EDINBURGH
BUSINESS SCHOOL

HERIOT-WATT UNIVERSITY

Corporate Governance

Dr. Kathryn Vagneur

CG-A2-engb 1/2016 (1032)

This course text is part of the learning content for this Edinburgh Business School course.

In addition to this printed course text, you should also have access to the course website in this subject, which will provide you with more learning content, the Profiler software and past examination questions and answers.

The content of this course text is updated from time to time, and all changes are reflected in the version of the text that appears on the accompanying website at http://coursewebsites.ebsglobal.net/.

Most updates are minor, and examination questions will avoid any new or significantly altered material for two years following publication of the relevant material on the website.

You can check the version of the course text via the version release number to be found on the front page of the text, and compare this to the version number of the latest PDF version of the text on the website.

If you are studying this course as part of a tutored programme, you should contact your Centre for further information on any changes.

Full terms and conditions that apply to students on any of the Edinburgh Business School courses are available on the website www.ebsglobal.net, and should have been notified to you either by Edinburgh Business School or by the centre or regional partner through whom you purchased your course. If this is not the case, please contact Edinburgh Business School at the address below:

Edinburgh Business School
Heriot-Watt University
Edinburgh
EH14 4AS
United Kingdom

Tel + 44 (0) 131 451 3090
Fax + 44 (0) 131 451 3002
Email enquiries@ebs.hw.ac.uk
Website www.ebsglobal.net

The courses are updated on a regular basis to take account of errors, omissions and recent developments. If you'd like to suggest a change to this course, please contact us: comments@ebs.hw.ac.uk.

Corporate Governance

Dr. Kathryn Vagneur, BSc, MSc, PhD, CPA
Dr. Kathryn Vagneur manages a private investment portfolio in London. Previously, she was a director with PricewaterhouseCoopers.

She became interested in the issues of complex governance control and operating systems, when she undertook to design one for a university department as an undergraduate project. The department had adopted a strategy to integrate processes that historically had been operated as individual units, and, thereby, to achieve improved efficiency and service delivery effectiveness. The problem involved recycled inventory, a new departmental building (under construction), high volume throughput and the opportunity to specify new technologies to control and account for the management and security of the assets, revenues and asset replenishment. Business and operational control systems had to be redesigned. There were issues about transitioning from old paper-based processes run by administrators who had been in role for years, and budget restrictions that meant new technologies needed to be prioritised and implemented in phases. Most senior managers today will recognise this problem as one they face every day.

Her PhD research, undertaken at London Business School, explored management and control process factors that differentiated companies with good long-term performance from the rest. One of those factors, the way performance is measured and how those measures are used, was the focus of her thesis. Since then, she has continued to research board level corporate governance issues. She is a past-President of the UK Society of CPAs and a member of the Management Control Association and the Business Governance and Ethics Panel of the London Society of Chartered Accountants.

She has experience designing and managing start-up businesses and managing in established companies. She has advised companies and taught on management development courses. One of her most interesting projects was helping the government of a Russian Republic to think about how to develop and phase in a privatised economy and a tax system to replace their Soviet state economy.

First Published in Great Britain in 2004.

© K. Vagneur 2004

The rights of Dr. Kathryn Vagneur to be identified as Author of this Work has been asserted in accordance with the Copyright, Designs and Patents Act 1988.

All rights reserved; no part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise without the prior written permission of the Publishers. This book may not be lent, resold, hired out or otherwise disposed of by way of trade in any form of binding or cover other than that in which it is published, without the prior consent of the Publishers.

Contents

Acknowledgements

For comments on and contributions to the ideas that form the basis of this course, the author is grateful to Alexander Roberts, Peter Drucker, A.P. Sloan, Jay Forrester, Maury Peiperl, David Otley, Nigel Nicholson, Jonathan Levie, Gabi Beau, Tony Berry, Richard Boss, Al Blumstein and the many wonderful people who have said, 'I am sorry, but that just does not make sense to me.' Without them, this text could not have been written.

Also, a special thank you to Stephen Clark, Carolanne Cunningham, Vincent Mercer, Chris Prior-Willeard, Anthony Sharp and Mark Spragg for taking time from their very busy lives to review the legal, professional and specialist material in this text. Any errors that remain are the author's responsibility, but without these superb professionals, there would have been many more.

Introduction

This course introduces the concepts, issues, public policies and practice of corporate governance. The aim is to provide tools with which you can understand the essence of an existing system of corporate governance and how it might be improved.

The first challenge for a student of corporate governance is that few of those who combine the words 'governance' and 'corporate' into the term 'corporate governance' define what they mean. Even those who do define the term do not agree on what that definition is. This risks significant confusion so, in order to reduce that risk, we are going to rely on dictionary definitions for the components of the term. Those definitions are shown in the box just below

Definition

Corporate

refers to a group or association of people, usually authorised by some form of agreement, acting as an individual (i.e. the group) especially in business and civic activities.

Governance

is the act, manner or functioning of the rules, guidance and controls which determine a course of action through an intended or emergent system of processes.

Relying on these definitions means that throughout this course we shall be examining the policies, rules, controls and norms which are used to guide activities of individuals who are acting in 'corporate' settings. While some may view corporate governance as a matter for listed corporations, this definition leads us to consider the governance of activities undertaken by individuals within other entities such as private commercial companies, not-for-profit organisations, civic bodies and the markets where these entities operate.

We are going to differentiate between 'external' and 'internal' governance because these are different sets of governance mechanisms and the authority for the management of them belongs to different groups. External governance is the framework of mechanisms by which society seeks to influence the behaviour of 'corporate' entities from outside those organisations. In contrast, 'internal governance' is the set of mechanisms and processes that corporate entities use within themselves to organise, co-ordinate and govern internally. Although you might prefer to call internal governance 'performance management' – because that is what it is – we shall avoid that term to prevent confusion.

We shall consider how governance mechanisms function and how this might be improved. As a result, we are going to touch on a diverse range of subject matter including accounting, economics, ethics, finance, law, politics, psychology and systems thinking because these are all relevant to the functioning and management of corporate governance systems.

We shall contrast some of the international differences found in external governance frameworks and explore some themes about this variation and the implications these have for public policy. We shall explore differences in internal governance practice. However, we shall not argue that there are international themes in internal governance because intra-national variation can be as great as international variation.

Corporate governance systems are organic – they develop piecemeal over time in an evolutionary process. Many governance mechanisms have developed because corporate activities were found to be inefficient, ineffective or allowed behaviour that society or management or owners found unacceptable.

In other words, governance mechanisms are created for a purpose. They are often modified as well. Over time the implied and express objectives that guide this developmental process also may change. The result, as we shall see in the last sections in this course, is that governance systems often contain inconsistent elements and produce results that are not what was intended.

It is helpful to understand this evolutionary process, so throughout the text, we shall explore history, especially history about corporate problems and behaviours that have influenced the development of public policy and/or corporate practice.

When you have completed the course, you should appreciate the state of public policy as well as the huge variation in the art of internal governance practice. You will have been introduced to what is currently promoted as 'best practice' and to limitations in those recommendations. You will have analysed complex governance problems and developed your own solutions to them. You will have examined the behaviour and properties of complex systems, explored problems associated with the organisation of human beings and considered why these may contribute to corporate governance failure.

As a result, you should be able to make a meaningful contribution to public policy debates. You should be prepared not only to find practical ways to improve the quality of external governance but to build more successful internal governance systems. By successful, we mean governance systems that encourage the desired outcomes from corporate activities, rather than hinder them.

Achieving the norms of behaviour desired by society, is just one of many measures by which corporate governance can be assessed. A governance system can be judged on its ability to deliver not only against ethical and social performance standards, but other performance standards such as customer satisfaction, economic returns, employee morale, environmental care, risk adjusted returns or supply efficiency.

While we hope the course will make you think differently about organisational performance and risk management, our primary objective here is to help you to become familiar with the concepts and issues that make corporate governance important and to develop the confidence to analyse governance problems, develop realistic ways to solve them and the ability to persuade decision makers to adopt them.

Hopefully, everyone who completes this course, whether they are a manager, company director, analyst or regulator, will be prepared to assess a corporate

governance system and develop ways to improve it. These could be local improvements to be implemented by a junior manager, company-wide changes put in place by a board of directors or changes in public policy developed by regulators.

The challenge is that often a thoughtful analysis results in an innovative idea for improvement that is well beyond the day-to-day responsibilities of its author. This requires finding ways to influence and debate with those who are the decision makers. A thorough grasp of the issues covered here should make this easier to do.

The material covered here may encourage you to question concepts, policies and practices commonly used. In other words, you may begin to challenge accepted wisdom – those widely accepted beliefs about corporate supervision, management controls and executive incentives embedded in public policy and company practice. If so, you may feel like you have opened Pandora's box. This is because many strategies and technologies used in modern organisations appear to have outstripped the ability of the existing governance systems, both internal systems and external frameworks, to achieve the intended result.

If more people begin to question why and how governance is achieved, and how different elements of a governance system interact, it may begin to have a significant influence on corporate governance. This will improve our understanding of what differentiates the next generation of practice from its predecessors and how to move organisations to deliver a better standard of performance – social, economic and behavioural.

Hence, there is a challenge for each of us: We are on a journey to improve the functioning of corporate governance systems – both the internal systems and the external frameworks. A first step is to understand how these systems developed and why they work as they do because knowledge about how a system works increases the ability to make significant improvements to it.

This promises to be an exciting journey, so welcome aboard.

Abbreviations

aka	Also known as (usually the terminology used in various jurisdictions)
CEO	Chief executive officer
CFO	Chief Financial officer, also called a Finance Director
CIO	Chief Information Officer
FASB	Financial Accounting Standards Board
FD	Finance director, also called a chief financial officer
GAAP	Generally accepted accounting principles
IAS	International accounting standards
IASB	International Accounting Standards Board (successor to IASB)
IASC	International Accounting Standards Committee (predecessor of IASB)
IOSCO	International Organisation of Securities Commissions
IPO	An initial public offering of shares in a company

NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation System
NIRI	National Investor Relations Institute
OECD	The Organisation for Economic Cooperation and Development
PCOAPB	Public Company Accounting Oversight Board set up by the Sarbanes-Oxley Act 2002 in the US
SEC	US Securities and Exchange Commission
SI	Securities Institute
S&P500	Share price index of the largest 500 firms listed on US stock exchanges

Module 1

Corporate Governance Issues, Concepts and Domain

Contents

Learning Objectives

When you have completed this first module you should be able to:

- distinguish between internal and external corporate governance, and explain how they relate;
- engage in a general discussion about the interdependence between economic development and corporate governance;
- explain the foundations of the present system of corporate governance, and how they developed;
- understand the driving forces that have shaped corporate governance reform efforts, and what triggered them;
- understand the problems experienced in the 2000–2003 capital market downturn, and why these are different from those in previous 'bear markets'.

1.1 Introduction

This module will introduce the issues that make corporate governance important, the concepts about governance that distinguish it from other areas of management

study, and the domains that are relevant to it. We shall begin by exploring the external and internal governance of corporate activity – what it is and what it does. We shall introduce the most recent round of corporate governance reform, which began in 1987 and continues today, reflecting on the narrow focus of corporate governance reform since the term was coined in the 1970s.

Throughout this text we are going to discuss the historical context of corporate governance in order to make it easier for you to understand why good governance facilitates economic development and financial market functioning, and how it aids in the strategic success of organisations. We shall learn from this historical exploration how important it is for external and internal governance to be aligned if they are to achieve their intended purposes.

Examining historic efforts to reform corporate governance, understanding why these have occurred and what they have been meant to achieve will help us to understand modern governance problems. It should help us to understand emerging governance issues to explore governance failures, some infamous and others ignoble. This will demonstrate how weaknesses in the external and internal governance systems cause problems and what existing weaknesses might exist, and perhaps provide clues to how we might better solve them.

