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CORPORATE GOVERNANCE

CHRISTINE A. MALLIN

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PREFACE

Corporate governance is an area that has grown rapidly in the last few years. There has been an explosion of interest in the corporate and investment sectors and more and more universities, both in the UK and internationally, are offering corporate governance as a module, either on undergraduate or postgraduate degree programmes. Some universities have dedicated taught masters in corporate governance and/or PhD students specializing in this as their area of research.

Corporate governance is now an integral part of everyday business life and this book provides insights into its importance not just in the UK, but also globally including the US, Europe, Asia, South Africa, and Latin America. This book is designed to provide an understanding of the development of corporate governance over the last decade and to illustrate the importance of corporate governance to the company itself, to directors, shareholders and other stakeholders, and to the wider business community.

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LIST OF ABBREVIATIONS

ABI	Association of British Insurers
AITC	Association of Investment Trust Companies
CalPERS	California Public Employees' Retirement System
CEO	Chief executive officer
CEPS	Centre for European Policy Studies
CSR	Corporate social responsibility
CSRC	China Securities Regulatory Commission
EIRIS	Ethical Investment Research Service
ERISA	Employee Retirement Income Security Act
FTSE	Financial Times Stock Exchange (Index, UK)
ICGN	International Corporate Governance Network
IMA	Investment Management Association
IMF	International Monetary Fund
ISC	Institutional Shareholders' Committee
MOF	Ministry of Finance
NAPF	National Association of Pension Funds
OECD	Organisation for Economic Co-operation and Development
PBOC	People's Bank of China
PIRC	Pensions Investment Research Consultants
PSPD	People's Solidarity for Participatory Democracy
SETC	State Economic and Trade Commission
SRI	Socially responsible investment

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1 Introduction

Businesses around the world need to be able to attract funding from investors in order to expand and grow. Before investors decide to invest their funds in a particular business, they will want to be as sure as they can be that the business is financially sound and will continue to be so in the foreseeable future. Investors therefore need to have confidence that the business is being well managed and will continue to be profitable.

In order to have this assurance, investors look to the published annual report and accounts of the business and to other information releases that the company might make. They expect that the annual report and accounts will represent a true picture of the company's present position—after all, the annual report and accounts are subject to an annual audit whereby an independent external auditor examines the business' records and transactions and certifies that the annual report and accounts have been prepared in accordance with accepted accounting standards and give a 'true and fair view' of the business' activities. However although the annual report may give a reasonably accurate picture of the business' activities and financial position at that point in time, there are many facets of the business which are not effectively reflected in the annual report and accounts.

There have been a number of high profile corporate collapses which have arisen despite the fact that the annual report and accounts seemed fine. These corporate collapses have had an adverse effect on many people: shareholders who have seen their financial investment reduced to nothing, employees who have lost their jobs and in many cases the security of the company pension which has also evaporated overnight, suppliers of goods or services to the failed companies, and the economic impact on the local and international communities in which the failed companies operated. In essence, corporate collapses affect us all. Why have such collapses occurred? What might be done to prevent such collapses happening again? How can investor confidence be restored?

The answers to these questions are all linked to corporate governance: a lack of effective corporate governance meant that such collapses could occur; good corporate governance can help prevent such collapses happening again and restore investor confidence.

To illustrate why corporate failures might occur, despite the companies seeming healthy, it is helpful to review a few examples from recent years, each of which has sent shock waves through stock markets around the world.

Barings Bank

The downfall in 1995 of one of England's oldest established banks was brought about by the actions of one man, Nick Leeson, whose actions have been immortalized in the film

'Rogue Trader'. Nick Leeson was a clever, if unconventional, trader with a gift for sensing the way that stock market prices would move in the Far Eastern markets. In 1993 he was based in Singapore and made more than £10 million, about 10 per cent of Barings' total profit that year. He was highly thought of at that time.

However, his run of good luck was not to last, and as a severe earthquake in Japan affected the stock market adversely, he incurred huge losses of Barings' money. He requested more funds from Barings' head office in London which were sent to him, but unfortunately he suffered further losses. The losses were so great, £850 million, that Barings Bank collapsed and was eventually bought for £1 by ING, the Dutch banking and insurance group.

Barings Bank has been criticized for its lack of effective internal controls at that time which left Nick Leeson able to cover up the losses that he was making for quite a number of months. The case also illustrates the importance of having effective supervision, by experienced staff with a good understanding of the processes and procedures, of staff who are able to expose the company to such financial disaster. The collapse of Barings Bank sent ripples through financial markets across the world as the importance of effective internal controls and appropriate monitoring was reinforced.

Enron

Enron was ranked in the USA's Fortune top 10 list of companies, based on its turnover in 2000. Its published accounts for the year ended 31 December 2000 showed a seemingly healthy profit of $979 million and there was nothing obvious to alert shareholders to the impending disaster that was going to unfold over the next year or so and make Enron the largest bankruptcy in US history.

Enron's difficulties related to its activities in the energy market and the setting up of a series of 'special purpose entities' (SPEs). Enron used the SPEs to conceal large losses from the market by giving the appearance that key exposures were hedged (covered) by third parties. However the SPEs were really nothing more than an extension of Enron itself and so Enron's risks were not covered. Some of the SPEs were used to transfer funds to some of Enron's directors. In October 2001, Enron declared a non-recurring loss of $1 billion and also had to disclose a $1.2 billion write-off against shareholders' funds. Later in October, Enron disclosed another accounting problem which reduced its value by over half a million dollars. It looked as though a takeover might be on the cards from a rival, Dynegy, but in November announcements by Enron of further debts led to the takeover bid falling through and in December 2001 Enron filed for bankruptcy.

