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Not as Easy as It Looks: Regulating Effective Corporate Governance

by Jerry L. Jordan

Accounting scandals, executive misconduct, and poor management at once-prosperous corporations have shaken investor confidence in corporate integrity, and worse, in the mechanisms that are supposed to ensure good corporate management. What will it take to restore confidence? This *Commentary* suggests that the markets will respond with innovations and adjustments that lead to better management, accounting, and disclosure. Greater government policing has an important, but limited, role to play. This *Commentary* was adapted from talking points and notes prepared for various seminars and workshops related to financial system reforms.

Recent calamities in the financial markets—from the collapse of Enron and Global Crossings to the problems at Kmart—have weakened the integrity of the financial markets and led people to wonder how things got so out of hand and how investor confidence can be restored. How *do* we ensure that companies are well run and honest? Many market observers are calling for greater government policing of companies, but will that help?

We should be very careful about what we impose on the market by edict. Absolute principles of good corporate management are hard to specify, and trying to regulate companies' management approaches too heavily can backfire. When government interference in markets goes wrong, which it often does, its worst effect is to impede the natural innovation of the marketplace. The markets' natural innovation improves almost *everything*—from products and prices to accounting practices and corporate management practices.

This *Commentary* discusses some pressing questions of corporate governance and reflects on how the marketplace is evolving to address those questions. And evolve it has—perhaps most attention has been focused on legislative solutions—the Sarbanes-Oxley Act—but markets have reacted in their own way—from the New York Stock Exchange's (NYSE) new corporate governance listing standards to changes in accounting at firms such as Coca-Cola.

■ Roles and Duties

Effective corporate governance requires what companies sometimes have a hard time remembering: Everyone involved in governing the company must be assigned a carefully chosen role and, perhaps more importantly, they must be provided with what they need to fill that role. Three provisions are essential: responsibility, authority, and accountability. People must be assigned explicit responsibility for the duties associated with their roles, authorized to carry out the actions necessary for their roles, and held accountable for the actions they take. The absence of any of these elements compromises anyone's ability to successfully serve his or her role. It is unfair to assign responsibility to an individual, not provide him with the authority to take action, and yet hold him accountable when the responsibility is not fulfilled. Likewise, to give someone both responsibility and authority without holding him accountable for his actions is signing a blank check—and that's not fair to the stakeholders. And certainly providing authority for a task is futile if no one is responsible for it.

Much of the recent talk about improving corporate governance has centered on the need for establishing proper controls and ensuring separation of duties. These suggestions are ultimately about getting the three essentials just named in place, for they concern the roles of various entities in the governance structure, what they are responsible for, and who they are accountable to. Frequently heard questions lately—Who is the CEO accountable to? What is her authority? What auditing structure best holds management accountable?—are all about getting responsibility, authority, and accountability right.

■ The CEO

One fairly common practice that's currently being scrutinized carefully is allowing the chairman of the board of directors to be the company's chief executive officer as well. Some argue that one person should not be given this dual role. The board of directors' job is to oversee the company's management team on behalf of the owners of the company, the shareholders. The CEO leads the company's management team, and the chairman leads the group that is supposed to oversee the management team. Allowing one person to be both CEO and chairman seems like a surefire conflict of interest, bound to prevent objective decision making and interfere with appropriate checks and balances. But wait, what about companies like Microsoft, which would not be the company it is today if Bill Gates

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weren't both chairman and chief executive officer? In fact, many entrepreneurial and innovative companies thrive largely because one person is both chairman and chief executive officer.

So the one-size-fits-all manner of determining the appropriate structure and relationship between the chairman and CEO won't work. Mandating a split may be counterproductive, but a market solution—where directors decide when a split is appropriate for their firm—may work better.

Another practice that's come under fire is allowing the CEO too much influence in appointing members to the board of directors. CEOs often participate in the search for new directors—and for good reason: The CEO is likely the person who can best describe the company's business, enabling candidates to make informed decisions about their interest in being on the board. However, when it comes to selecting the slate of candidates submitted for shareholder vote, most people believe the CEO should have no voice. Candidates should instead be determined by an objective group or committee of outside directors, so that newly appointed directors (and often, long-standing ones) will not feel obligated to the CEO as the person who brought them in to the organization.

It is really up to the board of directors to ensure that the CEO stays out of the nominating process. The directors are agents of the owners of the corporation—the shareholders—not the CEO, and they are expected to act in the shareholders' best interest. To serve the shareholders well, the directors must provide objective oversight of the corporation's management team, and to do that they must maintain the board's independence from the management team. Indeed, the NYSE reforms have recognized the importance of this independence and mandated that companies listed on the exchange must have a nominating committee composed solely of outside directors.