1.2 External and Internal Governance of Group Activities

The organisation of human endeavour and the process of creating and moving goods for sale have always been restricted in some way. Even economically primitive societies using barter systems have taboos and expected norms of behaviour that influence how such activities are conducted. *These are mechanisms that regulate or govern human behaviour within a society and form its system of external governance.*

Human beings tend to draw together into groups for social and work activities. They might do this for many reasons, including a desire for greater efficiency, better effectiveness or for mutual protection.

Informal groups form. Many of these disband in a short time. However, some do survive, and the individuals who form one of these will develop an agreement, either tacit or explicit, that they will act collectively in order to achieve some mutual purpose. As part of this association, they will begin to coordinate the activities of the individuals in order to achieve the group's collective objectives **and/or** to ensure that the individuals acting within the group do not violate the norms of behaviour expected of them from outside the group. This results in the development of a system of internal governance – the rules, guidance and controls that determine the course of individual actions within the collective group.

Definition

External corporate governance

is the set of mechanisms that regulate, oversee, direct and control human behaviour with the intent of ensuring that collective and individual behaviour within a group meets the norms expected by society.

Internal corporate governance

is the set of rules, guidance and controls that determine the course of individual actions within a collective group.

External and internal

governance develop and evolve over time as a set of intended or emergent processes.

Systems of both external and internal governance develop over time as a collection of intended or emergent processes. External governance limits the autonomy of any collective enterprise, both in its organisation and in the activities of individuals operating within it. Internal governance limits the autonomy of the individuals who form the collective enterprise.

Without a system of internal governance, group activities of any complexity will fail. Arguably, without a system of external governance collective groups will fail to meet the community's expectations as well.

When activities become more complex, governance tends to increase in complexity as well. As societies develop, they codify many of their social control requirements. Systems of interpretation, supervision and enforcement also develop. So the increasing complexity of human activity is accompanied by increasing complexity in the institutions that develop and manage the supervision and enforcement of the rules society puts in place to govern those activities.

The history and development of the craft guilds and livery companies illustrate this developmental process. Informal social governance in communities grew more complex as commerce developed. Craft workers drew together in informal groupings. The need for protection from unscrupulous workers or competitive threats from outsiders led these groups to evolve from informal assemblies into chartered organisations with formal internal governance systems and institutions to manage their members and enforce the rules to which they ascribed. These complex fraternities combined the regulation of work with religious observance and duties to the community and the church.

Exploring the development of the financial markets, and the accompanying emergence of formal external and internal governance processes for those financial markets, demonstrates how such a developmental process can occur.

1.3 Feudal Economies and Financial Markets

In a feudal economy, the capital needs of government and religious institutions are met through taxation, donation, or booty obtained in war. When funds are available, large capital projects such as monuments, public buildings, defence structures and roads can be undertaken. If funds are not available, work on such projects must be delayed until enough funds are available to do work on the project. As a result, many large projects such as cathedrals have been built in stages. For example, the Notre Dame Cathedral in Paris took almost 200 years to build.

In a feudal economy, the capital needs of commerce and industry usually must be met locally. Most business activities are financed with cash flow. When greater funding is needed, transactions must take place directly between investors and those seeking capital, because a feudal economy does not have any other mechanism to affect such transactions. So, in a feudal economy, the market of potential investors is restricted to those who are readily available to a commercial enterprise – in other words they are its neighbours. For example, if a trader wants to finance the purchase of a cargo of goods and the price exceeds his available cash, he must seek the capital needed from local moneylenders or wealthy neighbours who have money to invest.

1.3.1 Financial Need Stimulates Market Developments

As industry and commerce develop, capital need grows. If this need is not satisfied, commerce may not grow further and may even contract. Capital markets and financial institutions will begin to form to meet those needs when the enterprises engaged in commerce and industry can produce enough profits to attract capital. The transition from a feudal to industrial to market economy is gradual, and easier to see in retrospect than it probably was during the evolutionary process.

The 17th century began to see colonial and industrial development in Europe. By 1700, 76 per cent of England's international commerce passed through London. A thriving trade in valuables as well as goods had also begun to develop within the City of London. Goldsmiths began to take the deposit of valuables. Perhaps they began to perform depository services because they had demonstrated that they knew how to protect valuable assets. Soon many goldsmiths' offices had become places that people trusted to deposit their valuables such as gold, silver and jewels.

When depositors needed to execute an economic transaction, they visited the goldsmith's office where their valuables were deposited, withdrew what they needed, and carried the valuables to where they were to settle the transaction. Members of the Company of Goldsmiths began to establish banks in London. These included Francis Child and Richard Hoare, whom the Earl of Clarendon called 'men known to be so rich, and of so good reputation that all of the money of the kingdom would be trusted or deposited in their hands'.

Soon others began to establish banks as speculative ventures; the Bank of England was one of these. Initially, the Bank of England was a speculative venture developed by a group of London merchants; over time it evolved into the country's central bank. (See the case study in Box 1.1.)

Box 1.1: The Bank of England

Founded as a commercial bank with capital of £1.2 million, the Bank then advanced those funds to the government as part of a swap engineered by William Paterson. The deal gave the company banking privileges and the right to issue notes up to the amount of its capital, and gave the government badly needed cash in exchange for annuity payments. Thus the Bank began as the government's banker and debt-manager, and continues in that role today. It has played an important part in English commercial and industrial expansion in both a public and a private function, ever since it was founded. It has protected the

national currency, and it operated for private profit until 1946, when an Act of Parliament provided for its nationalisation.

The Bank established a Mint, near the Tower of London, and began to produce coins called 'guineas' from the gold bullion it had on deposit. In 1709, the amount of the Bank's capital was doubled. Its Charter was renewed by Parliament in 1742, and then again in 1764 and 1781. Each Charter renewal was paid for with loans, often painfully negotiated, from the Bank to the government. The Bank gained its first official sanction when soldiers were sent to guard it during the Gordon Riots in June 1780. The Gordon Riots were among the most violent and widespread riots ever to occur in Britain. They began as a demonstration against the Catholic Relief Act, legislation in favour of Roman Catholics. Rioting spread and turned into an attack upon institutions of the State. Crowds threatened the Bank of England, so the military moved in to protect the Bank. This official protection was an external governance mechanism that sent a strong signal that this was a special bank above the other institutions in the City of London.

The Bank Charter Act 1844 set out the modern structure of the Bank of England. The Issue Department, which handles the issuing of banknotes for general circulation, was separated from the Banking Department, which handles its banking functions, including the management of the public debt and the deposit of government funds. The Bank took on the role of lender of last resort, providing stability during several financial crises. Over time it developed a banking supervision role as well. When panics or wars occurred, the huge reserve of gold on deposit at the Bank helped to maintain the financial security of the country. Military protection of the Bank's premises continued until 1973.

In 1997, the power to set interest rates was transferred from the UK Treasury to the Bank of England, and the oversight of the British banking industry was transferred from the Bank to the Securities and Investments Board (now the Securities and Futures Authority). These changes, which had a far-reaching effect in the UK, will be explored in a later module.

1.4 Embryonic Corporate Governance Mechanisms

By the end of the 17th century, the practice of holding and moving physical valuables was replaced by a new concept: depositing valuables and issuing banking orders (*aka* cheques, checks, drafts). These drafts permitted someone else besides the depositor to draw upon the valuables. This allowed the movement of capital, represented by financial instruments, in place of the movement of gold, silver and other valuables.

Bankers' orders were developed to solve a problem: the practice of hoarding and moving physical valuables was inefficient and risky, and the assets on deposit did not earn a return. However, bankers' orders also illustrate how some corporate governance mechanisms develop as an internal governance solution and evolve over

time into a set of processes that involve both internal and external governance mechanisms.

1.4.1 Individualised Internal Governance Mechanisms

In theory, a bankers' draft system facilitates financial transactions while enhancing asset safety and risk management. However, the use of bankers' drafts involve holding valuables on deposit, which can then be drawn upon by the issuance of banking orders permitting someone other than the depositor to withdraw some or all of the valuables on deposit. This created a new set of problems that, in the 17th century, may never have been seen before.

A number of significant risks must be managed to make processes such as depositing valuables, drawing up, acceptance and presentation of drafts work successfully. For example, the depositor (the payer on a draft) has to be depositing valuables they actually own. The bank has to be a reliable place to hold the valuables. In other words, it has to be trustworthy as a depository, reliable with its inventory management and accounting, and safe from theft. There have to be sufficient valuables on deposit and available to settle an order when it is presented. The valuables must be appropriately valued as well. The person who presents the draft for collection at a bank (the payee) has to be the person for whom the valuables were intended. If these problems are not solved, people will not use the bank's services.

Initially, each individual bank developed, issued and processed its own drafts. At first, each bank determined its own rules and designed its own processes to manage deposits, drafts and the risks they created. There would have been great variation between banks in the rules and how the processes functioned, and how well the risks involved were managed. Some banks may have established internal governance systems that worked well; others most likely failed to perform well enough to meet customer expectations about the management of risks.

1.4.2 Evolution toward External Mechanisms

When solutions to risk problems are developed by individual organisations, the only mechanism available to assure the public that the risks will be handled appropriately is the good name and reputation of each individual organisation. Over time, experience may demonstrate that this was not enough.

While some organisations may have been careful to establish a reputation for probity, good management and reliability, public discovery of bad behaviour by a few caused problems for all. Also, as the volume and geographic breadth of transactions increased, a better way to manage the risks and the processes associated with bankers' drafts needed to be developed. For example, the holder of a draft had to present the draft at the bank where the valuables it represented were held. It was not possible to present one bank's drafts at another bank.

Over time, some organisations joined together to develop collective solutions to the risks they faced and to problems encountered when delivering services to customers. Risks that threatened public institutions or economic stability resulted in government involvement in the solutions. In other words, external governance

mechanisms were imposed by governments while others were developed as cooperative solutions by the institution themselves. Development of the membership rules by members of the London Stock Exchange is an example of a governance mechanism developed by a group of organisations. It served multiple purposes. It provided the means to ensure that agreed on standards were maintained, but it also provided a method for limiting competition and ensuring that a 'seat', or membership, on the exchange was valuable.

Today, banking and the other financial services are highly regulated sectors. Module 7 will explore the corporate governance mechanisms found in the financial markets.

1.5 Foundations of the Corporate Governance Framework

It is helpful to understand the social, political and economic importance of land in Europe, because the modern corporate governance framework used around the world today appears to have evolved from the external and internal governance system used in this land-owning system. Historically, land was not merely a source of income and an economic asset but a source of power and status. Until the First World War, land was the most important single passport to social and political consequence in many European societies, and the more land that was owned the greater a family's chance of advancement. The ownership of a country estate was the goal for many wealthy industrialists because it granted its owner vastly greater social status than wealth made from 'trade'. This was a status enhanced by the length of time during which the land was owned. As a result, a prime preoccupation of many wealthy landed squires was to preserve the family inheritance intact and to pass it on to the next generation according to the principle of primogeniture down the male line.

Land in the various European social systems represented not merely wealth, but stability, continuity and an interest in the state, which conferred with its title the right to govern. If possible, many wanted to pass it on in an improved condition, financially, socially and aesthetically, and, with appropriate mechanisms in place, it could be passed on to one's heirs, potentially in perpetuity. It is this that helps to explain why influential landowners who wished to provide for continuity of ownership by their descendants sought a legal structure and administrative systems to achieve this end.

1.5.1 Ownership as Life Estate – A Deed of Settlement

A legal structure of land ownership developed in England called **strict settlement** which allowed title of property to be established so that successor generations of landowners only owned a tenancy for their lifetime and operated under legal and social constraints. The full exploitation of the estate was restricted, and successor landowners were, in general, able to use only the actual cash revenues of the estate for their own purposes.