In retrospect, it seems that the directors were not questioned closely enough about the use of the SPEs and their accounting treatment. What has become clear is that there was some concern in Enron's auditors—Andersen—about the SPEs, and Enron's activities. Unfortunately Andersen failed to question the directors hard enough and Andersen's own fate was sealed when some of its employees shredded paperwork relating to Enron, thus obliterating vital evidence and contributing to the demise of Andersen which has itself been taken over by various rivals.

The Enron case highlights the overriding need for integrity in business: for the directors to act with integrity and honesty, and for the external audit firm to be able to ask searching questions of the directors without holding back for fear of possibly offending a

lucrative client. This latter situation is exacerbated when auditors receive large fees for non-audit services which may well exceed the audit fee itself, thus endangering the independence of the auditors. Enron also highlights the need for independent non-executive directors who are experienced enough to be able to ask searching questions in board and committee meetings to try to ensure that the business is operated appropriately.

Royal Ahold

Royal Ahold is a Dutch retail group with international interests, being the third largest food retailer in the world. The financial scandal surrounding it is unfolding during 2003 and is being referred to as 'Europe's Enron'. In February 2003, Royal Ahold announced that it had overstated the earnings of its US subsidiary by $500 million. Royal Ahold's Chief Executive Officer and Chief Financial Officer resigned immediately.

There were a few warning signs at Royal Ahold before the further problems became apparent in 2003. The Chief Executive Officer was dominant and had a long service agreement; directors' remuneration was spiralling upwards; its management had a poor reputation for their relations with investors; and in 2001 Royal Ahold had introduced a voting system for voting on board members which meant that it was effectively impossible for shareholders to oppose the board's nominations. These were all signs of a company where the directors might be likely to be acting in a way that was detrimental to the shareholders.

The three examples above of high profile corporate collapses in the UK, US, and Europe have had, and continue to have, international implications, and would seem to illustrate a number of shortcomings in the way that the companies were run and managed:

- Barings appears to highlight the lack of effective internal controls and the folly of trusting one employee without adequate supervision and understanding of his activities.
- Enron appears to highlight a basic need to ensure as far as possible that directors are people of integrity and act honestly; that external auditors are able to ask searching questions unfettered by the need to consider the potential loss of large audit/accounting fees; and the contribution that could be made by independent directors on boards and committees who question intelligently and insightfully.
- Royal Ahold appears to highlight what may happen if the involvement of investors is suppressed: a corporate structure that had empowered a dominant Chief Executive Officer; enabled the directors to have over-generous remuneration packages; and ultimately led to Ahold's demise as income was found to be overstated.

This brings us back to our original questions about corporate failures such as Barings Bank, Enron, and Royal Ahold. Why have such collapses occurred? What might be done to prevent such collapses happening again? How can investor confidence be restored? The answers to these questions are all linked to corporate governance.

Corporate governance is an area that has grown very rapidly in the last decade particularly since the collapse of Enron in 2001 and the subsequent financial problems at other companies in various countries. As mentioned above, emerging financial scandals such as Royal Ahold in 2003 will continue to ensure that there is a sharp focus on corporate

governance issues, especially relating to transparency and disclosure, control and accountability, and to the most appropriate form of board structure that may be capable of preventing such scandals occurring in future. Not surprisingly, there has been a significant interest shown by governments in trying to ensure that such collapses do not happen again as these lead to a lack of confidence in financial markets. In order to realize why corporate governance has become so important, it is essential to have an understanding of what corporate governance actually is and how it may improve corporate accountability.

A fairly narrow definition of corporate governance is given by Shleifer and Vishny (1997) 'corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'. A broader definition is provided by the Organisation for Economic Co-operation and Development OECD (1999) describing corporate governance as: '. . . . a set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance, are determined'. These definitions serve to illustrate that corporate governance is concerned with both the shareholders and the internal aspects of the company, such as internal control, and the external aspects, such as an organization's relationship with its shareholders and other stakeholders. Corporate governance is also seen as an essential mechanism to help the company to attain its corporate objectives and monitoring performance is a key element in achieving these objectives.

It can be seen that corporate governance is important for a number of reasons and is fundamental to well-managed companies and to ensuring that they operate at optimum efficiency. Some of the important features of corporate governance are as follows:

- it helps to ensure that an adequate and appropriate system of controls operates within a company and hence assets may be safeguarded;
- it also prevents any single individual having too powerful an influence;
- it is concerned with the relationship between a company's management, the board of directors, shareholders, and other stakeholders;
- it aims to ensure that the company is managed in the best interests of the shareholders and the other stakeholders;
- it tries to encourage both transparency and accountability which investors are increasingly looking for in both corporate management and corporate performance.

The first point above refers to the internal control system of a company whereby there are appropriate and adequate controls to ensure that transactions are properly recorded and that assets cannot be misappropriated. Each year a company has an annual audit and a key part of the auditor's job is to assess whether the internal controls in a business are operating properly. Of course, the auditor has to place a certain degree of judgement on the assurances given by the directors, the directors being ultimately responsible for the implementation of an appropriate internal control system in the company. The directors are also responsible for ensuring that there are risk assessment procedures in place to identify the risks that companies face in today's business environment, including for

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