■ The Audit Function

The board of directors' audit committee is another function that analysts say should exclude company executives. The audit committee ensures the effectiveness of audits performed on the company. The job is critical because the directors cannot oversee the corporation effectively without reliable audits. Of course, the audit committee should consist of directors who are adequately informed and knowledgeable about the activities of the company, but they should not be company employees. The Sarbanes-Oxley Act goes even further, mandating that all audit committee members be independent directors.

The Enron–Andersen scandal drove home the need to separate a company's external auditors from its business consultants. And while various activities can be considered either or both—such as tax consulting—separating these particular service providers is clearly required if a company wants to achieve an independent audit function. But what about the relationship between the external and internal auditors? Must these auditors be from different firms? It may be more efficient for the same firm to do both, but it may also make getting an independent, objective external audit more difficult. The external audit builds on the results of the internal audit, and the first step of the external audit is to validate those results. Since one auditing firm can supposedly validate the results of its own internal audit more easily than a new auditor can, it should speed the validation process. However, some business analysts question whether a single firm can assess its own work as objectively as another could. Without an objective assessment of the internal audit, the quality of the external audit will suffer. Certainly, the current competitive environment makes finding and exploiting efficiencies more important than ever. But if these efficiencies are achieved at the expense of objectivity, independent oversight loses its value. That seems to be how the NYSE viewed the matter, as its new guidelines forbid the same firm to do both internal and external audit.

■ Accounting

Recent business scandals in the United States have led to calls for an oversight board or committee that would establish and enforce minimum operating standards for auditing firms. Some countries already have something similar. For example, the United Kingdom and the Republic of Ireland have empowered the Auditing Practices Board to set auditing standards there. The International Federation of Accountants, a professional organization representing 114 countries' national accounting organizations, issues recommendations on good auditing practices as well as standards intended to make some auditing practices uniform across all countries. In the United States, a new agency has been formed, the Public Company Accounting Oversight Board (PCAOB).

Required standards are a step in the right direction, but they won't work if they're not enforced. Creating an oversight board won't work either if care isn't taken to ensure that its members are adequately independent of a country's auditing firms. This may make the appointment process somewhat delicate and at times controversial (as it has been in the United States) because it's difficult to find someone knowledgeable enough to police the accounting firms without being beholden to them. It is also important to ensure that funding for the board's activities doesn't depend on the good will of the accounting firms themselves—and, indeed, the PCAOB funding will come not from assessments on accounting firms (as did the Financial Accounting Standards Board's), but from corporate clients of the accounting firms.

The ultimate goal of an effectively functioning audit environment—both globally and for individual corporations—is to assure that adequate information is disclosed in a timely enough manner for stakeholders to accurately assess the condition of a company. Without this adequate and timely disclosure, potential investors, suppliers, and customers do not have the proper information upon which to base their decisions about interacting with the company—buying its stock, selling it goods on credit, or depending on its products.

Financial markets around the world have become increasingly interconnected, and, as a result, concern over appropriate standards for disclosing this information has grown. Two main sets of standards have become favored in different countries, international accounting standards and generally accepted accounting principles. Both standards have their merits and, depending upon the circumstances, one standard may be more useful than the other. Certainly, neither standard, if adopted globally, would meet the needs of all users. So lately the benefits of "harmonizing" both standards to create a new, global standard is often discussed. This best-of-both-worlds theory has some appeal—until one recognizes the accompanying ramifications of such an effort. Achieving a global set of standards and convincing enough countries to adopt it would require creating a worldwide board to establish the

standards, administer the rules, deliberate on instances of noncompliance, and determine enforcement actions—an undertaking easily likened to creating the United Nations. And while this certainly can be done (we do, obviously, have a United Nations), such harmonization may not be worth the effort or even wholly beneficial. Forging a uniform standard that would work across many different countries may require compromises that render it ineffective.

Another downside of a single worldwide standard might be that it stifles the continued experimentation, innovation, and adaptation of standards to best meet the needs of evolving financial markets. Opponents of a single standard ask whether we aren't focusing on changing the wrong variable, much like the security guards who observed a man, night after night, carting away wheelbarrows full of dirt from a construction site and were bewildered, until it occurred to them he wasn't stealing the dirt, but the wheelbarrows. Perhaps we should not worry about changing accounting standards, but rather global financial markets and exchanges. Some finance analysts have suggested that dual or multistandard systems of accounting principles should be recognized and accepted in all financial markets and exchanges. Such plurality might promote a healthy competition among the respective governance boards and encourage wider adoption of improvements and advancements in principles when they emerged, which would benefit market participants. Clearly, high-quality international accounting standards—whether the result of one system or multiple systems—improve investor confidence, enhance market liquidity, and may ultimately reduce the cost of capital.

■ What Information Should Companies Provide?

Multiple standards of accounting principles are likely to lead to greater disclosure of pertinent information for investors. As various companies provide information consistent with one accounting standard, the market will demand similar disclosures from others. Disclosures made consistent with another accounting standard will prompt the demand for similar information from all companies. For in a competitive financial environment, companies often need to raise money from outside investors. Investors want to know where they can most profitably put their investment, and they must decide on the basis of the available information. Without enough information of sufficient quality—without the information they demand—they will not invest.

