay in necessary changes in outdated business models, thus adversely affecting resource allocation and economic growth.

2.2. *Investment in companies*

Corporate governance and investment decisions are linked insofar as outside investors – facing the risk of expropriations by management or larger shareholders - will be more willing to buy shares in corporations in which management strategies and actions are properly supervised. La Porta et al. (1999) provides evidence of higher company valuation in countries with better minority shareholder protection. The paper argues that dominant shareholders have in many countries even within the constraints of the law the power to legally expropriate minority shareholders and creditors. By using a model of a corporation with a single controlling shareholder, it is shown that - although having less than 50 per cent capital at stake - superior voting rights, ownership pyramids or control of the board might give this dominant shareholder the possibility to divert company cash flow for its own ends. These private benefits of

[4] In principle the causation could also run the other way around, namely that higher GDP growth leads to a less stable index of corporate stability. However, in this context it would be interesting to see if growth leads to the emergence of a new generation of firms, or if it makes just the established ones stronger (personal e-mail from He, K.S. to author). A reverse causality would also imply - taking the author's findings on the sources of corporate stability into account - that the growth of an economy leads to smaller government and opens previously closed economies. The question is, however, if this is realistic.

corporate control might therefore be measurable by looking at the value of controlling block votes. An empirical analysis by Nenova (2003) suggests that the legal environment, law enforcement, investor protection, takeover regulations, and power-concentrating corporate charter provisions explain a high amount of cross-country variation in the value of control block votes, with the value of a controlling voting block falling close to zero in Finland and consisting in almost half of the firm's market value in South Korea. Doidge (2003) tries to value the benefits of private control through another venue by looking at US listed foreign companies with dual voting structures, whereby shares are only differentiated by their voting rights. In that case, the percentage difference between the prices of high voting shares and low voting shares would be the voting premium, here used as a proxy for the private control benefits. The paper finds that, on average, foreign firms that cross-list on a US exchange have significantly lower value premiums on their voting shares, than firms that do not. In addition, the size of the difference in voting premiums is negatively related to measures of minority investor protection.

Empirical analysis by Doidge et al. (2001) suggests that poor shareholder protection is penalised with lower company valuations. Based on a multi-country study, it is shown that foreign companies listed in the United States have higher share valuations than those listed only in their home market, with the biggest effect for firms from countries with poor investor rights.[5] Reese and Weisbach (2001) suggest that non-US firms cross-list in the US to increase protection of their minority shareholders after finding that new equity issues following listings in the US tend to be in the US for firms coming from countries with strong protection, and outside the US from companies coming from countries with weak investor protection. Companies from weaker investment protection regime countries would therefore signal through their listing in the US a commitment to protect minority shareholders, which would allow them to raise additional equity – even at home - to more favourable conditions than before their US listing. The relatively low level of small-investor protection in many countries outside of the United States is thought to explain the home bias of US investors (Dahlquist et al., 2002).

A necessary condition for investor confidence is transparency. Using transparency measures and a micro investment data set containing the country allocation of over 300 emerging market funds, Gelos and Wei (2002) find that international funds prefer to hold more assets in transparent markets than in obscure environments. In addition, it is found that openness makes herding among investors less likely. Transparent financial reporting is therefore another pillar in attracting and retaining capital. In contrast, an absence of transparency facilitates corruption, which in turn reduces the incentive to invest. A paper by Wei (2000)[6] studies the impact of corruption on a country's composition of capital inflows. Combining two typical explanations for large capital outflows - local crony capitalism or self fulfilling expectations by international creditors - the analysis suggests that corruption affects the composition of capital inflows to a country in a way that makes it more vulnerable to international creditor's shifts in expectations. This is because foreign direct investments are more

[5] The authors concede that alternative explanatory approaches for explaining the higher equity valuation of US listed foreign firms might be also of value. To give an example, a firm originating from a country in which the financial market is small or not very developed, might gain value by listing in the US. This would indirectly suggest that a firm of such a country benefiting most from an US listing would be a corporation with very good investment opportunities.

[6] An assessment of the different forms of capital flows and their vulnerability to sudden withdrawal is given by Williamson (2000)

likely to be exploited by corrupt locals, causing a corrupt country to receive substantially less foreign direct investment, but instead a larger share of the more volatile portfolio investment.

The link between corporate governance and capital flow was highlighted spectacularly by the SEA crisis of 1997-98, when inadequate corporate governance and the weakness of legal institutions had the effect of exaggerating the severity of the crisis in several countries by accommodating a significant mismatch between assets and liabilities in the private sector. Johnson et al. (1999) investigates the large exchange rate deprecations and stock market declines in some Asian countries during 1997-98 and presents evidence that the weakness of legal institutions in enforcing corporate governance had an important effect by augmenting the loss of investor confidence in emerging markets. This seems to be underpinned by theoretical reflections in conjunction with evidence showing that managerial expropriation is worse when a corporation's troubles deepen. Empirical results demonstrate that in cross-country regressions, corporate governance variables explain more of the variation in exchange rates and stock market performance during the Asian crisis than the use of macroeconomic variables. The need to strengthen the institutional arrangements for corporate governance has therefore been one lesson drawn from the SEA crisis.[7] Eichengreen (1998) discusses the possibility that the IMF should become more active in monitoring countries compliance with best practices and standards as a tool for crisis prevention.

2.3. Financial market development

Good corporate governance and investor protection is necessary also for financial-market development. Financial markets and other intermediaries help in bringing savers and investors together and can find innovative solutions to financial problems. La Porta et al. (2000) argue that the typical distinction between bank-based and financial-market based systems should be replaced by a measure of investor protection. Strong investor protection is linked to effective corporate governance, allowing the development of valuable and broad financial markets, dispersed ownership of shares, and efficient allocation of capital across firms. An important conclusion of the analysis is that financial markets need outside investor protection.[8] However, as the nature of investor protection arises from deeply rooted legal

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[7] However, Singh et al. (2002) rejects that view by stating in the abstract of their paper: "The thesis that the deeper causes of the Asian crisis were the flawed systems of corporate governance and a poor competitive environment in the affected countries is not supported by evidence." Huizinga and Denis (2003) are arguing in the same vein, by stating that foreign ownership is negatively related to financial development and to a range of indices related to investor protection such as shareholder rights, the rule of law and a lack of insider trading.

[8] Doidge (2001) looks at the role of investor protection for changing ownership structures and corporate control changes, by using an emerging market based firm sample, which – in addition to listing their firms in their home country – decide to embark on an US listing as well. The research shows that although the mean voting rights held by controlling shareholders falls over time, the decline is small and many controlling shareholders do not decrease their voting rights at all. However, there is a high incidence of control changes as about one in four firms exchanging the old controlling shareholder with a new controlling shareholder. The shift is explained by pointing to the fact that the US listing, which imply a higher degree of shareholder protection, makes controlling stakes relatively more attractive for buyers that cannot exploit the private control benefits and less attractive for previous owners that were better able to exploit them.

structures in each country, marginal reform may not succeed in bringing about the necessary degree of investor protection. In contrast, Rajan and Zingales (2003) dismiss the notion that some law systems would be better, per se, in assuring investor protection - noting that English corporations had been considered to be more opaque than their German counterparts at the beginning of the twentieth century, but the reverse view holds today. The paper highlights the role of dominant interest groups successfully opposing financial development in order to avoid competition and shining light on their opaque business dealings.

The effects of poor corporate governance can extend beyond shareholders and management to third parties, e.g. retirees with pension assets tied up in company shares, or savers with investment funds. Thus, the negative effects of a lack of corporate governance can extend beyond a reduced willingness for investors to invest in companies to a more generalised reluctance to save. Apart from the shorter-term implications for investment and economic growth, lower savings rates in the more developed economies would pose particular challenges in the context of their ageing populations.

Box: Corporate Governance in Transition Economies

Beside macroeconomic stabilisation policies, microeconomic elements are equally crucial for a successful economic conversion of transition economies. Secure property rights, the rule of law and the fight against corruption but also sound and effective corporate governance structures can be decisive for attracting portfolio investment (Garibaldi et al., 2001) and advancing domestic growth and prosperity (Havrylyshyn and van Rooden, 2000). In addition, effective corporate governance has been found to increase the value of transition country firms and lower thus their cost of capital (Black, 2001).

However, transition economies are facing a number of challenges in achieving these micro goals. The most prominent challenge for them would be in having to steer a course between the cliffs of governmental dictatorship and private disorder (Djankow et al., 2003). While a dictatorship could deprive basic rights from individuals through state sponsored violation of property rights and even murder, a breakdown of governmental authority on the other hand leads to social losses due to private expropriation.[9] Striking the right balance in such a context is not easy.

However, eventual policy advice might be facilitated by taking into account the transition countries' history and distinct institutional players, instead of – as often the case – seeing them as "tabula rasa" economies (as criticised by Murrell, 1995). For example, Berglöf and Pajuste (2002) point out that most corporations in transition economies are owned by dominant shareholders. This might have some immediate implications for policy formulation as, for example, hostile takeovers and proxy fights will not be effectual in disciplining a straying companies' management. Equally the role of executive compensation schemes might also be limited and boards of directors cannot be expected to be truly independent. An environment of fragile property rights and weak legal enforcement is often seen as another characteristic of transition economies.