Under strict settlement, the land belonged to the estate, not to the squire. This must have developed because of the desire that estates would be preserved intact

and handed on to the next generation. Given these constraints, it is not surprising that 'rational' pursuit of efficiency and profitability by landowners was not the primary object of the administrative system developed to manage these estates. Strict settlement ownership meant that, until the late 19th century, when the Settled Land Acts allowed life tenants to sell land and reinvest in securities, land owned by an aristocratic estate in the UK was effectively absolute. This distinction is important because the principle has carried into company law. A company owns its assets, not the shareholders. It is only when the company is liquidated that the shareholders can exercise their claim on the assets.

1.5.2 Landed Estate Administration

Great estates in Britain ranged in size from a few thousand to several hundred thousand acres, so the amount and style of administration required differed greatly from estate to estate. Landowners had many other interests, and some were no doubt content to regard their estates merely as the source of twice-yearly remittances to their London bankers. However, all but the smallest estates were likely to have some form of administration, if only a country attorney who collected the rents or a tenant farmer who acted as a part-time bailiff to enforce the husbandry covenants often contained in farm leases. But for estates of a certain size (probably 3000 acres or more), the administration would almost certainly have been placed in the hands of a full-time resident agent, to whom considerable executive authority would have been delegated. On the largest estates, which often consisted of multiple properties in different counties, there would probably be a chief or supervisory agent bearing the title of 'auditor', and sophisticated administrative systems.

The resident agent would be responsible for finding tenants for farms, negotiating leases, ensuring that husbandry covenants were kept (e.g. rotation of crops), recommending and supervising improvements, and for the collection, disbursement and accounting for estate revenues and expenditures. The prime accounting records were usually running statements of cash received and paid out, and these records might be kept by the estate officials responsible for receiving rents and making payments. Depending on the organisational structure of the estate and the allocation of responsibilities, accounts might be kept by various levels of estate staff, from agents to sub-bailiffs. The resident agent managed all of these activities as well. This job description has some resonance with the current role description for a chief executive in a small to mid-sized company.

1.5.3 Estate Accounting System

The estate accounting system developed in the 16th century. The accounts of the receivers (i.e. income collectors) for the various groups of properties were brought together for audit in the central estate office every six or twelve months and settlements made of the balances in the receivers' hands. In a well-conducted estate office copies were made of the whole collected accounts, arranged systematically under various headings and bound together in volumes as a permanent record. Quite often an abstract of the totals under each main heading was included at the end of the volume for easy reference and analysis.

Accounting existed to report on the source of net cash revenues, and expenditure to enhance these would often be made after a consideration of potential rates of return (here, the landowner might be considering the 'opportunity cost' of investing in the estate rather than in alternatives such as mortgages or government debt, or indeed doing nothing but using estate revenues for consumption).

But once an investment had been made, its cost became invisible, as it was not the custom to prepare a **balance sheet** for an estate. This might lead owners of an estate to pursue developments that were unprofitable on a **capital return** basis. For example, the second Marquess of Bute and the trustees of his grandson the third Marquess sank hundreds of thousands of pounds over a 40-year period into the construction of Cardiff docks, following a grossly over-optimistic assessment of likely returns, only to discover at the end of this period that cash generated by the docks provided virtually no return on the capital invested.

Estates were managed on a hierarchical basis, with accounting designed to aid accountability and to inform the life tenant of the net cash resources being generated from his land. Industrial, extractive and transportation activities such as docks, coal mining and ironworks were commonly regarded as adjuncts to the exploitation of land, and owners rarely were able to keep track of amounts invested in such activities from information generated within their estate accounting systems. Thus, while the notion of a **rate of return on investment** was not alien to aristocratic landowners, it was more of a planning device than something they could readily calculate in hindsight.

It is these two features – the emphasis on net cash as revenue, and the invisibility of capital – that are central to understanding early enterprise accountability. The system was essentially a cash-based one. In its early form, the closure of the capital account and subsequent non-reporting of how capital funds had been disbursed made capital effectively invisible.

1.5.4 Adoption by Canals and Railroads

The use of a system similar to estate accounting on canals and railways reflects the extent to which these transport systems may have been regarded as devices for exploiting and achieving a return from land. Landowners were particularly active in the promotion of canals, some ending up as outright owners. For example, the Duke of Bridgewater and Earl of Dudley owned canals named after them. By the 1840s, many landowners had invested significantly in railways.

Canals and railways required a substantial initial investment to create the infrastructure, but then would, in theory, require only maintenance to keep running. This was reflected in the system of canal and railway accounting. Capital investment needs were funded by the issuance of shares and loans. These transactions were recorded in a capital account. The construction of the canal or railway was financed from this capital, and the expenditure of money on construction was shown in the capital account. The providers of capital could see that the capital they had furnished was being applied for the purposes of the company and not allocated to meet operating expenses or otherwise misapplied. Once the canal or railway was com-

plete, the capital account could be closed and operations reported through an operating statement.

Railway accounting reflected its aristocratic history by accounting for the permanent right of way, rails, engineering works and rolling stock as if they represented permanent (fixed) capital, which generated net revenues through its exploitation in the same way as land. However, a difference between the landed estate and the railway lay in the greater proportion of the latter's assets that were known to deteriorate and require replacement (rails, rolling stock). On an estate, assets with short lives, such as farm equipment and animals, tended to be provided by tenant farmers rather than the landowner. In the 1840s there was experimentation with depreciation accounting on the railways, reflecting an awareness that not only rolling stock but also the railway itself wore out, so that fixed capital needed to be 'recovered bit by bit'. These experiments were conducted within a double account framework and often involved the establishment of specific funds for asset replacement.

To the aristocrat, an accounting statement told him how much cash he had available from his estate, how much had already been remitted and how much was still in hand, and thus provided a guide to consumption and to estimating future estate cash flows. It was the life tenant's decision how much of this cash flow should be spent on major improvements and how much on consumption or other portfolio investments. But the principle was that the net cash generated by the estate was at the life tenant's disposal and entered his personal estate, over which he had full rights. Similarly, on the railways, shareholders expected the full revenues of the company to be distributed as dividends, and provision for depreciation, indeed any but the most innocuous of profit retentions, may have been seen as pre-emption by an agent of his master's right to dispose of the net cash flow of the estate as the master chose. Landowning shareholders might regard themselves as 'life tenants' of the company, entitled to its entire net revenues.

1.5.5 Directors and Their Duties

The history of the first board of directors is lost in the mists of time. However, by 1600 the concept of a board of directors was written into the charters of English joint stock companies, as illustrated by the East India Company below. How the directors elected to fulfil their job was a matter for them to decide. But by the 19th century there was an extensive judicial debate about the duties of company directors. Much of this debate took the form of questioning whether the directors were more appropriately regarded as *agents* of the shareholders or as *trustees*. In both the arguments and the cases, the history of the aristocratic estate is obvious:

- As agents, the directors were seen as standing in the same position *vis à vis* the shareholders as a steward stands in relation to his lord of the estate
- As trustees, directors of limited liability companies were seen as the successors of directors of unregistered companies, which were created as trusts under a deed of settlement

Hence, whichever analysis was used to determine the duties of the director, it was derived by the courts from duties arising from and developed by the aristocratic estates. Also, UK company law was interpreted by the Courts of Chancery, whose main activity had been dealing with settlements and trusts. Attitudes held by many Chancery lawyers reflected those derived from their experience with the administration of trusts and estates. Chancery judges regarded a company as somewhat like a trust, and the company's articles of association as akin to a deed of settlement: therefore they could readily apply their precedents drawn from cases involving the settlement of land to a company whose purpose was the exploitation of land (in the form of a concession that could be seen as analogous to a lease).

So, in the UK, the limited liability company was based on the settlement concept, dividends were regarded as akin to rents, directors were seen as agents or trustees (or a bit of both), and the owner of shares in a company was regarded as being, if not a life tenant in the company, then a temporary holder of the right to the produce of the company. And, over time, accounting began to develop a **true** and **fair** profit determination intended to reveal the rate of return on capital. It also created the conditions for many of the anomalies discussed later in this text.

1.6 External Governance Mechanisms to Facilitate Economic Development

In London, and other cities such as Paris and Vienna, coffee houses developed into embryonic capital markets. A capital market is an investment forum where those with excess funds place those funds with those who need them in exchange for a promise, either implied or actual, of a return of income on those funds.

These coffee house capital markets were gathering-places where men with money met and engaged in both social discourse and financial business. Someone seeking capital to fund a venture would visit these coffee houses, explain their venture to people who were gathered there and, if they found investors who were interested, could finance their enterprise.

Soon men began to act as intermediaries in transactions conducted in the coffee house markets located in Change Alley in the City of London, among them Jonathan's and Garraway's. The first of these intermediaries were probably scriveners who had prepared documents for land exchanges and asset transfers. The intermediaries, soon called **jobbers** in London, began to organise the transfer of assets by matching buyers with money with the sellers of assets. Slowly, the role became that of market makers in the various shares traded in the market.

This occurred in London and other cities such as Paris and Vienna as well. Investment was needed in order to exploit the economic opportunities the colonies presented, but a number of changes would be necessary before the capital markets could develop and fulfil the need for capital. For example, the markets needed a better legal form for enterprise organisation.

Definition

Partnership

is an association of persons formed for the purpose of carrying on a business. A partnership is not a legal 'person'. Partner-owners are liable for the debts and actions of the firm. Local laws will differ, but generally a partnership does not have a fixed term and will end automatically upon the death or withdrawal of a partner unless their agreement specifies that it will not. Partners do not receive a salary and are not paid interest on their capital.

Corporation

is a body of people authorised by law, either charter, statute or common law, who have rights, responsibilities and liabilities as a 'legal person' that is distinct from those who formed the association.

Traditional forms of commercial organisation – partnerships and sole proprietorships – had disadvantages that impeded the raising of capital, especially for large projects. These included the following:

- Those who held an ownership interest put their entire personal wealth at risk should the enterprise become insolvent
- The death of an owner resulted in dissolution of the enterprise
- Transfer of an ownership interest required the agreement of all the other owners

These problems were first solved by the development of a limited liability form of organisation called a **joint stock company**. Granted by Royal Charter or Act of Parliament, a joint stock company limited the risks of investors. This new form of entity permitted shares to be transferred from one owner to another without the permission of the other owners. Some joint stock companies were also granted special advantages such as monopolies and tax waivers. Early joint stock companies included several East India Companies chartered by the Dutch, British and French governments; the Massachusetts Bay Company and Hudson Bay Company charters were granted by the British Crown. Charters were also granted for banks and a limited number of other business enterprises as well. A summary of the history of the British East India Company can be found in Box 1.2 below.

The financing needs of colonial and commercial expansion increased the demand for capital to unprecedented levels. This growing demand for capital was difficult to satisfy in private transactions or informal coffee house markets because finding counterparties was inefficient, and the problem of managing counterparty risk was difficult. In other words, it was inefficient for investors to find investments fitting their specifications and for those needing funds to find investors who would be interested in making an investment in their venture.

Box 1.2: East India Company 1600–1874

Queen Elizabeth I chartered the East India Company on 31 December 1600 for the purpose of trade with Asia, and to challenge the Dutch-Portuguese

monopoly of the very important spice trade. The Company had a humble beginning as a trader, however:

> In the middle of the seventeenth century, Asia still had a far more important place in the world than Europe…The riches of Asia were incomparably greater than those of the European states. Her industrial techniques showed a subtlety and a tradition that the European handicrafts did not possess. And there was nothing in the more modern methods used by the traders of the Western countries that Asian trade had to envy. In matters of credit, transfer of funds, insurance, and cartels, neither India, Persia, nor China had anything to learn from Europe. (Jacques Pirenne (1950) *Panorama de l'Histoire universelle*)

The East India Company established a factory in India in 1611. After the Dutch massacred English traders at Amboina, New Guinea, in 1623, the Company concentrated on trade with India. It gradually acquired trade rights from the Mogul emperors of India. Parliament granted it monopoly rights to bring goods from India to Britain. With the approval of local Indian rulers, the East India Company established 'residencies' (trading posts) in Madras, Bombay and Calcutta. It was now trading in cottons, silks, indigo, saltpetre and tea.