We should note that a firm's "investors" must be understood broadly as all of its stakeholders, not just equity holders. Bondholders, too, want sufficient information to know that the return they are getting is worth the risk. If it is not, the price falls, and the return is higher—that is, the firm faces higher financing costs (or even obtains fewer funds). Likewise, suppliers, who supply trade credit (trade payables were 15 percent of corporate equities in 2001) or undertake actions that place their interests at risk, such as configuring dies for specific parts or otherwise creating durable, nonredeployable assets (as Oliver Williamson often emphasizes in his book, *The Economic Institutions of Capitalism*)—need assurances before they invest their time and money in the firm. Even some employees, knowing it takes time to learn the ropes and that unemployment is a possibility, will want information about the viability of the firm.

How do we determine what information the entire set of stakeholders might need to make informed decisions? Who should we expect to assemble it? Merely enforcing current accounting rules may not give us a true picture of the viability and future profitability of the firm because the rules may already be obsolete. It's possible to do much more by demanding greater transparency in the information companies and their accountants report. When stakeholders know where information about a company comes from, how it was gathered, and how it has been modified from its raw state, they can judge not only the company's interpretation of the data, they can reassemble the data to suit their own unique or evolving needs.

An example might be taken from the financial markets. It's quite easy to find the current level of the S&P 500 or even the price of an individual stock. Financial markets have moved to real-time access. Information technology has made this possible, and the customers desired it (see Robert K. Elliot's paper, "Do We Need a New Accounting Model?"). Something similar will happen in accounting. In the future, it won't matter if you count employee stock options as an expense or not. In fact, the company may not even report "earnings" as conventionally defined. Those stock options will be reported and disclosed, however, and markets will incorporate the information into the company's stock price and the borrowing terms it faces. Another sticky problem—how to account for customer acquisition costs (such as advertising and marketing)—might yield to the same treatment. Currently, this cost is treated as an investment if the customers stay with the company for a year, or as an expense if they do not. So you can't tell if your ad campaign this June is truly an investment until next June—well after you've closed the books at the end of the year. You only know the right answer when it is too late. Properly disclosed, the cost of acquiring new customers will be evaluated by the market, not the company's accountants, and the market will judge what the cost means for stock prices. And it may not give the same answer for every firm—the best approach for a virtual company may not be the best for an aging steel company.

This is not to say that reports of "earnings" will completely disappear. Information intermediaries will arise to aggregate and analyze the information disclosed by firms. Some will involve human judgment and input, while others will be pure spreadsheet aggregations, and still others will use artificial intelligence. These will compete with one another in timeliness, accuracy, and analytic ability. Investors, with scarce time and analytical ability, may then look at summary statistics, which might be some descendant of EBITDA (earnings before interest, taxes, depreciation and amortization).

Greater transparency may even spread to more basic practices of corporate governance. Often the board of directors of a mutual fund hires senior management on a term-contract basis. Now, a steel or software company is not a mutual fund, but to the extent that information becomes readily and speedily available, when transparent disclosure in real time replicates at least one aspect of those funds, companies may then converge in other dimensions. That is, all senior management, not just the CEO, would then be more clearly dependent on the board of directors for continued employment.

■ Conclusion

The true future of corporate governance and accounting reform is not something that should be imposed by regulators or blue-ribbon commissions. Given the variety of corporate forms we see—holding companies, M-form corporations, partnerships, worker-owned cooperatives—this should come as no surprise. It does not mean governments should play no role, however. Rather, their role should be to establish an environment conducive to effective and efficient financial markets. This may include establishing the rules of the game, defining and enforcing property rights, and setting up the basic infrastructure that allows the market to work. Even information-sharing activities—educating others about best practices encountered in financial exams—are legitimate. But the temptation to correct alleged market mistakes by imposing accounting standards, restricting the market for corporate control, or removing financial discipline in the name of safety move beyond the appropriate functions of government.

Reforms in the financial markets related to the rules of corporate governance, accounting and auditing principles, and matters regarding disclosures and transparency, all must be developed within the markets themselves rather than imposed upon the markets by an outside entity.

■ Recommended Reading

Robert K. Elliot, “Do We Need a New Accounting Model?” Paper presented at the American Economic Institute for Public Policy Research conference, Is GAAP Accounting Worth Fighting For? Wednesday, March 13, 2002. <http://www.aei.org/past%_event/elliott.pdf>

Federal Reserve Bulletin, vol. 88, no. 6. Table 1.60 is the source for the data on trade credit and corporate equities.

New York Stock Exchange, *Report of the NYSE Corporate Accountability and Listing Standards Committee*, June 6, 2002.

Oliver E. Williamson, *The Economic Institutions of Capitalism*, The Free Press, New York, 1985.

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