This basic analysis would suggest that attracting international outside investors could be a straightforward way of importing international corporate governance standards. After all, outsiders might be able to take-over entire corporations and thus replacing existing dominant shareholders. This might allow them to spread their own traditions of transparency and control practices but foreign investors might also train and educate the emerging managerial class. An additional, more indirect stimulus for good practices may come from foreign owned banks.

However, the breathing space thus possibly provided by outside investors has to be used for pursuing structural reforms for securing property rights, implementing the rule of law and protecting minority investors' rights, without letting vested domestic interests wield undue influence in the formulation and implementation of the respective rules and regulations (Hellman et al., 2000). After all, exchanging the "neglect of history" approach – an extreme form of policy advice - against a "powerful domestic interest accommodating" approach would do no transition country any good.

9 A case in point would the description by Rogers (2003, p. 36 and p. 38): "As the country was falling apart, an entrepreneur… would get an export license for, say, chemicals; such a license would be difficult to acquire, but only in the absence of a bribe. Once he had his export licence, he could buy chemicals from the [domestic] factory at [domestic] prices, which were ludicrous … So he would buy chemicals from their manufacturer and, with his export license, sell the chemicals in the West for hard currency at market prices. … The entrepreneurs are not building anything. They are stripping assets. As fast as they can".

3. Financial reporting and corporate governance

Financial reporting, which is typically seen as a rather arcane exercise except by those responsible for producing company accounts, has been brought into the mainstream of economic and financial analysis by the recent wave of corporate accounting scandals. The effective functioning of capital markets requires that basic information on the financial condition and performance of a company is prepared and presented in a manner that allows the market to assess its performance relative to other companies. From a broader economic perspective, financial reporting fulfils essential functions by (i) allowing an ex-post assessment of a company's use of resources and (ii) by providing the information necessary for the owners of a company to control its management. Consequently the narrow function of financial reporting is of critical importance to the functioning of financial markets in conveying information about a company's financial condition, performance and risk profile. Yet, this is not always the case. A recent parody described the accounting and reporting methods of Enron as follows:

> *"You have two cows. You sell three of them to your publicly listed company, using letters of credit opened by your brother-in-law at the bank, then execute a debt/equity swap with an associated general offer so that you get all four cows back, with a tax exemption for five cows. The milk rights of the six cows are transferred via an intermediary to a Cayman Island company secretly owned by your CFO who sells the rights to all seven cows back to your listed company. The annual report says the company owns eight cows, with an option on six more."*[10]

While clearly an exaggeration, there is unfortunately some truth in this view of the creative accounting and reporting methods that underlay the rise of Enron from a regional oil and gas supplier to a global player in financial trading.

Modern financial engineering techniques have transformed the way in which companies and investors behave, with new risk management tools allowing the packaging and re-distribution of risks to those most willing to bear them. While there is a broad consensus that these developments have strengthened the financial system and improved the efficiency of the economy, recent corporate scandals reflect a failure of traditional accounting standards to keep pace. In consequence, investors - and most likely many company boards – have difficulties in assessing a company's risk profile and performance in various business lines. The result is that companies and investors may be confronted with unknown and unsought risk exposure, raising important issues of corporate governance and, ultimately, financial stability.

Even more worryingly, recent scandals have revealed that company earnings were often manipulated. Having based their earnings predictions on unrealised assumptions, many corporate managers were trapped by the sharp reversal in financial-market sentiment in Spring 2000. With companies heading deeper and deeper into financial difficulty, some managers chose to conceal the fragility in their balance sheets. Earnings manipulation has been the favoured strategy in such circumstances, with sometimes only a thin line between what is acceptable and

[10] From the internet, see http://www.andrewtobias.com/bkoldcolumns/020124.html

unacceptable practice. Many of these issues are discussed in the remainder of this section, which looks first at barriers to effective reporting and motives for distorting information. The growing complexities of information disclosure themselves – caused by financial innovations such as derivative contracts - are highlighted in a second part. The section includes also a box on different account variations recently utilised for massaging earnings and another one on credit derivatives.

3.1. Barriers to effective information disclosure and motives for distorting information

Barriers to effective information disclosure

In the absence of conflicts of interest and cost-free monitoring, managers and investors would be expected to agree on the extent and nature of financial information to be provided. In reality, financial markets are characterised by important principal-agent problems in conditions where the respective interests of management and shareholders diverge. Often, management enjoys an informational advantage over shareholders, whose numbers may be such as to restrict the scope for collective action. Moreover, the management function in a large company is highly complex and only partly observable so that direct monitoring becomes impossible. In such circumstances, the following factors constitute barriers to effective disclosure and shareholder oversight:[11]

- The concept of bounded rationality acknowledges that information is a scarce resource, leading to contracts between management and investors that are not only incomplete but also costly to design, to monitor and to enforce. Therefore actors refrain from setting up ideal contracts and fail to supervise or implement agreed arrangements;

- The existence of asymmetric information points to the natural informational advantage that management might have over investors, suggesting that actions proposed by management, unknowingly to investors, benefit the management;

- opportunistic behaviour where management may willingly "produce" an asymmetric information environment. Hidden actions, hidden information or false signalling can achieve this. Management may under-supply disclosure information as the costs of providing, reporting and interpreting all company relevant information are private but the benefits accrue to all potential users. There is also a question of time consistency of commitments, as management may promise ex-ante to disclose all relevant information but renege on this promise in the event of negative developments.[12]

Barriers to effective disclosure are already difficult to overcome, but the task becomes all the more daunting when considering the possible tempting motives for distorting financial information.

[11] For an interesting discussion of these phenomena see Apreda (2002)

[12] Moser and Venkataraman (1996)

Motives for distorting information disclosure

The recent wave of corporate scandals since the year 2000 indicates that the bubble psychology of the late 1990s inspired excesses not only among investors but also among company managers. Although corporate scandals are not an inevitable feature of sharp market corrections, the pressures associated with sudden changes in the economic and financial environment of companies can be a source of corporate malpractice and even crime. Moreover, the post-bubble period since 2000 has been characterised by higher scrutiny of company accounts, with a number of investigations (internal as much as external) into company accounts uncovering substantial fraud.[13] The following looks at motives for information disclosure distortion.

Accountants and auditors can disagree on the best accounting method to be applied for recording a specific transaction. Such disagreements are at the very heart of efforts to keep accounting standards relevant to changes in the economic and financial environment in which companies operate and, over the years, accounting rules have evolved to reflect such changes. For example, rules allowing major investment costs to be recorded over several years reflect more accurately the implications for a company's medium-term financial condition. As such investment would be expected to impact on the future profitability of the company and reporting sharply reduced outlays in the period the firm made its investment would be to distort economic reality. Similarly, rules have evolved that allow companies to select projects and/or time decisions in such a way so as to achieve a desired earnings profile.[14] However, the evolution of accounting rules to reflect better the financial conditions of a company must be distinguished from financial reporting with the purpose to deceive the public.

While the assessment of a modern company's balance sheet can already be complex, there may also be incentives for company management to further obscure the true financial condition of the company. The ex-ante incentives for managers to maximise shareholder returns depend crucially on the process through which company profits are expected to be divided ex-post. These incentives induce management to create or destroy value, as rational agents cannot be expected to allocate resources optimally if they are not properly rewarded by the company's governance system. To monitor

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[13] Accounting fraud has emerged in many instances after financial bubbles have burst. Corporate bankruptcies and fraud were among the hallmarks of the 1930s, as the financial system adjusted to the earlier collapse in stock market values. A particular accounting trick of that era was to create elaborate webs of holding companies, each helping to hide another's financial weaknesses. The creation of such artifices finds a current parallel in Enron's use of a multitude of business partnerships to conceal the true extent of its indebtedness. In a further parallel, the 1930s also witnessed the collapse of Middle West Utilities, a vast utilities and transportation corporation (Browning 2002).

[14] In more general terms, the recent corporate scandals have fuelled the ongoing debate on whether the goal of a true and fair statement of the financial conditions an assessed company is better achieved through a rule based accounting framework like US General Agreed Accounting Principles (GAAP) or principle based framework such as the International Accounting Standard (IAS). The criteria of understandability, relevance, reliability and comparability are in either case essential components of a reliable accounting framework.

management performance, shareholders resort typically to observable and publicly available indicators (e.g. such as earnings per share or the share price). However, if the division of profit can be influenced by manipulating management performance indicators, rational agents will try to alter these indicators in their favour even if this implies non-value maximising (or even value destroying) behaviour. Manipulation could take the form of accounting adjustments to the balance sheet with the intention of adjusting recorded earnings per share, net income, operating cash flow etc.; While the rationale for such manipulation will vary from case to case, possible motives could include[15]:

- To encourage investment in the company by making it appear more profitable than it really is;
- To enhance the credibility of managers by the achievement of superior results or to increase the remuneration of company officials, which is often directly linked to the performance of the share price;[16]
- To smooth the stream of company profits - by artificially reducing profits in favourable conditions by overstating the reserves and tapping reserves to inflate profits when conditions are less favourable;
- To reduce share prices prior to a management buy-out;
- To minimise tax liabilities or financial penalties following accidents like tanker breaks, environmental damages or alleged cartel behaviour.