During the 17th century its monopoly was threatened, first by independent traders and then by a rival chartered company. This later challenge was resolved by merging with the rival in 1708. As the power of the Moguls declined, local princes began to harass the Company settlements, so the Company began to intervene in local political affairs.

A French company expanded aggressively in India until Robert Clive's military victories over the French left the English dominant in India. A 1765 treaty gave the Company control of Bengal; the Company was now in charge of a country. As Governor of the East India Company and Bengal, Clive sought to reduce corruption and improve the company's disorderly administration. When Clive assumed the right to collect state revenues, it drew him into political difficulties at home. He was summoned home and accused of 'peculation' (embezzlement). Acquitted in 1773 after a long investigation, but broken in health and spirit, Clive committed suicide.

To check the power of the Company and to access its revenues, the British government intervened with the Regulating Act 1773, by which a governor-general of Bengal, whose appointment was subject to government approval, was given charge of all the Company's possessions in India. In 1784 the government assumed more direct responsibility for India and set up a board of control. The Company continued to control commercial policy and lesser administration, but the British government became the effective ruler of India. On 1 March 1801 the debts of the East India Company amounted to £5 393 989 while 'their effects' were £15 404 736. Its revenues had increased since February 1793 from £4 988 300 to £7 602 041. There were more than 3670 staff employed by the Company in England. Then, Parliamentary acts of 1813 and 1833 ended the Company's trade monopoly. Finally, after the Indian Mutiny of 1857–58 the

government assumed direct control of the Company's operations. In 1873, the East India Company was dissolved.

Jobbers began to organise the flotation of companies and facilitate the transfer of shares from one investor to another. This stimulated changes in the informal capital markets. Some coffee house capital markets grew in size, while others failed. Some began to specialise in particular types of financial instrument (e.g. bonds, equities, options) and others in particular types of investment (e.g. shipping, metals, industrial development, agricultural products). For issuers needing sizable amounts of capital, consolidated and specialised markets provided easier access to a larger group of investors. This made it easier to aggregate large pools of funding. Focused markets also helped investors to access a broader range of investments more easily. This helped in diversifying the risks inherent in the investments people made.

Box 1.3: The South Sea Company and the First Stock Market Crash 1710–1720

Problems with £9.4 million in unfunded short-term war debt waited for Robert Harley when he was named Chancellor of the Exchequer in 1710. A scrivener turned financier, John Blunt, proposed a solution. In 1711 the British war debt was exchanged for shares in a newly chartered joint stock company, the South Sea Company. The Company would earn profits from commercial concessions and annuity payments that the government would grant it. A similar debt swap and concessions had been used with the Bank of England and the East India Company. The directors of both had profited handsomely.

This transaction created a firm with the potential to rival the new Bank of England. Harley, now the Earl of Oxford and Lord High Treasurer, became Governor of the Company. Robert Knight was appointed Chief Cashier. The War of Spanish Succession ended in 1713 and Parliament granted the Company a 30-year concession on the slave trade with Spain's American colonies. Blunt and Knight never made a profit on the slave trade; however, they dreamed of eclipsing the Bank of England and granted discounted shares to important people to achieve this aim. The South Sea share register was a 'who's who' in society. When George I acceded to the throne, Harley fell from favour and the new Prince of Wales became Governor of the Company. The King and his son squabbled, and the King took over the role.

In 1719 and 1720 more government debt was swapped for Company shares. Parliament allowed the Company to do a complex restructuring, and it repeatedly issued more shares to investors. At each issue the price spiralled upward. Despite some criticism, the Company was allowed to set the price for each of these share issues. Company insiders purchased shares at discounted prices and then sold them to outsiders on the Stock Exchange at market prices. It seemed a foolproof way of making a fortune, and it proved to be an irresistible temptation. In January 1720 the shares traded at £120 per £100 of par value. By 24 June, they achieved a peak price of £1050.

The speculation for South Sea shares encouraged promoters of other companies to take advantage of the buying mania. Some were honest; many were not. One hundred and ninety new ventures were floated on the London Stock Exchange in the last months of 1719 and in early 1720. Many of these ventures did not have a joint stock charter. In other words, they were unincorporated enterprises. South Sea promoters and their influential friends persuaded Parliament in June of 1720 to pass 'The Bubble Act', which prohibited flotation of any company except those with a joint stock charter.

In August, South Sea shares began to decline. In early September, the market capitalisation of the Company was £60 million more than the net tangible assets of the firm. By 1 October the price had collapsed to £290. When the speculative bubble burst for South Sea shares, it triggered the first great stock market crash.

Public hysteria over the market crash and disclosure of corruption at the highest levels in UK society created a political crisis. Amid the hysteria, Robert Knight, the Chief Cashier of the South Sea Company, vanished with the company's books.

By 1719 the London share markets had become very active. From September 1719 through August 1720, 190 new ventures were floated in London. However, while a large capital market may be more efficient compared with smaller informal fragmented markets, it also requires greater organisation and control. This lesson was painfully demonstrated in September 1720, when the London share market began to fall. By 1 October the market had crashed. It was the first ever share market crash. See the South Sea case study above.

1.7 Protecting the Providers of Capital and Society

In his famous treatise *The Wealth of Nations*, published in 1776, the Scottish philosopher and political economist Adam Smith examined the collapse of the South Sea Company and 54 other corporate failures that occurred between 1600 and 1776. Smith was concerned not only about the creation of wealth, but also about its equitable distribution. As a result of his investigation, Smith concluded that the corporate form of organisation, which limits the owners' risk to the amount of their investment, has inherent problems that are dangerous to society. These problems, Smith concluded, were unlimited life, size, power and licence. In essence, Adam Smith was concerned that granting a corporate entity unlimited life would allow it to continue to grow its capital base and seek greater power for which it was not accountable.

Smith was worried that unlimited life permits organisations to outlive their original purpose and grow their capital until they gain excessive power and mismanage their assets. Smith prophesied that:

> …negligence and profusion therefore must always prevail in such a company… [and] no other sovereigns ever were, or, from the nature of things, ever could

> be, so perfectly indifferent about the happiness or misery of the subjects [as] the proprietors of such a mercantile company are, and necessarily must be.

1.7.1 Effect on Organisational Forms and Capital Formation

Although not important in itself, the speculative bubble that the South Sea affair induced led to the first great stock market crash, which was important for the long-lasting hostility it evoked in the UK towards the dealing in shares of companies. In other words, it created a social norm that influenced both capital formation and, arguably, organisational form as well.

In 18th century Britain the corporate form could be obtained only from Parliament or the King. Reluctance to allow the corporate form of organisation in the UK, and other jurisdictions influenced by the UK, continued for decades after the stock market crashed in 1720. During the late 18th century, when Adam Smith expressed concern with the corporate form of organisation, which still required Royal Charter or an Act of Parliament, its use was rare.

Figure 1.1 The South Sea Scheme

'The South Sea Scheme' by William Hogarth (1724) is a satire about the financial business in the City of London. It depicts a vast demonic casino and amusement park. In the centre, investors ride a financial merry-go-round; at the left the Devil throws haunches of Fortune to the crowd; at the bottom, Self-Interest tortures Honesty on the Wheel; in the darkness at the bottom right, a female Trade lies languishing.

Although there were few flotations after the South Sea collapse, it did not end the capital market activity in London. People held shares, and often wanted to

exchange them. The markets themselves grew and became chaotic. The coffee houses where the jobbers did business became so noisy that the jobbers moved to New Jonathan's, a newly built coffee house market, which was renamed The Stock Exchange in the summer of 1773. Soon, the exchange built and moved to new quarters on a site adjacent to the new Bank of England building. It began to limit access to those jobbers who would subscribe to its newly developed rules and with whom the other members wanted to do business. They developed a mechanism for the removal of a member of the exchange who violated its membership rules.

However, most commercial enterprise was undertaken in unincorporated forms of organisation such as partnerships, which put the owners at risk for the actions of the enterprise. Use of partnership and other unincorporated organisational forms has the effect of limiting the size, scope and longevity of the commercial activities. This is because of the practical limitations inherent in organising a group of owner-decision makers, the finite amount of capital that small groups of individuals hold personally, and the limited life they tend to have. So financial market funding of commerce and industry may have been retarded by the South Sea affair.

For another 200 years most business activity around the world was funded privately, although the capital markets did provide funding for some large industrial, transportation and natural resource development projects, especially those with elements of public interest and requiring large amounts of capital. Even well into the 20th century many UK companies in long-established sectors like banking, retailing and manufacturing were still organised as partnerships.

1.7.2 World Dependence on the Financial Markets

By the second half of the 20th century this had changed. Many enterprises were organised as limited liability companies and funded by capital acquired, either directly or indirectly, in the public markets. Banks often lent money that they obtained in the capital markets, rather than from depositors. In the last few decades more and more companies have sought capital in public markets, or they have relied on credit obtained from retail financial institutions that have raised those funds in the capital markets.

Today, most developed economies are dependent on financial markets. This is because many organisations in those economies are either directly dependent on capital markets because they raise funding in those markets themselves, or because they obtain funds that have been accumulated in the retail financial markets through deposits and made available as debt or equity financing through the capital markets. So, if investors lose confidence in the markets, the funding mechanism for the global economy is put at risk.

1.7.3 Governance Frameworks – Evolutionary, Complex and Interconnected

Modern financial market economies developed slowly, a bit at a time. Financial need stimulated the development of capital and retail financial markets and, as those markets developed, the economies evolved.

When there arose efficiency, administrative or behaviour control problems, these led to the development of governance solutions. Society, government and professional bodies imposed some of these solutions externally; companies created other solutions themselves internally.

The Bubble Act, passed by the UK Parliament in June 1720, was an early attempt at external governance purportedly intended to protect the providers of capital by prohibiting the raising of capital in the public markets, except by chartered joint stock companies. The Bubble Act also prohibited companies from engaging in any activities except for those permitted in their charters.

However, like many public policy solutions, there was another side to this piece of governance legislation. The flotation of unincorporated entities in the London market created significant competition for investment funds. The promoters of the South Sea Company reportedly encouraged their powerful connections in government to eliminate that competition. The Bubble Act was the solution created to do so.

An iterative pattern of development can be observed in any corporate governance framework or financial market. Concern about problems leads to the development of various public and/or private solutions. As confidence improves, due at least in part to the governance solutions, it enables the markets and companies to develop further, and, as they do so, the economy evolves and makes further progress, and new problems emerge. These require the development of further solutions.

Problems with the behaviour of stock market intermediaries led to the development of rules for members of the various stock exchanges. This was accomplished by market intermediaries creating their own rules and ejecting anyone who failed to follow those rules.

Problems with the behaviour of the management of listed companies led governments to develop regulators to supervise the relationship between companies whose financial instruments were traded in the public markets and the investors who held those instruments. Accounting developed to support internal decision-making in companies, and then auditing and accounting standards developed as a means to provide consistent and reliable information reporting externally. This information is used both to evaluate company and management performance and to value the financial instruments traded in the capital markets.

Because external governance frameworks develop locally, there is significant variation between them. In other words, France, Germany, Japan, the United States and the United Kingdom have their own unique external corporate governance frameworks. Although there are many elements that have developed in one jurisdiction and have been adopted by others, each jurisdiction has created its own unique set of governance mechanisms. Similarly, companies create their own internal governance systems.

