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THE POLITICS OF ACCOUNTING RULES:

A choice for whom?

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THE POLITICS OF ACCOUNTING RULES:

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CORPORATE REPUTATION: AN ACCOUNTING PERSPECTIVE

*Reputation is an idle and most false imposition; oft
got without merit, and lost without deserving: you
have lost no reputation at all, unless you repute
yourself such a loser.*

Shakespeare

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1. Introduction

The question I seek to answer in this paper is how a better quality of disclosures can improve corporate reputation. Reputation is a multidimensional concept including both financial and social aspects. For this reason, in this paper I try to bring together two strands of literature: the literature on corporate reputation and the literature on corporate disclosures.

The empirical analysis uses a new database on international corporate disclosure – the Transparency and Disclosure survey developed by Standard and Poor's. These recently released scores provide a measure of corporate annual report disclosures. I use Fortune 2003 ranking of the world most admired companies. My sample consists of 262 firms worldwide. I test the hypothesis that firm with a better quality of disclosure in their annual reports have a better reputation as measured by Fortune scoring. I find significant evidence in favour of this hypothesis.

2. Definition of reputation

Reputation is a powerful concept for business, government, and nonprofit organizations, just as it is for individual. Executives, administrators, external and internal stakeholders, critics, and supporters of organizations all use the concept of reputation routinely to evaluate and communicate their perceptions about organizations.

But what is *reputation*?

Despite the increasing number of studies published in this area, there is no unambiguous, generally accepted definition for the term corporate reputation.

Although the term reputation is clearly defined by Webster's Revised Unabridged Dictionary (1913) as "the estimation in which one is held; character in public opinion; the character to attribute to a person, thing or action; repute",¹ over the years authors in this area have adopted different, sometimes even contradictory definitions for the term corporate reputation. This is confirmed by Fombrun and Van Riel (1997, p. 5) who emphasise the effects of this ambiguity, by stating that the lack of a single common definition partly explains why "although corporate reputations are ubiquitous, they remain relatively understudied". Fombrun and Rindova (1996) in their cross-disciplinary literature review argue that this problem of definition regarding the concept of corporate reputation mainly derives from the diversity of relevant studies, which explore the construct from different disciplinary perspectives. The authors illustrate how economists (Myers and Majluf, 1984; Ross, 1977; Stigler, 1962; Stiglitz, 1989; Weigelt and Camerer, 1998), accounting researchers (Dufrene et al., 1998; Sveiby, 1997), sociologists (Abrahamson and Fombrun, 1992; DiMaggio and Powell, 1983; Shapiro, 1987) and strategists (Caves and Porter, 1977; Freeman, 1984; Dutton and Dukerich, 1991) adopt different definitions for the term corporate reputation based on their disciplinary perspectives and highlight the need for an integrative view. However, there is no consistency in defining the concept of corporate reputation. This comes mainly as an effect of a debate regarding the concepts of corporate reputation and corporate image (Balmer, 1997; Brown and Cox, 1997; Gray and Balmer, 1998; Rindova, 1997). These concepts frequently appear in the literature as identical, as totally separate concepts or as interrelated

¹ Oxford Reference Online: "The beliefs or opinions that are generally held about someone or something – widespread belief that someone or something has a particular characteristic". A Dictionary of the English Language by Samuel Johnson London MDCCLV: Credit; honour; character of good.

Although the term reputation is clearly defined by Webster's Revised Unabridged Dictionary (1913) as "the estimation in which one is held; character in public opinion; the character to attribute to a person, thing or action; repute",¹ over the years authors in this area have adopted different, sometimes even contradictory definitions for the term corporate reputation. This is confirmed by Fombrun and Van Riel (1997, p. 5) who emphasise the effects of this ambiguity, by stating that the lack of a single common definition partly explains why "although corporate reputations are ubiquitous, they remain relatively understudied". Fombrun and Rindova (1996) in their cross-disciplinary literature review argue that this problem of definition regarding the concept of corporate reputation mainly derives from the diversity of relevant studies, which explore the construct from different disciplinary perspectives. The authors illustrate how economists (Myers and Majluf, 1984; Ross, 1977; Stigler, 1962; Stiglitz, 1989; Weigelt and Camerer, 1998), accounting researchers (Dufrene et al., 1998; Sveiby, 1997), sociologists (Abrahamson and Fombrun, 1992; DiMaggio and Powell, 1983; Shaphiro, 1987) and strategists (Caves and Porter, 1977; Freeman, 1984; Dutton and Dukerich, 1991) adopt different definitions for the term corporate reputation based on their disciplinary perspectives and highlight the need for an integrative view. However, there is no consistency in defining the concept of corporate reputation. This comes mainly as an effect of a debate regarding the concepts of corporate reputation and corporate image (Balmer, 1997; Brown and Cox, 1997; Gray and Balmer, 1998; Rindova, 1997). These concepts frequently appear in the literature as identical, as totally separate concepts or as interrelated

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phenomena depending on the viewpoints adopted. It is therefore the aim of this section to review and merge different viewpoints in the literature regarding what is actually meant by the term corporate reputation, in an attempt to clarify the concept by identifying its relationship with corporate image and adopting a clear definition of corporate reputation.