3.2. The growing complexity of information disclosure

While the importance of financial reporting may be acknowledged, its significance has increased in the context of a modern financial system.[17] The process of liberalisation and deregulation since the 1980s has led to a generalised relaxation of controls on financial-sector activities and fostered the creation and application of many new financial techniques and products. These have, in turn, facilitated an ongoing trend of disintermediation, whereby market-based finance is growing rapidly. With many factors already complicating the interpretation and comparison of balance sheets, differences in national accounting standards, definitions and regulations make cross-border comparisons particularly problematic.[18] In this context it is worth noting

[15] For a more detailed discussion, see Stolowy and Breton 2000.

[16] A common practice for a newly appointed chief executive or financial officer is to clear the desk of any previous accounting tricks and blame the predecessor, the so-called "big bath" accounting.

[17] Crockett (2002).

[18] For example, a recent report from Standard & Poors describes the difficulties in comparing the quality of credit decisions and the adequacy of provisioning between banks in Western Europe as being "exacerbated ...by the diverse regulations and management practices relating to asset quality accounting." The report goes on to say that "there are major differences between the definitions of impaired, non-performing, and doubtful loans, and related to this, policies on interest accrual vary. There are also significant differences in provisioning and write-off policies applied in light of the prevailing regulation in the individual countries in Europe." See Standard & Poors (2003).

that globalisation has increased the demand for internationally comparable levels of information disclosure.

As dis-intermediation and off-balance sheet activities increase the risk of information asymmetry between management and shareholders, adequate public disclosure of information becomes even more important. Indeed, sentiment in modern financial markets is increasingly driven by published earnings figures and forecasts, as this type of information forms the basis of investor's perceptions of value and risk. All these factors increase the information need for the modern investor.

However, at this juncture the company balance sheet has become more and more difficult to interpret and so a less straightforward guide to investment decisions.[19] Moreover, many of the new financing techniques and instruments are associated with the growth in off-balance sheet activities. A notorious example of techniques to move assets and/or liabilities off balance sheet is the Special Purpose Entities (SPE), which is created by pooling together receivables (or other financial assets) into a newly created entity, then to be used to issue securities to the capital market. SPEs are routinely used for securitisations and fulfil a useful role in project financing. However, SPEs have been abused on a grand scale, concealing from investors the accumulation of massive amounts of corporate debt (see box: Accounting variations).

Box: Accounting variations

An interesting feature of the current wave of corporate scandals is the variation in techniques used to massage earnings. One example of aggressive accounting reportedly involved booking expected profits from long-time contracts up-front. For example, a 30-year contract to deliver electricity to a city for a pre-specified price would have entered the accounts at the estimated value for which the contract could be sold in the market. In this way, the corporation reported the expected accumulated profits from the contract in the first year, instead of reporting profit in each respective reporting period. The effect was to overstate the companies profitability and to conceal emerging problems with the company's business model.[20]

A further means used to inflate earnings was to conceal debt via the creation of Special Purpose Entities (SPEs)[21]. SPEs can serve as vehicles for various intentions such as financing big projects, holding assets/liabilities or receiving cash flows in a financial transaction. Often such vehicles are not formally owned by the company, which benefits from the financing transaction, and so are not consolidated in the company's financial statement. While the use of SPEs is allowed by the US GAAP framework, some companies have created a complex web of SPEs designed to bring many liabilities off-balance sheet and to enable an accounting (not economic) hedge against losses in unprofitable investments. [22]

(To be continued)

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[19] The construction of a balance sheet has always been complex, particularly if a company's activity extended beyond simply selling a product and receiving immediate payment. For example, if the valuation of a company's assets is based on their capacity to generate future revenues, subjective (albeit criteria-based) assessments of the probability of future events come into play. This is the case if fair value principles are used; other valuation methods like historic cost accounting come to different valuations.

[20] See for example Dharan, B.G. (2002)

[21] they are also sometimes called Special Purpose Vehicles (SPV).

[22] On this see for example Powers et al. (2002)

(Continued)

A further means to inflate earnings has been the irregular accounting of leasing operations, where expenditure on leasing is booked as a capital cost rather than as current expenditure. The treatment of leasing costs as a capital item allowed the costs to be spread over a number of years.[23] However, this accounting technique is irregular because the US GAAP allows the booking of leasing as capital investment only if the corporation had extended its own network. Similarly, the accounting of leasing operations has also been used to bring revenues forward.[24]

Derivatives

An important example of how complex innovation in modern finance affects balance-sheets is the treatment of derivative instruments. Derivatives, which can be traded via an exchange or over-the-counter (OTC), are leveraged contracts over securities, commodities, interest rates or foreign exchange rates. Their common characteristic is that they require money to change hands at (some) future date(s) and they are priced on the valuation basis of the underlying instrument. A major advantage of derivatives is that investors and sellers can use these instruments to acquire or transfer risk according to their respective risk tolerance and this can be achieved without transferring ownership of the underlying asset. The use of derivatives was once confined to financial institutions but non-financial companies now use these instruments on a regular basis, to hedge or transfer risk but also to increase profits or even circumvent rules and regulations. Derivatives have also facilitated efforts by companies to develop global operations by, for example, protecting against exchange rate fluctuations and other financial risks not stemming from their normal business operations. Derivatives are not always straightforward and combinations of different derivative tools can result in the creation of opaque financial instruments - with the potential of a complex and even dangerous cocktail of risk factors. [25] While derivatives are generally regarded as beneficial to financial markets, there are those who warn in stark terms about the dangers they pose.[26]

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[23] See for example Stern and Noguchi (2002)

[24] Securities and Exchange Commission (2002a)

[25] As an example of what might go wrong with derivatives, one might recall the case of Metallgesellschaft, a large German industrial conglomerate engaged in a wide range of activities, from mining and engineering to trade and financial services. In December 1993, the firm reported derivative-related losses of ultimately more than US$1 billion. Early reports blamed lax internal controls, but later investigations confirmed that its use of energy derivatives had been an integral part of its business. Derivatives had been used to allow the firm to offer customers long-term price guarantees on deliveries of petroleum products such as gasoline and heating oil. The demise of the company came as product prices – which had been hedged against rising oil prices – began to fall sharply. See Kuprianov (1995)

[26] Federal Reserve Chairman Greenspan has described derivatives as "the most significant event in finance during the past decade", while the famous financier Warren Buffet, CEO of Berkshire Hathaway, sees derivatives as "time bombs, both for the parties that deal in them and the economic system." See Greenspan (1999) and Buffet (2003).

Companies may be very active in the derivatives market and enter into highly complex contracts. Given their complexity, the valuation of derivatives raises a host of complications. Many observers favour the use of mark-to-market valuations of derivatives as a means to ensure that these instruments are correctly valued in company accounts.[27] However, some instruments are not traded in liquid markets and consequently uncertainty in the valuation of derivatives might arise. Although an independent auditor can guarantee consistency in the valuation methodology, it can be extremely difficult to make an "objective" valuation of derivatives positions.

To this end, recommendations exist on how companies can ensure adequate disclosure of their derivatives positions, for example in the banking and securities firms sector.[28] As a minimum, investors should know the extent and nature of these positions (e.g. notional principal, their maturity, any short or long term cash requirements, market values, credit risk), their purpose (e.g. for hedging or for speculation) and the underlying accountancy choices made in their valuation. If a corporation cannot provide quantitative information, it should disclose a qualitative valuation assessment. The objective should be to ensure that derivatives are used in a manner consistent with the overall risk management policies of the company, to be already established and approved by the board of directors. Policies governing the use of derivatives should be clearly defined in published documents, including the purposes for which these transactions are to be undertaken. These documents should make it clear that the senior management has approved the procedures and controls to implement these policies, and that management at all levels is actively enforcing them. Companies should also assure investors on their internal control mechanisms (e.g. value at risk measures) and provide reports on stress testing for evaluation of overall credit and liquidity risk. In addition, off-balance as well as on-balance sheets instruments should be brought to the attention of investors. Another risk inherent in OTC derivatives arise due to uncertainty about the creditworthiness of counterparties[29], which is increasingly addressed via the use of credit derivatives (see box).[30]

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[27] Mark-to-market valuation determines the market price of an asset. The term is synonymous with "fair value", although fair value is more explicit in including the cases where a market does not exist and the value of an asset has to be constructed according to an evaluation model (mark-to-model). More generally, it has been argued that mark-to-market accounting makes earnings more volatile, although this volatility would simply be a reflection of realities in the market place. Markets would reflect more volatile earnings by, for example, placing a higher risk premium on the relevant companies' share prices. Mark-to-market valuation could create problems when the size of a company's holding of an asset relative to the overall market would imply a collapse in the price of the asset if that holding were to be liquidated e.g. due to an urgent need for liquidity. The mark-to-market valuation technique has also been questioned in relation to assets that are to be held to maturity, as current market prices are irrelevant in that case.

[28] See for example Basel Committee (1999). The issue of disclosure is also addressed in the currently discussed International Accountancy Standards 32 and 39 (Financial instruments: disclosure and presentation) and IAS 39 (Financial instruments: recognition and measurement) from the International Accountancy Standards Board (IASB).

[29] A counterparty is the other side of a trade. If a bank buys a credit default swap protection from another bank to insure itself against the possibility that a loan might not be repaid, this other bank is its counterparty. The risk is that the counterparty itself goes bankrupt, making the bought protection unenforcable.

[30] Another possibility for protecting against counterparty risk is the use of embedded rating triggers in derivative contracts (discussed in the section on rating agencies).