1.8 Listed Company Behaviour – On (Off) the Agenda

The 1970s was a period of economic stagnation in the West, and yet Japan's economy boomed. Then the Reagan and Thatcher reforms changed the economic systems in the United States and the United Kingdom, and both economies took off rapidly. In the UK, the biggest changes to the regulation of the capital markets occurred in 1986. As the markets boomed, however, there was a new climate of greed in the City.

Box 1.4: The City

By 1985, the London Stock Exchange had lost its place as a leading world financial centre. It had a turnover that was 1/13th of that in New York and 1/5th of second-place Tokyo. The Reagan reforms had shaken up the US financial system, unleashing the forces of enterprise in previously sleepy American financial markets. New technologies for trading and management of investments and information made the growth of financial service firms possible. Larger firms meant larger capital bases, bigger transactions and greater earnings.

A shift towards foreign trading and over-the-counter (i.e. off-exchange) block transactions had shaken the confidence of the leadership of the London Exchange. They could see no way to respond to threats from the US firms that were adopting internationalisation strategies because of legal and regulatory constraints in the UK.

In 1986, amid a wave of reforms introduced by the Thatcher government, 'Big Bang' occurred. It produced key rule changes for the capital markets:

- The rule fixing a minimum commission for exchange transactions was abolished
- The regulation that forbade firms from performing both as a broker for clients and as a market maker (a 'jobber') in the same shares was eliminated
- A restriction that prevented non-stock exchange members from owning stock exchange members was lifted

These changes increased competition and made it possible to introduce vast amounts of new capital into the London market (i.e. capital of non-members), which could then underwrite the large-scale privatisations planned by the Thatcher government. In 1987 the London Stock Exchange replaced its face-to-face trading floor with a computer trading system.

After these reforms, the market expanded rapidly. Pre-Big Bang, the financial sector provided 13.6 per cent of UK GDP; by 1990 it accounted for 17.2 per cent. There were more cross-border share transactions. However, the number of shareholders and investors did not increase. Commissions for block trades lessened, while small block trading experienced a slight increase in cost. Commissions on the whole achieved a standard that was low relative to other major markets. The capital of securities firms increased. Financial sophistication increased as well, and innovative products such as complex derivatives were introduced in London.

Reagan and Thatcher had shaken up the international financial system, unleashing forces of enterprise, but these changes meant that many UK share jobbers and brokers disappeared through acquisition, some by local merchant banks but most by non-UK full service financial firms. The 'Union Jack' was disappearing from the London markets, but London slowly regained her old position as the European investment centre. However, it was at a cost. The congenial club-like atmosphere of the London capital markets was replaced by an environment in which greed and avarice flourished.

In 1987 the Asian markets crashed, and then slowly other major markets caught this economic 'Asian flu'. Unlike the crash of 1720, which was limited to the London share market, in 1987 the economic problems spread around the world, thus demonstrating the interdependence of the major industrial economies. The US stock market crashed in late 1987 and the UK markets followed in mid-1989.

The late 1980s and early 1990s was a period of economic weakness in the United States, the United Kingdom, Europe and Asia. A number of large listed companies failed, and this resulted in substantial interest in improving the supervision of listed companies. In the United States the financial accounting professions joined together and appointed the Treadway Commission to examine fraudulent financial reporting. The Treadway report is viewed as a landmark statement on internal control practices.

The London market crash in 1989 had a sobering effect in the UK. The public was outraged over a series of spectacular company failures. Two of the best known of these were Polly Peck and a massive £10.0 billion fraud at BCCI. These corporate collapses led to media and public demands for improved supervision by boards of companies listed on UK stock exchanges. The demands stimulated, in turn, the appointment of the Cadbury Committee in 1991 and the development of new capital market controls. The Cadbury Committee was asked to examine the financial aspects of corporate governance. While its work was under way, Robert Maxwell drowned in the Atlantic Ocean and his publishing empire collapsed, disclosing that he had plundered the pension plans of two large listed companies (*see* Table 1.1 for descriptions about these scandals).

Table 1.1 Triggers for contemporary British corporate governance reforms

Polly Peck International	Asil Nadir built PPI into a worldwide group of more than 200 direct and indirect subsidiaries. Nadir also controlled a Turkish Cypriot bank. PPI became a hot share to own, growing to a £2.0 billion market capitalisation by the late 1980s. Nadir had a compelling, rags-to-riches life story, having risen to become one of Britain's wealthiest men. The City was stunned when PPI collapsed in 1990. Nadir was bankrupted and charged with fraud for diverting PPI funds to his bank. A long-drawn-out prosecution and Nadir's sensational escape to Turkish-held Cyprus left unanswered questions. The Serious Fraud Office and political establishment were discredited. A government minister resigned, after denouncing prosecuting authorities. A High Court judge and top Queen's Counsel were accused of a 'plot' to pervert the course of justice. The Attorney General had to apologise for misleading Parliament. PPI's auditors were fined, and ordered to take training.
Bank of Credit & Commerce International	There were few international banks in the 1970s – just a few colonial banks from Britain, France, Germany, and a few new American institutions. Developing countries were not served well as these were really national banks with limited international networks. BCCI's unique criminal structure took advantage of this gap and created an elaborate web with BCCI's founder, Agha Hasan Abedi and his assistant, Swaleh Naqvi, the spiders in the middle. This was the reason for its spectacular growth, and guaranteed its eventual collapse in 1991. The structure was designed to evade by frustrating anyone from understanding its operations. From its earliest days it had layers of entities, impenetrable holding companies, affiliates, subsidiaries, banks-within-banks, insider dealings and nominees. The complexity allowed it to evade restrictions on the movement of capital and goods as a matter of daily routine. Fundamentally free of government control, Abedi facilitated illicit activities by others, including government officials. The criminality included fraud by BCCI and its customers involving billions; money laundering, bribery, support of terrorism, arms trafficking, and the sale of nuclear technologies, prostitution; the commission and facilitation of income tax evasion, smuggling, and illegal immigration; illicit acquisitions; and a panoply of financial crimes limited only by the imagination of the players.
Maxwell Group	Robert Maxwell's business empire was falling apart when his body was found floating in the Atlantic off the Canary Islands in November 1991. Maxwell ran a large publishing empire, and was the majority shareholder of two listed companies, Maxwell Communications and Mirror Group Newspapers, each of which maintained large pension funds. These pension funds were managed by organisations also controlled by Maxwell. When a number of private companies owned by Maxwell got into financial trouble, he plundered as much as £400 million from the pension funds in unauthorised loans to his troubled private companies. Within weeks of his death the deceit was revealed.

In the early 1990s, the term 'corporate governance' emerged from the shadows and took a place firmly on the agenda of public concern. The first known use of the term **corporate governance** is in Tricker's book *The Independent Director: A Study of the Non-executive Director and the Audit Committee*, published in 1976. Although the term 'corporate governance' was coined in the mid-1970s, it was rarely utilised until the capital market turbulence in the late-1980s. When it *was* used, it tended to be in publications intended for company secretaries, called corporate secretaries in some jurisdictions. The company secretary's role developed in contemporary company law. This is the person responsible for ensuring that the company meets all of the requirements set out in company law, a responsibility specified within those laws.

Beginning with Treadway and Cadbury, studies about 'corporate governance' were commissioned, reports were published, hearings held, changes in law and regulation initiated. There was a flurry of books, articles and training courses about 'corporate governance', soon this became an avalanche. A host of consultancies dedicated to 'corporate governance' were launched.

At one point there was so much activity under way that one pundit on BBC radio remarked, 'The boards of listed companies are so busy doing "corporate governance" that they may forget about the businesses that they are meant to be overseeing.'

But by the second half of the 1990s an economic boom had made even mediocre companies look successful. The public was making money, and 'corporate governance' slowly slipped off the agenda of public concern.

1.9 Market Madness, Excess and Trust Lost

The second half of the 1990s saw the stunning growth in reported earnings at many listed companies. The US stock market only seemed to go up, although 'old economy' shares such as Dupont, 3M, ConAgra and Mellon Bank suffered in comparison with the astronomical valuations commanded by 'new economy' companies such as Internet start-ups, telecoms, software giants, silicon chip makers and IT hardware manufacturers.

Share values in other countries grew as well. Those markets also reflected valuation differentials between 'old' and 'new' economy companies, although the gap was not as large as seen in US markets. Nor did any other market grow at quite such a dizzying pace as the US NASDAQ, the home of many US technology shares.

Increased share prices were accompanied by growth in executive compensation to levels that would have been unimaginable a decade before. While the typical hourly American worker received a pay raise of 3 per cent in 2000, the average CEO of a big company received a 22 per cent increase, and the top 800 American executives took home a total of $6 billion in compensation, a significant proportion of which was in the form of shares or share options. A similar, although smaller, gap developed in the UK.

During this period, many people who ran listed companies bet on big deals. Scores entered lines of business in which they had no previous experience. A host of celebrity CEOs became household names.

Jack Welch transformed GE from a heavy industrial company into one of the most diversified and admired companies in the world. GE manufacturing produced light bulbs, X-ray equipment and locomotives, while GE Capital financed purchases such as cars and airplanes, and serviced credit-card accounts. GE also owned NBC broadcasting, a TV network and production company.

Founded as a US research laboratory, Tyco was turned by Dennis Kowalski's acquisition spree into a global company employing more than a quarter of a million people. Its manufacturing ranged from steel pipe to adult incontinence products; its services included residential burglar alarm monitoring. A regular in the New York society pages, Kowalski also used Tyco resources to make major charity contributions, even funding a chair of corporate governance at the University of Cambridge in the name of a Tyco board member.

Jean-Marie Messier transformed a French water utility into Vivendi Universal, a media, telecommunications and Internet giant. In the mid-1990s he used the French utility to build a diversified business empire in a series of deals that created a presence in the telecoms and media industries. Using high-priced shares as his acquisition currency, Messier paid €12.5 billion for control of Canal Plus, a French pay-TV group, and €32.6 billion to acquire Seagram, owner of a branded liquor group and Universal, one of the world's leading film and music brands. Integrated with Vivendi's existing telecoms and media businesses, Universal became the core of the new empire. More acquisitions followed; then in 2000 the original utility company, now called Vivendi Environment, was partially floated, with Vivendi retaining majority ownership and control.

Some executives used 'pro forma' performance measures such as EBITDA to persuade investors of the efficacy of their decisions when traditional accounting measures failed to reflect what these managers believed were the 'real results' of these decisions. Increased share price appeared to confirm that belief.

The public excess and conspicuous consumption of investment bankers during the 1990s became the stuff of legends. They earned astronomical fees from deals and stockbroking, while privately many were entering into back-room arrangements with fund managers and company executives in order to gain their business.

Some analysts became stars. They touted unknown, untried managers as the 'next generation' leadership in a 'new economy'. Some publicly hyped the shares of companies that privately they ridiculed. Many had buy lists that included ventures with no sales and no prospect of earnings in the foreseeable future.

Investment banks cynically pushed shares at investors. While many were shares of good companies, the banks also promoted firms based on untested or even flawed ideas. Some even pushed the shares of firms they knew would not live up to the glowing reports their analysts published.

Institutional investors entered into cosy transactions with investment banks whereby the investors gave the banks commission business in exchange for allocations of initial public offerings (IPOs), which were priced at a discount so that they immediately jumped in value when the issues began secondary trading.

When investment funds underperformed rapidly growing market indices, their managers were pressured to move a larger percentage of their portfolios into the

technology sectors that were leading the parade in share price growth. This drove the market valuations of these riskier investments even higher.

And what about individual investors in the US? Well, they changed as well during the 1990s. Americans who had never owned a share before were now talking about EBITDA performance and how much could be made on the next IPO. Day-trading became a way of life in the United States.