Box: Credit derivatives – a growing concern for regulators and supervisors

More recently, the attention of regulators and supervisors has turned to a specific subset of derivatives, known as credit derivatives. A credit derivative is a customised agreement between two counterparties in which the payout is linked solely to some measure of creditworthiness of a particular reference credit. Credit derivatives are thought to constitute only about 1% of the total derivatives market but their use is expanding rapidly. Stylised examples of the most important credit derivatives include:

- **Credit Default swaps**. A buyer of credit protection pays an annual fee or up-front payment to the seller in return for being protected if a "credit event" occurs. Default swaps can be structured around a country or a company. A recent Fitch study says that this off-balance sheet instrument accounts for about 47 per cent of the credit derivative market.

- **Collateralised Debt Obligations (CDO)**. A CDO is essentially a securitisation whereby the interest and principal payments are funded by the performance of the underlying assets. The possibility to structure the securities in various tranches, from very risky to very secure, enables different investor groups to take on their desired amount of risk. Off-balance sheet CDOs are estimated to represent about 39 per cent of the credit derivative market.

- **Total return swaps:** A total return swap covers derivatives where one party agrees to exchange with another the total return of a defined asset in return for receiving a stream of (periodic) cash flows. The total return of an asset can depend on many factors such as interest rate fluctuations or default. A bank (hedger) can transfer all rights originating from a loan - interest plus capital repayments - to an investor. The total return swap is a mechanism for the investor to accept the economic benefits of asset ownership without utilising the balance sheet. The secondary market for this typically off-balance sheet derivative is very liquid. It is estimated to account for about 4 per cent of the total credit derivatives market.

Commercial banks, insurance companies and hedge funds are major participants in the credit derivative market, which has raised concern in terms of potential threats to financial stability. A recent report by Fitch argues that the rapid expansion, immaturity and relative lack of transparency in the market presents "unique risks".[31] With disclosure varying greatly by sector and comparability further obscured by differences in international reporting standards, the report emphasises the difficulties faced by investors in making fully informed decisions. The report concludes that disclosure on credit derivatives is "less than optimal" under all accounting standards and that the underlying assumptions regarding mark-to-market valuations are often not transparent. Consequently, the report sees a need for improved disclosure practices concerning credit derivatives so as to avoid the creation of unintended risk concentrations. Finally, the report warns that heavily concentrated counterparty risk could pose an additional threat to financial stability in a time of severe market stress.

[31] Fitch (2003)

3.3. Assuring compliance

An international framework of rules and regulations on financial reporting is necessary, not least to ensure that the disclosed information is comparable among companies and so to avoid significant information processing costs for investors. In this context, the International Accounting Standards Board (IASB), whose accounting standards will be mandatory for EU listed companies from 2005 onwards, is currently consulting with European companies – mainly banks - to reach a common understanding on the necessary provisions for derivatives and hedging operations accounting. However, the existence of regulations and rules is unlikely to deliver full and proper disclosure in the absence of corporate governance structures that offer appropriate incentives for compliance.

Some commentators have called on management to become more active in disclosure of information and have suggested that this should be reflected in the content of the annual report. The need for greater financial sophistication among audit committee members has been emphasised. However, it has been argued that audit committees are not auditors and - as they typically meet two or three times a year - cannot detect accounting and operational tricks, let alone fraud.[32] Apart from the audit committee, the company board itself could also be required to understand better the use of financial instruments by the firm and the risks they might pose. It has been proposed that a public body of forensic auditors should examine bankruptcies that involve accounting fraud (i.e. analogous to arrangements for plane crashes). These reviews could examine eventual early audit firm warnings regarding (i) accounting irregularities or (ii) the failed company's viability as well as (iii) possible relevant overlooked warning signs (yellow or red flags). Such a forensic procedure would identify weak links in managing securities fraud and provide an incentive for management to behave ethically.

Insufficient financial disclosure poses a threat to corporate governance to the extent that it obscures crucial information and ultimately undermines investor confidence. Rules governing financial transparency and proper accounting are essential, although they are not a panacea. Rules must be accompanied by a climate of disclosure and openness within the company so as to overcome the numerous problems that are inherent in the effective transfer of information between the company management and its shareholders. This, however, can only be accomplished if the principle-agent problem - pitting the interests of management against those of shareholders - is successfully overcome.

[32] Warren Buffet has suggested that auditors ask themselves the following questions: (i) If the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way different than the manner selected by management? (ii) Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why? (iii) If the auditor were an investor, would he have received the essential information for a proper understanding of the company's financial performance during the reporting period? (iv) Is the auditor aware of any actions – either accounting or operational – that have had the purpose and effect of moving revenues or expenses from one reporting period to another? See Buffet (2003).

4. Addressing the principal-agent problem

The separation of ownership and entrepreneurial control is a central feature of modern capitalism, implying a specific interaction between the creator of a business idea and the investor with the necessary capital to convert that idea into reality. Consequently, the common theme in the corporate governance related literature is the existence of this principal-agent problem. For public companies, the principal-agent problem arises in the relationship between shareholders and management, a relationship, which can only be efficient if the interests of the management and the investors can be appropriately aligned. The challenge is how to ensure that the agent (management) acts in the best interests of the principal (the shareholders) in conditions where their respective interests may diverge, where management enjoys an informational advantage and shareholding may be so diffuse as to restrict the scope for collective action and control.

Various checks and balances exist inside and outside a company to minimise the risks associated with the principal agent problem and are exercised by what are often described as "company watchdogs". These include independent directors not involved in operational business and elected by shareholders, the company auditors, investment analysts and credit rating agencies. The problem with these watchdogs is that many of them experience their own conflicts of interest. For example, independent board directors may receive company "perks", thereby weakening their objectivity, auditors may be inhibited in their control function by a desire not to jeopardise other lucrative non-audit consultancy income from the company, and investment analysts may prefer to issue a favourable rating of a company in the hope of securing future underwriting business. Some commentators have even questioned the incentives for shareholders to monitor the company because inflated earnings can help to generate additional interest from potential new investors, resulting in a wealth transfer to "current" shareholders from "new" shareholders. In consequence, a central focus in responding to the more recent corporate scandals has been on improvements in the incentive structure of company watchdogs. Proposals for improving corporate oversight can be categorised under two main headings: (i) checks and balances inside the company and (ii) external control mechanisms, which are considered in turn below.

4.1. Safeguards internal to the company[33]

Proposals to strengthen checks and balances inside the company focus on (i) incentive structures for management and procedures for internal control; (ii) the role of the board of directors; and (iii) facilitating shareholder control as well as encouraging the responsibility of large institutional investors.

4.1.1. Incentive structures for management and procedures for internal control

Proposals to alleviate the principal-agent problem for management are focusing on:

- A competitive market for managerial skills: A competitive market for managerial skills can help the shareholder to assess the potential of individual managers more

[33] Valuable inspirations for this section have been the NBER working papers on Corporate governance from Zingales (1997); Shleifer and Vishny (1996) and Becht et al. (2002)

efficiently. However, the effectiveness of such a market can be limited by the fact that existing managers within the company are often responsible for recruiting new managers - creating yet another conflict of interest. In this context, proposals have been made for non-executive directors to be more involved in the selection process for new managers.

- Performance related compensation: A popular use of incentives to address the principal-agent problem involves performance-related compensation schemes for company managers. These schemes need to be carefully designed and implemented, as some variants (e.g. short-term stock options) can lead to abuse. Ideally, performance-related schemes should have a long-term focus and should not only rely on "objective" criteria – like the company share price - which could be open to manipulation. A further reason for caution in the use of these schemes is that their asymmetric nature - with good performance rewarded but no penalties for failure – can encourage excessive risk taking by management (see Box for more discussion).

- Clarification of fiduciary duties: Fiduciary duties to shareholders, which include reasonable care, diligence and loyalty, could be more clearly defined, together with liability regimes opening the possibility of seeking compensation for past actions that have harmed investors' interests.

- Standards of internal control: Effective standards of internal control are integral to effective corporate governance practices and include setting the "tone at the top". Proposals in this area include (i) making top management of a company more responsible for establishing and maintaining an effective internal control system with appropriate oversight by corporate monitoring bodies; (ii) adopting codes of conduct which provide information and guidance to those within a company about the company's philosophy toward ethical business conduct and the basic principles governing that conduct; and (iii) establishing or improving processes to monitor compliance with policies and procedures that are implemented to prevent and/or detect illegal acts.

4.1.2. Board of directors and audit committee

In the effort to make the board of directors (and the audit committee) a more effective check on the power of the management, special attention has been paid to the role of independent directors. A key set of proposals relates to a strengthening of the role of independent directors on the company board. For example, the NYSE has proposed that (a) independent directors should comprise a majority of a company's board and that boards should convene regular executive sessions, in which the non-management directors meet without management; (b) these directors should have more accounting or financial management experience; (c) the definition of "independent director" should be tightened, disqualifying any potential candidate who has a "material relationship" with a (listed) company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company); (d) no employee of a (listed) company can become an independent director until five years after his employment has ended; (e) no employee or affiliate of a present or former auditor of the company can become an independent director until five years after his employment/affiliation has ended.[34] However, apart from fulfilling formal

[34] New York Stock Exchange (2002)

requirements, the most significant characteristic of good independent directors is the courage to speak out and challenge management if necessary. On the other hand, doubts have been expressed about efforts to increase the role of independent directors. These doubts are based on concern that directors would either not be independent enough or be so independent of management as to create a rival power centre within a company, thereby diluting coherent control and effective governance (Greenspan 2002).