The entire country was caught up in a 'new economy' high. Consumer confidence and spending were at record levels. The success of a handful of early 'dot-com' millionaires stimulated a frenzy of new share issues as more people tried to capitalise on the investment boom. Investors who were unable to get IPO allocations from the investment banks snapped up the shares of those companies in secondary trading. People were lulled into a dangerous sense of invincibility by the ease of raising money for untried ventures.

During the last few months of the run-up in the markets, investors bid up shares in a frenzy of irrational exuberance. While a few doomsayers predicted problems ahead, most analysts, investment bankers and commentators said, 'This time is different.'

Why not? Anything seemed to go, and people saw it as an opportunity to get exceedingly rich.

The US stock market peaked in early 2000 and began to slip when the threat of an economic recession punctured the 'new economy' bubble. A mild recession was predicted, and many expected this to be a market correction, rather than a crash. So investors, while not happy with the market downturn, were not overly worried.

The S&P500, an index of share prices of the leading 500 firms listed on US stock exchanges, appeared to bear out this optimistic prediction. It established a bottom near the end of 2000 and began to climb rapidly in the first few weeks of 2001. However, the rally was brief, as investor confidence began to be shaken by one corporate scandal after another.

For corporate America 2001 turned out to be the cold shower after one of the dizziest binges in business history. The 1990s may have seen the longest bull market in US history, but it turned out that this time was only different in scale – it was bigger.

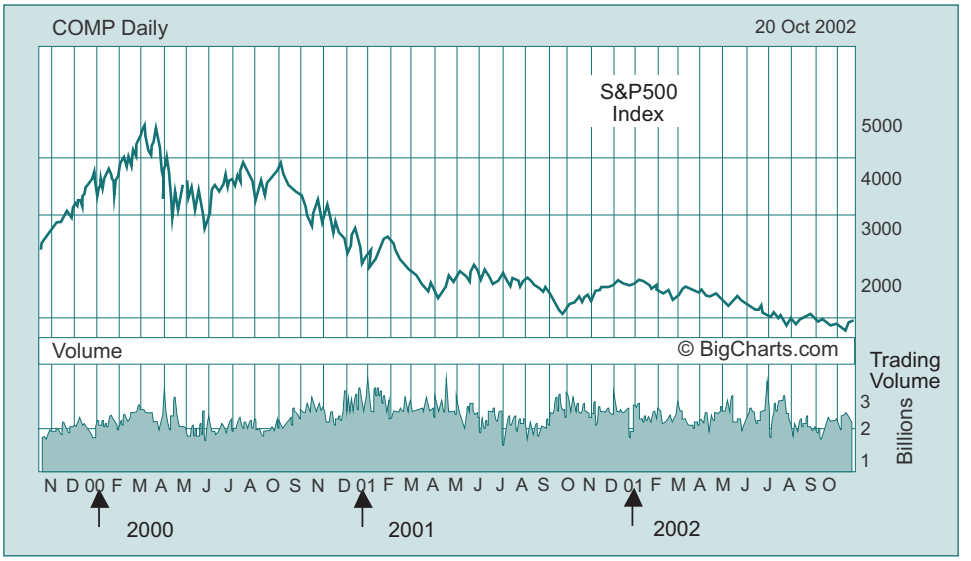

Figure 1.2 **From boom to bust in the S&P500**

World markets began to decline amid poor earnings estimates in other countries and fears that the US economy would slip deeper into recession. Nervous investors were stunned by the terrorist attacks on 11 September 2001, but while there was a sharp sell-off when the markets reopened after the attacks on the World Trade Towers, the US markets recovered.

Then the mighty energy trader Enron fell. As the story unfolded in early 2002, it was a sordid chronicle of gross malfeasance, greed and mismanagement. Arthur Andersen, Enron's auditor, was swept into the storm; within weeks the venerable accounting giant disintegrated and the US markets tumbled further. During the spring and early summer of 2002 more companies surprised the markets with large downward corrections in previously reported earnings. Although few in number, most of these accounting restatements were large, and the financial statements being corrected had been audited by the world's leading accounting firms – Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, PricewaterhouseCoopers.

As the number of audited financial statements that had to be restated grew, the markets reflected investor unease, with increased volatility and further declines. More stories about conflicts of interest emerged. Executives and directors of some of the troubled companies, as well as their advisors, were found to have sold their holdings before the public was alerted to the problems. Some well-known investment analysts were found to have kept companies on their buy lists long after they knew that they should have been recommending that the shares be sold. These were companies that had been doing profitable investment banking business with the analysts' employers.

Just as the markets began to show signs of a late-summer rally, and the US economy looked poised to recover from an otherwise mild recession, WorldCom, one of the world's largest telecom companies, issued a press release announcing a massive

correction to its previously reported earnings – WorldCom had manipulated its reported earnings by a massive US$3.85 billion.

The WorldCom press release (Box 1.5 below) triggered a further decline in the US markets. This plunge was larger than the one following the September 11th attacks. More companies announced restatements of their earnings, driving the US markets down even further. Global markets sank as well.

Box 1.5: Company Press Release

WorldCom Announces Intention to Restate 2001 and First Quarter 2002 Financial Statements

CLINTON, Miss., June 25, 2002 – WorldCom, Inc. (NASDAQ: WCOM, MCIT) today announced it intends to restate its financial statements for 2001 and the first quarter of 2002. As a result of an internal audit of the company's capital expenditure accounting, it was determined that certain transfers from line cost expenses to capital accounts during this period were not made in accordance with generally accepted accounting principles (GAAP). The amount of these transfers was $3.055 billion for 2001 and $797 million for first quarter 2002. Without these transfers, the company's reported EBITDA would be reduced to $6.339 billion for 2001 and $1.368 billion for first quarter 2002, and the company would have reported a net loss for 2001 and for the first quarter of 2002.

The company promptly notified its recently engaged external auditors, KPMG LLP, and has asked KPMG to undertake a comprehensive audit of the company's financial statements for 2001 and 2002. The company also notified Andersen LLP, which had audited the company's financial statements for 2001 and reviewed such statements for first quarter 2002, promptly upon discovering these transfers. On June 24, 2002, Andersen advised WorldCom that in light of the inappropriate transfers of line costs, Andersen's audit report on the company's financial statements for 2001 and Andersen's review of the company's financial statements for the first quarter of 2002 could not be relied upon.

The company will issue unaudited financial statements for 2001 and for the first quarter of 2002 as soon as practicable. When an audit is completed, the company will provide new audited financial statements for all required periods. Also, WorldCom is reviewing its financial guidance.

The company has terminated Scott Sullivan as chief financial officer and secretary. The company has accepted the resignation of David Myers as senior vice president and controller. WorldCom has notified the Securities and Exchange Commission (SEC) of these events. The Audit Committee of the Board of Directors has retained William R. McLucas, of the law firm of Wilmer, Cutler & Pickering, former Chief of the Enforcement Division of the SEC, to conduct an independent investigation of the matter. This evening, WorldCom also notified its lead bank lenders of these events.

The expected restatement of operating results for 2001 and 2002 is not expected to have an impact on the Company's cash position and will not affect WorldCom's customers or services. WorldCom has no debt maturing during the next two quarters.

"Our senior management team is shocked by these discoveries", said John Sidgmore, appointed WorldCom CEO on April 29, 2002. "We are committed to operating WorldCom in accordance with the highest ethical standards."

A Long Hot Summer of US Financial Scandals

During the summer of 2002, US investigations over accounting irregularities, bogus trading or misleading investors with biased stock picks:

Adelphia Communications	A cable operator that filed for bankruptcy in July, is under investigation by the Securities and Exchange Commission and two federal grand juries for multi-billion dollar, off-balance-sheet loans to its founders, the Rigas family.
Arthur Andersen	The global accounting firm that audited Enron was found guilty on 15 June in federal court for obstructing justice in the government's investigation of Enron.
Computer Associates	A technology company that agreed to a $638 000 penalty in April to settle charges with the Justice Department that it violated pre-merger rules after announcing it would acquire Platinum Technology Inc.
Dynegy	An energy trader that tried to acquire Enron, now under Federal probes into alleged sham trading aimed at artificially pumping up revenue and volume. Its long-time chief executive, Chuck Watson, resigned in May, and the company announced a major restructuring.
Enron Corp.	Once the nation's largest energy trader collapsed into the largest-ever US bankruptcy on 2 December amid an investigation surrounding off-the-book partnerships that were allegedly used to hide debt and inflate profits.
Global Crossing Ltd	A telecommunications company faced probes by the SEC and the Federal Bureau of Investigation regarding its accounting practices. It allegedly swapped network capacity with other telecommunications firms to inflate revenue.
ImClone Systems	A biotechnology company that is under investigation by a congressional committee seeking to find out if it correctly informed investors that the US Food and Drug Administration had declined to accept for review its experimental cancer drug. Samuel Waksal, its former chief executive, was arrested 12 June on insider trading charges.
Merrill Lynch	A major US financial services firm, which in May agreed to pay $100 million to settle a probe by the New York state attorney general into charges it tailored stock research to win investment banking business. In June, it suspended two employees after an internal probe on insider share-trading of ImClone.
Tyco International	A conglomerate that is under investigation into whether executives used corporate cash to buy art and a home. Its former chairman, Dennis Kozlowski, resigned 3 June, a day before he was indicted for evading about $1 million in New York sales taxes on art purchases.
Xerox	The copier and printer company announced that it was restating five years' results to reclassify more than $6 billion in revenues. In April, the company settled charges that it used 'accounting tricks' to defraud investors.

WorldCom	WorldCom, a telecommunications company, on 25 June said it hid $3.85 billion in expenses, allowing it to post net income of $1.38 billion in 2001, instead of a loss. The company fired its chief financial officer, and on Friday began cutting 17 000 jobs, over 20 per cent of its work force.

Source: Reuters.

Celebrity CEOs began to fall from favour as well. Jack Welch, who made GE into one of the most admired companies in the world, was in disgrace for having an affair with the editor of the *Harvard Business Review* and for secret post-retirement perks valued at around $2.5 million per year, over and above his huge share option and pension holdings worth hundreds of millions.

Welch's perks included a Central Park West apartment in New York City complete with housekeeper, chef, laundry, flowers and more, valued at $80 000 per month, the use of a Boeing 737 corporate jet worth $291 870 per month, limousine services, security guards, and box seats at the opera, US Open golf, Wimbledon, Yankees baseball and Knicks basketball.

Dennis Kowalski, the tycoon who built up the Tyco empire, was indicted for fraud, theft and tax evasion. Vivendi Universal, the French water company turned media, telecommunications and Internet giant, was in ruins, and Jean-Marie Messier, who had led the acquisition spree, was spurned by the politicians and financiers in France who had helped him to create the empire.

Ousted chiefs of FTSE-100 companies, the 100 largest listed companies in the UK, collected more than £170 million in termination payouts in 2002 while their shareholders saw billions wiped off their investments. The UK media were frenzied in their criticism of boards and regulation that permitted such things.

'Road shows', events where companies give presentations to investors, were dominated by questions about the efficacy of company reporting processes, about the relationships between analysts and the companies they follow, and about detailed information in company financial statements.

Stories emerged of insider trading and questionable behaviour by leading investment banks. High-flying companies had crashed in a series of corporate governance failures unequalled in history. These included the following:

- Accounting manipulation
- Boardroom breakdown
- CEO performance-related departures with large payoffs
- Corporate fraud or other criminal acts
- Environmental or social consequences of corporate activities
- Insider share trading
- Lack of transparency in corporate reporting
- Misuse of corporate resources
- Risk management failures
- Excessive remuneration for top management compared with performance
- Unexpected losses, profit declines or corporate collapses

By the spring of 2003, belief in the efficacy of companies and investment institutions had sunk to an all-time low. This was more than a bursting technology share bubble;[1] something appeared to be wrong with the whole corporate governance system.

> It has been very judiciously observed that a commercial country has more to dread from the golden baits of avarice, the airy hopes of projectors and the wild enthusiastic dreams of speculators than from any external dangers.
> John Millar (1845) *An Authentic Account of the South Sea Scheme*

1.10 Trust – A Fundamental Requirement in Economic Relations

Clearly, financial markets will not be efficient if the public cannot trust in the efficacy of the market itself. There also is a widely held belief that it is difficult to have efficient and reliable financial markets without broad-based trust in all aspects of those markets.

Actually, entering into almost any kind of economic transaction requires trust. For example, money forms the basis of modern economic transactions. However, money is an intangible that has no intrinsic value in itself. Rather money has implied value only if there is belief in the economic strength, efficacy and honesty of those who back the money. Without this trust money would be worthless, and each and every transaction would have to be conducted by barter, as is done in economically primitive societies.

Buying and selling shares and debt in a capital market requires the same kind of trust. There must be a belief that all counterparties to the transaction will fulfil their obligations, or else few people will be willing to enter into a capital market transaction unless it is very heavily discounted to make the risk worthwhile. The beliefs necessary to make a financial market viable include the beliefs that:

- those issuing the debt or equity instruments have the ability and the intent to fulfil their obligations;
- the financial instruments are valid and are what they purport to be;
- sellers will deliver what they have agreed to sell at the time and place agreed;
- purchasers will pay the price at the time, place and in the form agreed;
- all pertinent information about the issuers is available and can be relied upon;
- the financial instruments can be valued accurately with the available information;
- all relevant information is available to all parties to the transactions.

Every party to a transaction needs to believe that the marketplace itself is open and honestly run, and that they will not be at a disadvantage compared with any other party to the transaction. Without such beliefs, participants will not have

[1] For more on the history of technology-driven stock market bubbles, see Nairn (2002).

sufficient trust to enter into transactions willingly and, most likely, the market will fail.

Box 1.6: Waiting for the 'Bulls' or for Trust to Return?

A massive amount of cash is on the sidelines – cash in US bank savings accounts, bonds and retail money funds totalled $5.3 trillion. According to Trim Tabs, a mutual fund tracker, cash at the end of the first quarter of 2003 was at a record high, 51 per cent of the $10.4 trillion market capitalisation of the US stock market. The cash-to-market cap ratio was 49.5 per cent at the end of 1990, near the end of the last economic downturn.

The next year saw the S&P500 Index rise 31 per cent. At the end of 1999, just before the market peaked, cash on the sidelines was a record-low $3.8 trillion, 21 per cent of the total market cap at the time, which was $17.7 trillion. The following 40 months saw $7.3 trillion of market capital disappear from the US financial markets.

24 April 2003

1.11 The Domains of Corporate Governance

It has been assumed that improvement in external control and performance reporting will create and maintain the level of trust in companies that is required to allow financial markets to function smoothly. As a result, for centuries many of the reforms to the laws governing companies and financial markets, which are part of the external corporate governance framework, appear to have focused on achieving improved trust by addressing the classic principal–agent problem taught in economics.

Principal–Agent

An agent is someone to whom a principal has delegated decision-making authority. Conflicts naturally arise between the principal and the agent unless there is a reason or incentive for the agent to be efficient with the resources that he or she controls.

Corporate management is the owners' agent. Human nature causes some agents (many, most, all – depending on one's level of cynicism about human behaviour) to act in their own self-interest to the disadvantage of the owners. Agents need supervision to ensure that they are acting in the owners' best interest. In the existing governance system this role has been assigned to the board of directors.

Reflecting a widely held conviction that trust requires reliable external control and good quality performance reporting, the explicit aim of most recent corporate governance reforms has been to improve trust by improving:

1. the reliability of performance reporting through accounting standards, audit practice and legal sanctions for faulty reporting;
2. company reliability through the supervision of management undertaken by the board of directors

Other areas of the governance system to have received attention have been the auditors and, to a limited extent, the company executive. In other words, the overwhelming majority of recent corporate governance reform efforts, both as legal mandates and as recommended codes of best practice, addressed changes to and by the board of directors. Figure 1.3 illustrates the rather limited areas of reform focus, or what can be called domains, of the recent corporate governance efforts.

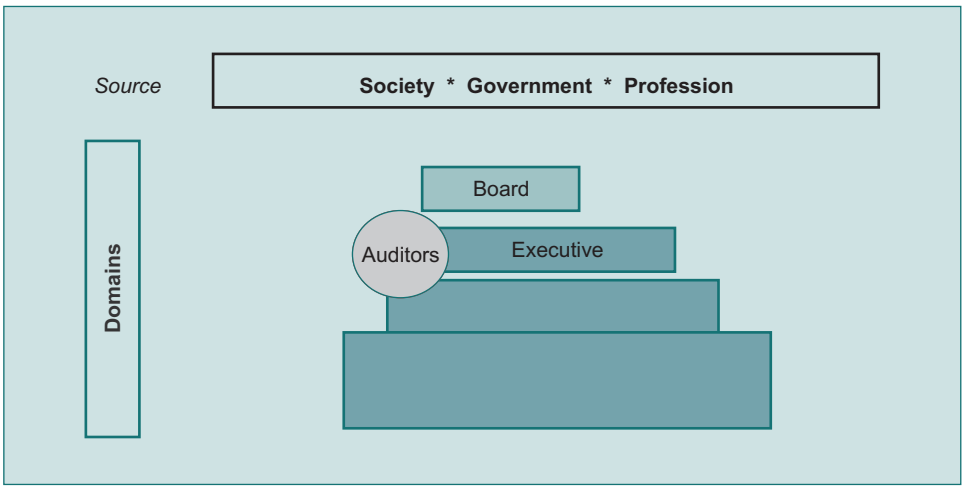

Figure 1.3 **Reform efforts focus on limited domains**

1.11.1 Many External Governance Influences

Yes, it is difficult to have efficient and reliable markets if the external control of companies in general, and reported performance information in particular, is unreliable.

However, although the focus of 'corporate governance' reform efforts has been narrow, external governance encompasses many domains. These are the many areas where public policies, rules and behavioural norms 'govern' 'corporate' activity.

Some of these governance mechanisms are explicit; others are tacit. In other words, they are understood, but this understanding is often unspoken. There are many different types of public policy mandate and recommendation on corporate practices, and these have been developed for many reasons. Some have been explicitly created to prevent corporate fraud or to improve financial market functioning. However, many have been stimulated by public reactions to various other failings and excesses in corporate behaviour.

For example, Justice Brandeis noted in one of his famous US Supreme Court opinions that he wrote for the minority view in a 1932 case:

> …[the public has a] fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjugation of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations and their perpetual life might bring evils similar to those which attended *mortmain* [perpetual ownership…and the] insidious menace inherent in large aggregations of capital.

Exposure of corporate excesses by journalists has often been the catalyst for translating a general public distrust of large corporate bodies into action towards specific reform legislation. Historically, as reports of one crisis of corporate misbehaviour have followed another, there have been successive attempts to assert external control on the actions of corporate bodies through legislation, regulation, recommended practice and social pressure.

Cases in point can be found in the history of companies, legislation and social movements. Early examples include the Bubble Act limiting the flotation of all but joint stock companies, and legislation to control the East India Company. There has been more than a century of corporate abuse by companies followed by reactions to that abuse. The history of Standard Oil, US Steel, the railroad and mining industries, and more recently large companies such as Walmart, Microsoft and Nike, carry examples of accusations of abuse of suppliers, customers, workers or communities. There are firms that have damaged the environment. Price-fixing and cartels have been common corporate behaviour over the years.

The issues of most concern to those who have worked to develop new explicit mechanisms for the external governance framework include company probity and honesty, accountability, influence, and the politics of profit and executive compensation. And there are other issues that have not been addressed explicitly by the governance reformers, yet which are viewed as important by many in society. These include corporate performance, social responsibility, ethics, the environment, and health and safety.

There is an anti-establishment view that is not well represented among those people who have worked to develop recent governance reforms. This is a belief that the recent scandals represent a 'crisis of capitalism' – greed, brainless belt-tightening and downsizing, and fraud. Social norms may be influenced by such an alternative view, or less extreme versions of a view, and, if so, it may affect decision-making by directors and managers and investors over time.

One potential example is suggested by observations made by Claude Bébéar, the former president of the French insurance giant AXA. He built that company through aggressive hostile takeovers and overseas growth. Recently, Bébéar, along with other French industrial leaders, has begun to criticise the Anglo-Saxon model of liberal free markets, which made it possible to build companies like AXA. They want to see a greater emphasis on social and national corporate responsibility.

Another example is suggested by Robert Monks, a well-known advocate of corporate governance reform. He argues that corporate money and a lack of accountability for the actions of large corporations and politicians have created a shift from participatory democracy to **corporacy**. In other words, he proposes that corporations have a degree of influence in political affairs not intended by those

who developed the concept of the limited liability company and the designers of western democracy (see Monks, 2004).

Along with law, regulation and professional guidance, social influence provides the framework of external influences on the actions of corporate bodies. These include the rules, guidance and controls established by society. Some of these are mandatory and others are non-mandatory. Figure 1.4 illustrates the framework of external corporate governance.

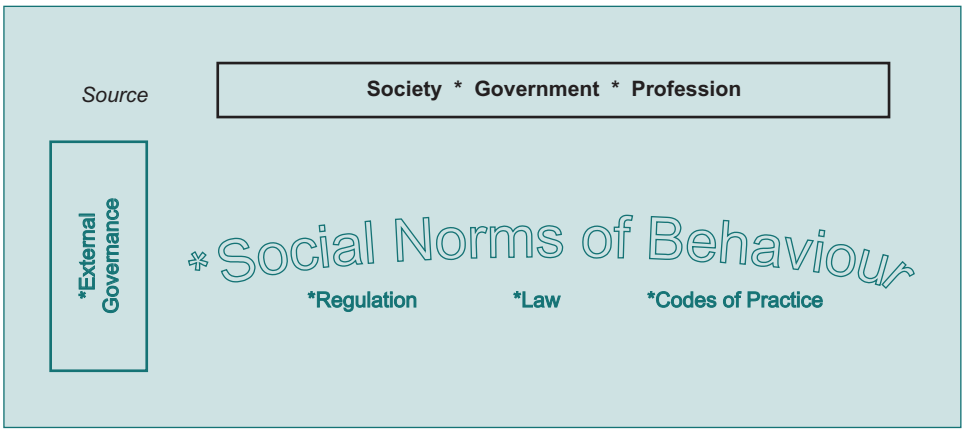

Figure 1.4 **Framework of external corporate governance**

1.11.2 Corporate Governance is External Guidance and…

Very little is known about why investors, boards of directors and the public get surprised by corporate misbehaviour. The respected business journal *Fortune* speculated about corporate behaviour and failure:

> Why do companies fail? Their CEOs offer every excuse in the book: a bad economy, market turbulence, a weak yen, hundred-year floods, perfect storms, competitive subterfuge-forces, that is, very much outside their control. In a few cases, such as the airlines' post-Sept. 11 problems, the excuses even ring true. But a close study of corporate failure suggests that, acts of God aside, most companies founder for one simple reason: managerial error. (*Fortune* in an article published on 15 May 2002.)

'Failure' does not mean bankruptcy. A dramatic fall from grace qualifies as failure as much as a bankruptcy such as Enron and WorldCom. In the most recent downturn, called a **bear market**, 26 of America's 100 largest companies lost at least two-thirds of their market value. These included such blue chip firms as Hewlett-Packard, Charles Schwab, Cisco, AT&T, AOL Time Warner, and Gap. Yet, in the 1990 bear market, by contrast, no blue chip firm lost so much market value, according to a study by the money management firm Aronson & Partners.

Few recent corporate governance reform efforts have explored the problems of managerial performance or organisational performance. Nor have they considered why this downturn was different from the last one, or examined the issues where

public policy mandates have imposed controls in matters beyond financial accountability and fraud.