Box: Conflicts of interests in the setting of executive compensation[35]

Executive compensation poses a special problem as it is not only the result of incentive contracts which try to align the interests of management to those of the company, but also the outcome of a power struggle within the company itself. In this latter respect, management enjoys a considerable advantage over more numerous shareholders in its capacity for collective action. Thus, the process of deciding management compensation becomes part of the corporate governance problem because of a range of conflicts of interest. Main conflicts of interest can be identified as follows:

Directors may not automatically seek to maximise shareholder value in compensation negotiations with the management as they face various incentive problems of their own. For example, directors may wish to be re-appointed to the board as a directorship provides – next to an attractive salary – prestige, as well as business and social connections. However, management plays an important role in the re-nomination process, as the management proposal is typically the only proposal offered to shareholders. In these circumstances, developing a reputation as a "difficult director" may hurt one's chances of re-nomination or of receiving additional directorships in other companies. On the other hand, agreeing to a large pay package for the management imposes little financial costs on directors.

Directors often lack independent expert advice and information sources when deciding on management compensation. Compensation consultants can be employed to provide the board with advice on management compensation. However, a consultant may have incentives to assist management in obtaining high levels of compensation if he or she has other involvements with the company. Furthermore, a consultant is typically hired by the management. Consultants can skew negotiations on compensation in favour of management by arguing that management compensation should reflect superior performance with a higher than average pay package or should at least reflect prevailing industry levels in the event of inferior performance. Consultants may also help to camouflage management compensation in the form of pensions, deferred compensation plans, management loans, post-retirement perks etc.

[35] The following is largely based on Bebchuk and Fried (2003)

4.1.3. Facilitating shareholder control

The focus in improving the effectiveness of shareholder control centres on the following measures:

- Facilitate voting in shareholder meetings: Measures to facilitate voting by shareholders encourages more active oversight of a company. Non-controlling (and especially small) shareholders experience what has been termed "rational apathy", because their voice is too small to influence the decision-makers in a company. However, the voting process could be facilitated (for both small and large investors) by exploiting new technologies, like the Internet, to disseminate information and invitations to general meetings. Electronic voting might even be considered at some time in the future.

- Investigative rights for minority shareholders: Another proposal to enhance shareholder control has been to assign a special investigative right for minority shareholders, which can be an important deterrent against wrongdoing by management.

- Enhance the role of institutional shareholders: Another set of proposals relates to the role of large institutional shareholders, encouraging their more active involvement in the oversight of a company. Larger shareholders have a greater incentive to scrutinise management of a company and stand more chance of success in efforts to remove the managers. Accordingly, these mainly institutional shareholders – such as pension funds - could be encouraged to vote in shareholder meetings, to raise issues of concern to other shareholders in general, and even to solicit votes against management proposals.

- Encourage the creation of larger investors: Diffuse ownership of shares magnifies the principal-agent problem by limiting the scope for collective action among shareholders. A possible solution would be to facilitate the concentration of voting rights into a small number of investors with a large collective stake in the company. Hostile takeovers are one way in which concentration can be achieved rapidly. In a typical hostile takeover, the bidder acquires control of the target firm and is then in a position to replace the management. However, takeovers are difficult and expensive (often made so by regulatory actions) so that only major performance failures by the management of potential target companies are likely to be addressed.[36] A major risk associated with large shareholders is that they are likely to represent mainly their own interests, which need not coincide with the interests of other investors or the firm.

4.2. Safeguards external to the company

Many proposals for corporate governance reform address perceived shortcomings in the external control of companies, mainly related to conflicts of interest. Audit firms,

[36] Apart from requiring liquid capital markets to give the bidder access to vast amount of capital at short notice, they are also politically vulnerable and opposed by managerial lobbies. Another problem arises if the bidding is initiated by a company management engaged in empire building. In that case it is likely that – for the benefits of control - the management will overpay for acquisitions.

investment analysts and credit-rating agencies provide the main safeguards outside of a company.

4.2.1. Audit firms

Audit firms are the main line of defence in ensuring effective external oversight of a company. In the case of several recent corporate scandals, potential conflicts of interest within the relevant audit firm have received much attention. It has been suggested that a minimum requirement for corporate governance reform would be to loosen the relationship between audit firms and company management. To this end, suggestions to prohibit auditors of a company from obtaining any significant revenues from non-auditing business with the same company have been made so as to avoid the creation of "too-big-to-lose" relationships. Another proposal in this vein is that companies should pay fees into a central fund, which would be used to pay for government-appointed auditors. Private-sector firms would still provide the audit, but the direct link between companies and their auditors would be broken. The counterview to these proposals is that they would destroy the synergy benefits of combined auditing and consulting and would necessitate high learning costs for new auditors extending over months or even years. More moderate proposals include to: (a) strictly divide the auditing and consulting functions on each firm or cap consulting charges to a certain per cent of the total fee; or (b) to rotate partners on each audit every five years, or even rotate the audit firm. Additional reforms proposed include (c) the appointment of auditors by shareholder vote, for a fixed, non-renewable 5-year term; and (d) a cooling off-period before auditors can join the companies they audit.

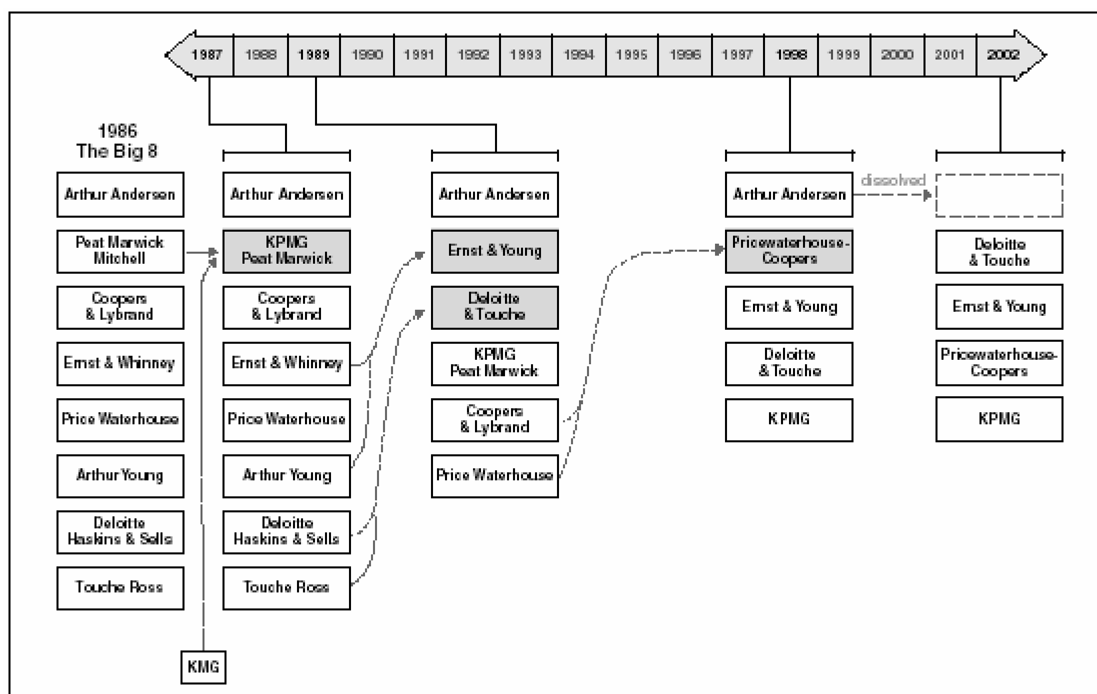
The following looks at the main findings of a report on the subject demanded in response to recent accounting scandals.

Audit Firm Concentration

Only a few firms are capable of auditing large publicly listed companies and smaller audit firms face significant entry barriers into that market segment, raising potential choice, price, quality and concentration risk concerns. These are main conclusions of a General Accounting Office (GAO) report, the audit, evaluation and investigative arm of the US Congress (General Accounting Office 2003). Congress demanded the investigation in the wake of the audit scandals in 2001 and 2002, at a time when the disintegration of Arthur Andersen - following its indictment on an obstruction of justice charge - eliminated one of the big 5 audit firms and left the remaining 4 with amplified market shares. The conclusions of the GAO report are equally relevant to the EU, where the big 4 are also dominant players in the market for audit services.

The GAO concluded that a few audit firms provide services for the vast majority of all public companies in the US, particularly for large national and multinational companies. The big 4 audit over 78 percent of all US public companies and 99 percent of public company annual sales. Internationally, the big 4 dominate the market for audit services as well. This concentration process, which had reduced the number of large audit firms in the US from 8 in the 1980s, to only 4 today, had largely been the result of mergers and the dissolution of Andersen in 2002 (see following table).

Table 1: The consolidation process of US audit firms



Source: GAO.

The most observable impact of audit firm consolidation is the reduced number of auditor choices for most large national and multinational public companies. The underlying reason for this limited choice is that corporations prefer audit firms with established records and industry-specific expertise. Based on a survey carried out by the GAO, 88 percent of all large company respondents said that they would not consider using a smaller (non big 4) firm for audit services. Evidence comes also in the form of an analysis of the over 1000 former Andersen clients that changed auditors between October 2001 and December 2002 suggesting that 87 percent of public companies changed to another big 4 audit firm. In addition, 94 percent of all survey respondents indicated that they would have 3 or fewer alternatives for switching audit firms. The result is that, in certain industry sectors, specialisation can limit the number of potential audit firms choices for large public firms to a few, sometimes only 2 firms (see table 2).

Table 2: Audit firm concentration in different economic sectors

Economic Sector (reference year)	**Concentration rate of the respective two most dominant audit firms, in percent**	
Reference year	1997	2002
General building and contractors	64,5	80,1
Petroleum and coal products	61,7	94,6
Transportation by air	77,4	86,1
Non-depository Institutions	81,7	87,9

Source: GAO.

Market barriers for smaller audit firms

The GAO notes that smaller audit firms face a number of barriers for entering the market for auditing larger public companies. Smaller firms generally lack staff resources, technical expertise, and global reach. Among other issues, the following is mentioned:

- Anecdotal evidence exists that – for reputational reasons - investment bankers and institutional investors often prefer that public companies use the big 4 to audit their financial statements.

- Small audit firms are perceived to have less uniform quality standards, practices and procedures between their affiliates and many public companies are not aware that smaller audit companies dispose of international expertise.

- Non-big 4 audit firms face problems due to their partnership structure in raising capital to expand their existing infrastructure to compete with the big 4.

- Small audit firms face disincentives to compete with the big 4 because of increased litigation risk and insurance costs associated with auditing large public companies.

The GAO concludes that the result might be a dual market structure, whereby in the first market the big 4 would compete with smaller audit firms for medium and small public companies and a second market where the big 4 compete among themselves for the largest public company clients.

Audit price, quality, and auditor independence

Despite the high concentration ratios, the GAO finds little empirical evidence to link past consolidation to changes in audit fees, quality or auditor independence. Existing research on audit fees suggest little effect of concentration. However, analysis is hampered by the evolving scope, technological developments and standards of audits and of the legal reforms altering audit firms' litigation exposure. The growth of management consulting services is a particularly striking development and the GAO cites the possibility that audit service prices have been kept artificially low so as to obtain new clients and gain entry into other more lucrative service markets, primarily management consulting. Therefore, stable audit fees may reveal little about the potential market power of the big 4 audit firms.

The GAO suggests that auditor independence and quality would be inextricably linked with independence being a component of audit quality. However, measuring audit quality is difficult, as quality becomes primarily a matter of public concern if a company experiences financial difficulties and thereby alerts investors. While audit re-statements have risen during the 1990s and audit firms seem to have issued fewer warnings to investors on the financial distress level of companies before bankruptcies, the GAO does not go so far as explicitly linking consolidation with declining audit quality by considering the available evidence as "inconclusive". However, others have proposed that the quality of audits should be subject to independent oversight by a regulatory body with the power to re-audit some companies at random on an ad-hoc basis.

In general, the GAO recommends that governmental agencies should continue to monitor the existing concentration effect on prices and audit quality, especially in some industry sectors. An evaluation of the barriers-to-entry facing smaller audit firms is suggested so as to determine whether their removal could prevent further concentration.

4.2.2. Investment banks

Other proposals for improved external control relate to the activities of financial analysts working for investment banks. Investment banks have come under the spotlight as a consequence of judicial investigations into their role in misleading investors. Calls for reform were fuelled by revelations that analysts in several investment banks had encouraged investors to purchase shares, which they privately dismissed as "junk", and had allocated desirable initial public offerings (IPOs) to their favoured clients. A result has been a global settlement reached on 20 December 2002 between leading Wall Street investment banks and a group of major securities regulators, the New York Attorney General and the Chairman of the New York Stock Exchange (Securities and Exchange Commission 2002b). In addition, the Securities and Exchange Commission (SEC) voted on 6 February 2003 to adopt a new Analyst Certification Rule, which will require research analysts to certify that the views expressed in their research reports accurately reflect their personal views about the securities or issuers concerned (Securities and Exchange Commission 2003a). The following section examines the background to the settlement with investment banks as well as the new SEC rule and provides an assessment of the proposed reforms.

<u>Potential Conflicts of Interests in Investment Banks</u>

A typical investment bank consists of (a) various trading departments (equity, bonds, mortgages, derivatives); (b) market analysis departments; (c) departments offering other services (private and public new offerings of stocks and bonds, tax advisory work and merger & acquisition services) as well as (d) client advisers or sales persons. In practice, the daily operations of these different departments present a series of potential conflicts of interests between the bank and its clients and between the corporate client looking for investment banking or advisory work and the investor client looking for a profitable investment. Some illustrative examples of these potential conflicts of interests include:

- Misuse of analysts by client advisers or sales persons to assist investment-banking deals**.** Typically, a company wishing to issue debt or equity will hire an investment bank to underwrite securities in a public offering. The bank receives a fee for this service and will normally publish research on the security. The risk is that the investment firm may have an incentive to publish positive research to help in selling the underwritten security to the market or to safeguard future investment banking opportunities with the client concerned. It has been reported that issuing companies have threatened to withdraw their business if the analyst coverage is not positive. The problem is compounded by the fact that analysts are most often paid on the basis of proceeds from the underwriting business. Consequently the analyst faces a serious conflict of interest in producing his research. The relationship between the investment bank providing positive research and its client is symbiotic, benefiting both sides. The misinformed buyer of the security is the victim.

- An investment bank can distribute specific favours to decision-makers in client companies, expecting business in return. An example would be company executives awarding investment banking business not to those banks, which offered the best terms, but to those which offered the most lucrative IPOs to the executives. The victims, in this case, would be the shareholder.

- Investment bankers often advise companies on acquisitions and issue a "fairness opinion" on the price paid. In the bull market of late 1990s, investment banks were reported to have advised clients to pay huge sums for other companies and thereby collected very significant fees. To shield the management of the acquiring company from shareholder lawsuits linked to over-pricing, the banks wrote "fairness opinions" in which they justified the high prices. Selling a deal to a client and justifying it at the same time with a "fairness opinion" is another conflict of interest – to the possible disadvantage of the acquiring company's shareholders (Tully 2002).

- Combining investment banking activities with commercial banking activities opens up a range of further potential conflicts of interest:[37]

  - Investment banks can acquire additional insider information from commercial banking relationships.

  - Traders can misuse retail client advisers to sell worthless positions to unsuspecting clients through the commercial banks' branch network.

  - Investment banks can link low interest rate loans to receiving highly profitable investment banking work (a practice known as tying)

  - A comercial bank may pressure a borrower that is in financial difficulties to issue securities that the bank will underwrite and sell to the public with the understanding that the proceeds of the issue are to be used to repay the loan.

The Wall Street Settlement

In the past, many observers viewed the possibility that investment banks would exploit these conflicts of interests to their own advantage as remote (Santos 1998). This view was supported by referring to potential reputational costs for the banks, the supervision exercised by regulatory authorities, and self-regulatory standards.

[37] The repeal of the **Glass-Steagal Act** in the US allowed investment banks to add a retail distribution network to their activities. The Act, undermined on a practical basis on many instances already earlier and completely repealed in 1999, has kept investment banking separate from commercial banking for 6 decades and had been enacted in the wake of discovered scandals in the great depression of 1929. The repeal allowed investment banks to expand, to merge, or to become commercial bank players as well, allowing them to give loans to companies and take deposits.

However, recent revelations have severely undermined this view. US Congressional investigators discovered evidence in October 2002 that[38]

- investment banks had linked the award of IPO shares for client firm executives to investment banking business and might have illegally underpriced the shares. As a result, share prices soared in many cases on the first trading day and small investors gaining access later in the process were more likely to be left with the losses in companies that, in many cases, never recovered.

- investment banks had potentially used improper due diligence in bringing companies to the public markets to create investment banking fees as some companies had clearly not enough assets and revenue to remain viable.

- questionable analysis had been used to justify unrealistic price targets, with some investment banks advising investors to hold (or even buy) shares in which the share prices were certain to plummet. Unwilling to issue any sell recommendations on investment banking clients, one investment bank instead suspended the coverage of underperforming companies.[39]

On 20 December 2002, after relatively short negotiations, a group of major securities regulators, the New York Attorney General and the Chairman of the New York Stock Exchange, reached a settlement with leading investment banks to change their practices in a number of areas. Under the so-called Wall Street settlement investment banks agreed to:[40]

- insulate analysts more effectively from investment banking pressures. Banks will be required to cut the links between equity analysts and investment banking, including the link between compensation of individual stock analysts and executed investment deals. The practice of analysts accompanying investment-banking personnel will stop.

- ban the distribution of IPOs to executives who are in a position to influence investment banking decisions (spinning).

- to provide investors with independent research for a 5-year period, bought from no less than 3 independent research firms. An independent person in each bank, chosen by regulators, will monitor the arrangement. This is meant as another assurance that individual investors can get access to independent research.

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[38] House Committee on Financial Services (2002).

[39] These Congressional findings came after the Attorney General of New York had agreed with Merrill Lynch to reform investment practices following the release of a series of company internal e-mails showing that investment bank analysts had privately derided the very same companies they were promoting in public (Office of New York State Attorney General 2002a,b). In another development, the National Association of Securities Dealers (NASD) has started an inquiry into Wall Street lending practices. The NASD, a self-regulatory organisation that oversees US securities companies, began an investigation last year into whether banks have been involved in "tying" (Silverman and Michaels, 2003).