Many of the external reform mandates have not been delivered very well at the internal corporate level. This would suggest that the internal governance mechanisms that guide, direct and control individual behaviour within a corporate setting are as important as the diverse external sources of the guidance, direction and controls that signal society's expectations about what is to be achieved by the enterprise and how it should achieve it.

The corporate governance system encompasses many elements or domains. Figure 1.5 illustrates some of the major domains of the system. Throughout the next 11 modules, this course will explore major aspects of that system.

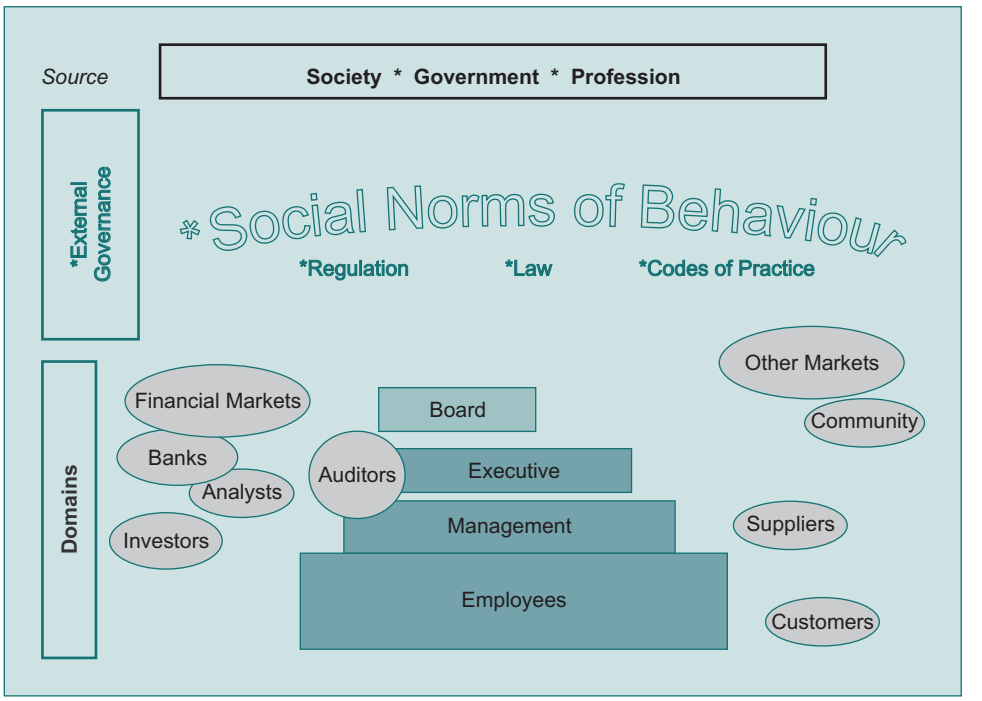

Figure 1.5 **The domains of corporate governance – internal and external**

Learning Summary

This module explored the external governance and internal governance of activities occurring in a corporate setting. External corporate governance is the set of mechanisms that regulate, oversee, direct and control human behaviour with the intent of ensuring that collective and individual behaviour within a group meets the norms expected by society. Internal corporate governance is the set of rules, guidance and controls that determine the course of individual actions within a collective association of those individuals. We examined the historical context where this system has developed and evolved over time as a set of intended or emergent processes, and the role that governance has in facilitating economic development

and the success of financial markets. Then we considered the efforts to reform corporate governance over the centuries, including why reform has occurred, what it has hoped to achieve, and generally the actions taken to bring about the improvement in corporate governance so clearly required. Finally, we examined the most recent round of corporate governance reform, which began in 1987 and continues today, and reflected on the narrow focus marking most of the attention that corporate governance has commanded. We found that the problems experienced in the 2000–2003 market downturn may be different from those in the previous 'bear market'.

Review Questions

True/False Questions

1.1 Restricting the organisation of human endeavour and the process of creating and moving goods for sale is a recent social phenomenon. T or F?

1.2 When informal groups form in order to achieve mutual objectives, as part of this association they coordinate the activities of the individuals within the group only to ensure that those individuals do not violate the norms of behaviour expected of them by society. T or F?

1.3 External corporate governance is the set of mechanisms that regulate, oversee, direct and control human behaviour with the intent of ensuring that collective and individual behaviour within the group meets the norms expected by society. T or F?

1.4 Internal corporate governance is the set of rules, guidance and controls that determine the course of individual actions within a collective group. T or F?

1.5 External and internal governance develop and evolve over time as a set of intended and emergent processes. T or F?

1.6 External governance limits the autonomy of any collective enterprise, both in its organisation and in the activities of individuals operating within it. T or F?

1.7 Internal governance limits the autonomy of the individuals who form a collective enterprise. T or F?

1.8 Experience has demonstrated that internal governance will always fail to deliver the expectations of society. T or F?

1.9 Concepts arising from the European landowning system made a major contribution to the foundation of corporate governance systems. T or F?

1.10 Shareholders own the assets of a company and can exercise their right to those assets at any time. T or F?

1.11 Common governance mechanisms develop and evolve over time. T or F?

1.12 The duties and role that boards of directors should fulfil are prescribed by law. T or F?

1.13 External governance mechanisms facilitate economic development. T or F?

1.14 Roles and mechanisms in a governance system evolve to fulfil emerging needs. T or F?

1.15 Governance failure and investor exuberance contributed to the first stock market crash following the 'South Sea' bubble. T or F?

1.16 During the late 18th century, when Adam Smith expressed concern with the corporate form of organisation, it was commonly used despite requiring Royal Charter or an Act of Parliament.
T or F?

1.17 Financial market funding of commerce and industry was not retarded by the South Sea affair.
T or F?

1.18 Public policy changes related to governance often have unexpected consequences.
T or F?

1.19 Even though external governance frameworks develop locally, there is no significant variation between those developed in different countries. T or F?

1.20 The first known use of the term 'corporate governance' was in 1976 by Robert Tricker.
T or F?

1.21 The economic boom in the late 1990s stimulated greater interest in 'corporate governance', and it rapidly rose up the agenda of public concern. T or F?

1.22 The world economy is not dependent on the capital markets. T or F?

1.23 Success at Polly Peck, BCCI and Maxwell resulted in new governance reform efforts. T or F?

1.24 Both governance failure and investor exuberance contributed to the most recent stock market crash following the 'New Economy' bubble. T or F?

1.25 In 2000, the average American worker and CEO received wage increases of 3 per cent.
T or F?

1.26 'Pro forma' performance measures such as EBITDA were used to persuade investors of the efficacy of management decisions when traditional accounting measures failed to

reflect what they believed were the 'real results' of these decisions; increased share price appeared to confirm that belief. T or F?

1.27 Financial markets will not be efficient if the public cannot trust in the efficacy of the market itself. T or F?

1.28 It has been generally assumed that improvement in external control and performance reporting will not improve the level of trust in companies. T or F?

1.29 An agent is someone to whom a principal has delegated decision-making authority. T or F?

1.30 Conceptually, external governance is narrow and restricted mainly to issues concerning the board of directors and company accountability. T or F?

1.31 Exposure of corporate excesses by journalists has often been the catalyst for translating a general public distrust of large corporate bodies into action towards specific reform legislation. T or F?

1.32 Corporate governance reformers have focused on management greed, brainless belt-tightening and downsizing. T or F?

1.33 An internal governance system is made up of law, regulation and professional guidance. T or F?

1.34 All of the elements in the external governance framework are mandatory for companies. T or F?

1.35 Few recent corporate governance reform efforts have explored the problems of managerial or organisational performance. T or F?

1.36 Since many of the external reform mandates have not been delivered very well, it suggests that the mechanisms in the internal governance system may be as important as the external framework. T or F?

Multiple Choice Questions

1.37 The organisation of human endeavour and the process of creating and moving goods for sale are restricted by:

A. taboos and expected norms of behaviour that influence how such activities are conducted.
B. formal mechanisms that regulate human behaviour within a society in its legal system.
C. codes of practice that are promulgated by professional bodies.
D. all of the above.
E. A and B only.

1.38 Which of the following statements is correct?

A. Complex group activities can succeed without a system of internal governance.
B. Governance tends to become more complex as group activities become more complex.
C. Governance develops first, followed by financial need and the markets to fulfil that need.
D. Legal mechanisms are necessary to make a financial system function.

1.39 Put these developments in a realistic chronological order.

A. Need for protection from unscrupulous practices leads informal assemblies to develop formal organisations.
B. Social norms and taboos, or informal rules of engagement and behaviour, guide behaviour in economic activities.
C. Formal internal governance systems and institutions develop to manage members and enforce the rules to which they ascribe.
D. External governance develops.
E. Internal governance fails to meet the expectations of society.

A. A, C, D, E, B.
B. B, A, C, E, D.
C. A, B, C, E, D.
D. B, A, C, D, E.

1.40 Corporate governance mechanisms often develop:

A. by bankers in response to a change in management strategy.
B. in response to customer demand.
C. as internal governance mechanisms in companies to manage their activities and risks and then evolve towards external mechanisms.
D. in the media in response to corporate scandals.

1.41 Accounting, like other common governance mechanisms, has developed and evolved over time. Which of the following are correct?

A. The resident agent on British estates performed duties that are similar to those of a chief executive in a small to mid-sized company.
B. Accounting on landed estates in Europe developed to report on the net cash revenues and expenditures related to the use of that land.
C. Capital assets were invisible in the early accounting methods used by estates, canals and railways.
D. Directors of the East India Company were allowed to determine what accounting methods to use and how to fulfil their duties.

1.42 The beliefs necessary to make a financial market viable include the belief that:

A. those issuing the debt or equity instruments traded there do not have the ability nor the intent to fulfil their obligations.
B. the financial instruments are valid and what they purport to be.
C. sellers will deliver what they have agreed to sell at the time and place agreed.
D. purchasers will pay the price at the time, place and in the form agreed.
E. all pertinent information about the issuers are available and can be relied upon.
F. all relevant information is available to all parties to the transactions.

1.43 The explicit aim of most recent corporate governance reforms has been to improve trust by improving:

A. the reliability of performance-reporting through accounting standards, audit practice and legal sanctions for faulty reporting.
B. company reliability through the supervision of management undertaken by the board of directors.
C. the auditors, auditing standards and their relationship with management and the board.
D. to a limited extent the company executive.
E. both mandated and non-mandatory codes of best practice, addressing changes to and by the board of directors.

1.44 The issues of concern to those who have worked to develop new explicit mechanisms for the external governance framework include:

A. company probity.
B. executive honesty.
C. corporate accountability.
D. high audit fees.
E. political influence.
F. the politics of profit and executive compensation

1.45 Other issues that have not been addressed explicitly by corporate governance reformers, yet which are viewed as important by society include:

A. corporate performance.
B. social responsibility.
C. manufacturing quality.
D. ethics.
E. environmental standards.
F. health and safety.

In-depth Questions

1.46 Distinguish between internal and external corporate governance, and explain how they relate.

1.47 Explain the interdependence between economic development and corporate governance.

1.48 Describe the foundation of the present system of corporate governance as it applies to limited liability companies, and how it developed.

1.49 What are the forces that shape corporate governance reform efforts, and what triggers them?

1.50 What problems appeared during the 2000–2003 capital market downturn, and what was different from previous cycles?

1.51 Some corporate governance issues keep reappearing. What example does this module provide?

1.52 It is arguable that corporate governance mechanisms are a form of risk management. Discuss.

1.53 Roles and governance mechanisms evolve to fulfil a need. Explain.

Case Study

1 You have been asked by the board of directors of a mid-sized listed manufacturing company to update them on the emerging corporate governance issues that should be of interest to them. Log on to the Internet and, using a good search engine, prepare a report for the board on the corporate governance issues that should be of current concern to the directors of this company. Keep this report.