[40] The settlement had been finalised on 28 April 2003, Securities and Exchange (2003b).

- a disclosure on stock analysts' ratings and price target forecasts, in order to be able to publicly evaluate and compare the performance of the analysts.

- a total payment of about 1.4 billion USD of fines from leading Wall Street firms; also to be used for restitution and for investor education.

The announcement of the settlement by regulators was hailed (by them) as an "historic agreement to reform investment practices". However, many other observers were more cautions or even cynical. Although some sources of problems, such as the distribution of IPOs to chief executives and conflicts for analysts will be addressed, many problems remain. One such issue concerns independent research and the willingness of investors to pay for it once the initial 5-year period expires. Another problem is that although analysts will no longer be compensated for their contribution to individual investment banking deals, their salary is still the result – ultimately - of deal making activity.

Another cause for concern are the many other conflicts of interests within investment banks, which have not been addressed by the settlement. For example, fixed income and credit analysts, responsible for the sale of bonds, other interest rate securities and the still booming area of structured finance are not covered by the settlement. Some say that similar conflicts exist in this sector also. It has been suggested that the fact that the fixed income and structured finance market is still performing very well – unlike equity business – makes the search for a scapegoat unnecessary for the moment.

Although investment banks say that remaining conflicts of interest are well managed within their firms and could even be a source of creativity, other observers beg to differ. Some suggest that the settlement might lull the investor into a false sense of security, as it could create the impression that investment banks will from now on be 100 per cent trustworthy and honest. However, this is not necessarily guaranteed.[41] An alternative approach to the settlement has been proposed and is based on "total transparency". Under this proposal, regulators and investment banks would have to expose their conflict of interests publicly. A consequence of this approach would be that investors – particularly retail investors - could probably never be confident that investment banks would be able to offer objective and independent advice. So instead of individual stock hunting, retail investors would in that case be transparently better of by buying index funds. And for professional and institutional investors, this approach would support the provision of independent analysis - offered by subscription-only niche research boutiques.

4.2.3. Rating Agencies

Credit ratings are important for both investors and issuers and their importance has been increasing since the 1970s. The wider use of credit ratings can be attributed largely to increased securities trading and market-based credit financing, while credit

[41] As economic commentator Robert J. Samuelson wrote: "…anyone who thinks the settlement will make investing much safer or more honest is probably someone who thought – only a few years ago – that the Internet was the greatest invention since the steam engine." Samuelson (2003).

ratings are also heavily used in the expanding field of structured finance.[42] The significance of credit ratings is set to increase even further with the adoption and implementation of the new Basle capital accord (Basle II), which will rely heavily on this type of information for the assessment of risk within the banking sector.[43] However, the rating agencies have recently come under heavy criticism due to their failure to anticipate high-profile debt defaults.

A notable feature of the recent wave of corporate scandals (as with the South East Asia financial crisis of 1997/98) has been the fact that rating agencies failed to warn investors about hidden problems. For example, the rating agencies downgraded Enron only when problems became too obvious to be overlooked. Critics argue that their failure to identify financial irregularities at Enron is a symptom of more deep-rooted problems relating to the environment in which these agencies operate. Concerns about rating agencies have focused on (i) potential conflicts of interests, (ii) the lack of transparency in their rating decisions, (iii) their said reluctance to downgrade issuers with rating triggers and (iv) barriers of entry which – some say - have removed the incentive to safeguard the quality of their research.

A SEC study - following a two-day hearing on the matter – was issued in January 2003 and had been followed by a discussion paper, soliciting comments on eventual reforms.[44] Although US originated rating agencies are by far not the only recognised rating agencies in the EU Member States, they have a strong – some observers use the term "dominant" - presence in most European countries. Therefore, any decisions concerning the modification of the US framework could have repercussions for rating agencies in EU Member States as well. Rating agencies in EU Member States are recognised by national regulators mainly on criteria like their credibility, integrity and market recognition. Like in the US, the ratings are used for grading corporations and their various forms of debt issuances. The remainder of this section examines the main elements of the current debate on credit rating agencies and possible proposals for reform.

The Rationale for the Existence of Credit Rating Agencies

A credit rating may be defined as a relative assessment of the creditworthiness of a borrower, i.e. the probability that the borrower will repay its debts. Ratings are usually issued together with a credit outlook.[45] On this basis, the role of rating agencies in credit markets can be understood as:

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[42] For example asset-backed securities, credit derivatives, especially also collateralised debt obligations (CDOs), where debt is structured into tranches and a specific rating for each of them is required. See also section 3.2. on the growing complexity of information disclosure.

[43] On background on rating agencies practices as well as certification procedures in an international context see Estrella et al. (2000).

[44] Securities and Exchange Commission (2003c)

[45] Rating agencies typically assign one or two analysts to every rating process, often a senior analyst and a junior analyst. They meet with the debt issuers to gather information, while the final rating is often assigned by a committee.

- *Monitoring for Investors*: Credit markets are characterised by informational differences between companies that wish to finance their operations and investors that wish to achieve reasonable returns while protecting themselves from the risk of default. Borrowers are unlikely to be entirely transparent to investors about their creditworthiness, as there may be substantial rewards from exaggerating more positive aspects. Verification of creditworthiness by outside parties may be costly and, while it may be feasible for large investors to undertake their own credit-analysis, small investors typically lack adequate resources. It is in these conditions of information asymmetry that rating agencies fulfil their role of monitoring credit quality on investors behalf.

- *Gatekeeper Function for Issuers:* In the absence of knowledge about the quality of individual projects, investors would place an average value on all investment opportunities. Without the capacity to discriminate, investors would be likely to invest in many low quality projects, while forgoing more profitable investment opportunities. Consequently, issuers of high quality debt or equity have an interest in overcoming the information asymmetry inherent in financial markets and credit rating agencies play this role.

Conflict of interests for credit rating agencies

The dual role of credit rating agencies as monitor for investors and gatekeeper for issuers has resulted in concerns about conflicts of interest.[46] It has been argued that they face the same conflicts of interests as equity analysts insofar as ratings are mostly given in exchange for a fee. Some observers suggest, therefore, that the established credit agencies may have an incentive to give favourable ratings to secure future business. Credit rating agencies concede that they rely overwhelmingly on debt issuer fees for their revenue - as charging the investor for the rating might give the rating agency only a fraction of what all investors in their totality would be willing to pay. This is because of the public-good characteristics of a rating, which result in the ability of a rating information purchaser to subsequently share or resell the information to other investors, without diminishing its usefulness to himself. Only some of the smaller niche agencies rely exclusively on user subscriptions.

Potential conflicts of interest are sharpened by the credit agencies practice of marketing ancillary services to debt issuers, such as consulting services. For example, agencies work with the companies concerned to assess how a merger might be conducted to achieve a desired rating. The question arises if this exercise gives the company implicitly the right to a “promised” rating. A more serious concern is that these additional services make agencies increasingly dependent on non-rating based fee income, leading to a similar conflict of interest as in the audit profession. Although these additional services represent a very small share of agencies’ overall revenues at present, there is ample scope for an increase in this share over time. The credit rating agencies counter that they do not face conflicts of interest because:

- credit analysts are paid on the basis of quality rather than quantity of ratings.

[46] A related conflict of interest claim is that agencies serve existing investors’ need for stable ratings well, thereby neglecting their role for new or potential investors who would be interested in up to date information.

- eventual conflicts of interests could be managed through strict company guidelines and firewalls (although even effective firewalls might lose credibility if a rating agency were to be owned by an investment banking firm or had any of its executives as independent directors on the boards of rated companies).

- companies would face financing requirements, whatever their ratings. Therefore a downgrade would not result in a loss of business for rating agencies, as the companies would in any case be forced to come to them for additional ratings. (although the need for companies to be audited did not prevent the audit scandals from happening).

- revenues from a single rating represent only a small fraction of overall revenues so that the issuer would never be in a position to pressure the rating agency in any way (although each initial public offering in the stock market boom of the 1990s constituted a similar small share of overall investment banking business and this did not prevent abuses).

Transparency aspects of credit rating

Another aspect of credit rating – high on the reform agenda - is a lack of transparency. For example, credit rating agencies have access to confidential information about issuers and can change a rating without providing a clear rationale for the decision to investors. More transparency and even binding general ratings criteria issued in advance of ratings might help to make the process more transparent. However, many critics go further and want rating agencies to list all incorporated information sources as part of their ratings justification in order to shed light on the reasoning behind any rating change. Greater transparency would also counter concerns that the bigger rating agencies could use the threat of unsolicited low ratings as a means to force issuers to purchase other services.[47]

Rating Triggers.

Rating triggers - embodied in private contracts and government regulations – lead to other concerns. These features are essentially insurance clauses, which lenders can use to lessen their exposure to a possible deterioration in the borrowing company's credit quality (below investment grade). Triggers require a company to retire its financing or post new collateral with counterparties in the event that its credit rating declines below a certain level. In that case, the requirement of companies to pay back their debt immediately can lead to sudden and sharp liquidity problems. The most lethal kind of trigger forces a company to pay off its debt as soon as a rating downgrade occurs - precisely when a company is least likely to have enough cash to do so and is at high risk of defaulting on its obligations. However, even in cases where the effect of the trigger is less severe - such as requiring a company to pay more interest, pledge collateral, or sell assets - the damage can be significant. A rating trigger can also

[47] A difference is said to exist between public and private deals. While unsolicited public ratings are said to reveal additional information, as the credit agency can refer to the mass of publicly available company information, private deals are different. In private deals, where creditworthiness depends on the specific structure and nature of the deal itself, there is insufficient public information available for a qualified unsolicited rating. However some ratings agencies argue that exactly because they do not have the necessary information available they have to assign a lower rating to take unknown risk factors into account. See also Wiggins (2002) and Joynt (2002).

oblige funds or banks not to buy certain securities or to sell them if their rating declines below a minimum level, due to regulatory or other contractual requirements.[48] Due to the severe consequences for companies and investors, some observers claim that credit agencies are reluctant to downgrade companies with rating triggers.[49] However, any hesitation in downgrading issuers with rating triggers is firmly denied by rating agencies.

Oligopolistic Market Structure and the NRSRO Concept

The credit rating industry has an oligopolistic structure. Accordingly, critics claim that the agencies lack incentives to safeguard the quality of their research and there have been proposals to improve market-entry conditions, with a view to fostering competition. However, such proposals would be difficult to implement given the reputational character of the rating business. Any new entrant would need a capacity to absorb losses in the process of building a reputation.[50]

The “reputational barrier” is not the only barrier to entry for new agencies. In the United States, the SEC designates some rating agencies as Nationally Recognised Statistical Ratings Organisations (NRSROs). Recognition by the SEC is based on whether the applicant agency is (a) nationally recognised, (b) credible in the marketplace and (c) has the necessary operational capability and reliability. The NRSRO concept exists not only in US federal securities law but also in a number of other private and prudential sector regulations. Consequently, NRSRO ratings are also used by brokers and fund managers, to ensure their fulfilment of fiduciary duties by proving to investors that they place their money only in highly rated securities, based on a NRSRO rating. Only three rating agencies currently enjoy NRSRO status - Moody’s, S&P and Fitch. All issuers must, therefore, rely on these agencies to receive a nationally accepted rating. It has been argued that the NRSRO concept constitutes the most significant barrier to entry for new rating agencies, such as independent research services and foreign-based agencies. While new entrants can, in principle, overcome this barrier there is little transparency about how NRSRO recognition is granted by the SEC. Several proposals have been put forward on how to deal with the issue of NRSRO status.

- First, there have been calls to abolish the national aspect of the NRSRO concept, enabling the emergence of sectoral rating agencies. This would allow the already existing niche research providers in a specific sector, e.g. the insurance sector, to provide official RSRO ratings.

- Second, some have called for immediate attribution of NRSRO status to foreign recognised agencies and other high-reputation firms - active in the evaluation of business and securities. The idea is that these firms should be offered NRSRO status on a trial basis before the SEC decides to make this status permanent.

[48] These can lead to phenomena such as a “credit cliff”, said to exist in the US commercial paper market, where an “A- rated” company can more easily issue five year notes than 30 day commercial paper. For the rationale behind from the perspective of a client see Van Orman (2002)

[49] One related issue is in the area of structured finance, one of the fastest growing sectors of the ratings business. It has been suggested that the main rating agencies are reluctant to downgrade companies that guarantee private structured finance transactions, as these arrangements provide one of the main pillars of the brisk rating business. See Wiggins and Boland (2003)

[50] For example, it has been estimated that Fitch incurred about $40 million US Dollar in accumulated losses in its first four years of operations. See Securities and Exchange Commission (2002c)

- Third, it has been proposed that the NRSRO concept should be abolished and that the market should be left to decide which rating agency has sufficient credibility. This proposal assumes that reputational effects - including missteps by the occasional agency - would eventually weed out unqualified rating agencies.

None of these proposals in themselves would guarantee more effective ratings. Increased competition among credit rating agencies might even induce a lowering of rating standards as issuers “shop around” for better ratings. On the other hand, rating agencies could face pressure from investors to impose higher standards, to protect them even from the slightest risk of default. It is also by no means clear that any form of governmental regulation could prevent these developments. In an effort to reduce barriers to entry, the SEC has agreed to spell out more clearly the criteria for acquiring the NRSRO status. However, the SEC could go further and focus less on the NRSRO concept in favour of a critical assessment of the process by which agencies assign ratings, making sure that the staff has adequate qualifications and that basic records are kept. In this way, the prospects of existing niche service providers, foreign rating agencies and other highghly-qualified firms acquiring NRSRO status, or an equivalent status for a specific economic sector, could be enhanced.

Whatever the outcome of the reform discussion, replacing ratings with more volatile bond spreads, prone to manipulation in thinly traded securities is not an option. However, the rating business, and its current regulatory framework, may need to adapt in order to remain credible among both issuers and investors.

Box: Corporate Governance in the EU

Recent corporate scandals involving European based companies have proven that the EU is not immune to accounting scandals. However, the EU did not await these developments to start working on a series of related issues. Already in the Financial Service Action Plan (FSAP) measures were proposed which reinforce safeguards for financial stability and market integrity. In addition, the EU has shifted its emphasis towards additional Corporate Governance topics by stating its intentions in Communications on the subject, which included an Action Plan on Corporate Governance:

Financial Market Integrity in the FSAP

- The proposal for a new Investment Services Directive would give investment firms a “single passport” allowing them to operate across the EU and would make sure that investors enjoyed a high level of protection when employing investment firms.
- The adopted Market Abuse Directive covers both insider dealing and market manipulation.
- In March 2003, the Commission presented a proposal for a Transparency Directive which addresses the frequency and content of interim reporting by listed companies.

Communication on Corporate Governance

- The Commission, DG MARKT, has launched a communication on Corporate Governance last year, which included an action plan. Main proposals were:

- to strengthen shareholder rights (i) by enabling an easier access to company information, (ii) by encouraging shareholder control - through facilitating voting in absentia and cross-border voting.
- to put an emphasis on independent non-executive Directors by strengthening their responsibilities in the areas of directors remuneration and audit supervision.
- to make the company board *collective responsible* for financial statements.

Communication on Audit and Accountancy issues

- Communication on Statutory Audits: Another Commission Communication has been issued on statutory audits last year. It dealt with audit oversight issues and might open a discussion on the question of an EU co-ordination on auditor oversight which could then act as equivalent to the newly created US Public Company Accounting Oversight Board. Another aim of the Communication is to address auditor independence and quality assurance.

- Accounting Standards: Central to fair financial reporting is a high quality of accounting standards. The EU has addressed this need with the adoption of the International Accountancy Standards (IAS) Regulation in June 2002. This requires EU listed companies to publish consolidated accounts in 2005 based on the IAS.

5. Conclusions

After discussing a number of issues related to corporate governance, the following conclusions might be drawn:

- The challenge of effective corporate governance is an essential feature of the capitalist system, but has increased in significance as the financial system has become simultaneously more complex *and* more accessible to the unsophisticated investor. Increased financial sophistication has enabled the development of a range of innovative financial products in recent years. In addition, technological developments like electronic trading and the Internet have facilitated a new range of investors to participate with or without intermediary in the financial markets. This is in contrast to the past, when participants had been mostly professionals – aware of conflicts of interests and treating investment recommendations with an appropriate degree if scepticism. The major corporate scandals of recent years reflect the modernisation and broadening of financial markets, suggesting that corporate governance structures have failed to keep pace.
- The current issues of corporate governance are not too complicated to be understood or addressed. A set of clear principles can be established which allow for more effective functioning of company management. Addressing harmful incentive structures, conflicts of interests, and encouraging transparency seem to be key. In addition, the interests of minority shareholders have to be protected as larger investors may abuse their power. These principles of good governance apply not only to the internal functioning of the company and financial reporting, but also to the activities of auditors, investment analysts and credit-rating

agencies. In this respect, the emphasis should be on forensic accounting after major bankruptcies or suspected accounting frauds, fostering a process of de-linking audit firms from their customers, exposing investment banks' conflicts of interests and disclosure of the basis of rating agencies decisions. Tackling the concentration of audit firms and lowering of entry barriers to this critically important industry might be useful as starting points for reform. In a similar vein, the activity of whistle-blowers should be encouraged.

- Looking forward, the significance of corporate governance as a determinant of investor risk tolerance is likely to increase in coming years, as investors in maturing economies with a declining population will be required to seek investment opportunities in other less-developed parts of the world economy – amplifying the need for good corporate governance and financial reporting practices on a global level. Thus, apart from broader stability concerns, good corporate governance may well become a strategic policy goal for the mature economies in the decades to come.[51] In return for adopting the desired corporate governance standards, emerging economies with efficient corporate governance structures would acquire access to international capital that is crucial for their further economic development.

The larger objective of effective corporate governance is to enable companies to maximise profit by honest means and so to enhance economic welfare. It is important that the recent regulatory initiatives and increased awareness of shareholder responsibility after recent scandals can avert the biggest risk of all - that further scandals would so undermine the integrity of the market to make public policy hostile to the very concept of modern shareholder-management based companies. Deficiencies in corporate governance can and should be forcefully addressed through enhanced management incentives, increased transparency and more shareholder activism combined with a clear and decisive regulatory framework. However, the separation of ownership and entrepreneurial control - as a principle - is too successful to be abandoned.

6. References:

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