Throughout the years definitions offered for the term corporate reputation by marketing academics and practitioners could be broadly merged into two dominant schools of thought:

- the analogous school of thought, which views corporate reputation as synonymous with corporate image; and
- the differentiated school of thought, which considers the terms to be different and, according to the majority of the authors, interrelated.

The following sections will provide a review of these schools of thought and conclude with a definition of corporate reputation based on the aforementioned literature review.

2.1. The analogous school of thought: corporate reputation as synonymous with corporate image

In the early writings of this area of study, authors have concentrated on the concept of corporate image rather than on corporate reputation (Bernays, 1977; Boorstin, 1961; Boulding, 1973; Budd, 1969; Crissy, 1971; Enis, 1967; Gates and McDaniel, 1972; Kennedy, 1977; Martineau, 1958; Schafhauser, 1967). Most of the aforementioned authors in this analogous school of thought define the term corporate image in a way that appears synonymous with corporate reputation. Martineau

(1958) regarded the term image as the sum of functional qualities and psychological attributes that exist in the mind of the consumer, while Boulding (1973) defined image as subjective knowledge. Additionally, in one of the early, yet most influential writings in this field, Kennedy (1977) appears to view corporate image as synonymous with corporate reputation. She notes in her study that "an image, whether of a product or company, takes many years to cultivate" (Kennedy, 1977, p. 124) and argues that the terminology used in corporate image studies is quite diverse in the sense that different terms may describe the same concepts. Kennedy (1977) believes that as long as the respondents of a study can understand the use of the terms, this confusion in the terminology should not be considered as a problem. However, a clear definition of terms has to be evident in a study so that the concepts and their interrelationships are clear to all potential readers; and this is actually the purpose of this section. Crissy (1971, p. 77) also adopts Kennedy's (1977) perspective and does not regard the term corporate image as the immediate mental picture that audiences have of an organisation (Gray and Balmer, 1998), but rather as "an aggregate stimulus value". It must be noted that the fact that the aforementioned early studies in this analogous school of thought have concentrated on the concept of corporate image rather than on corporate reputation, could be explained as an effect of fashion in the terminology used in this area of study. In the 1960s and 1970s corporate image studies appeared to be a very fashionable area for research, while the term corporate reputation was not common in the marketing literature at that point in time.

Nevertheless, a number of writers later on (Abratt, 1989; Alvesson, 1998; Bernstein, 1984; Dichter, 1985; Dowling, 1986; 1993; Dutton et al., 1994) have also adopted

the aforementioned early writings' perspective and regard the concepts of corporate image and corporate reputation as interchangeable. The majority of these authors do not include the term corporate reputation in their terminology, despite the increasing interest in the concept by marketing academics at this point in time. The terms corporate image and corporate reputation are considered as identical by Dowling (1993) and by Dichter (1985, p. 75) who defines image as "the total impression of the company", while Bernstein (1984) also suggests that reputation is a term loosely trading places with images. To add to the confusion, Dutton et al. (1994) argue that corporate reputation represents outside members' perception of corporate image, based on his own conceptual framework. From yet another perspective, Alvesson (1998, p. 98) defines a company's image as "a comprehensive summarised picture of the company held by a certain section of the environment". He regards an image as an overall picture of the company and by effect considers the terms corporate image and corporate reputation as identical. Contrary to the definition of image as a dimension of how people conceptualise and perceive an object from the psychologists' perspective, Alvesson (1998) considers the term corporate image as only meaningful when there is a certain distance between the observing group and the object in question. He argues that proximity to the object or even being part of it (e.g. being part of a particular company) leads to the object becoming too complex to permit discernment of any special "image". He therefore considers the term corporate image to apply only to the company's external audiences. Nevertheless, Alvesson (1998) does not provide any empirical research to support this view. Finally, Ind's (1997, p. 21) definition of corporate image as "the picture that an audience has of an organisation through the accumulation of all received messages", illustrates that the

author does not distinguish the term corporate image from that of corporate reputation.

Rindova (1997) argues that many of the aforementioned authors in this analogous school of thought have a public relations background and this is partly the reason why they have been traditionally focusing on the concept of corporate image rather than on corporate reputation. This public relations approach comes from the arts and regards image as "something that a communicator creates - constructs or projects or gives to other people - who often are called receivers" (Grunig, 1993, p. 126). However, Caruana (1997) suggests that the fact that many authors in this school of thought consider the terms corporate image and corporate reputation as identical, and hence use them interchangeably, has been the main factor causing the ambiguity surrounding the concept of corporate reputation nowadays. Increasingly, recent research has criticised the analogous school of thought's approach for either failing to refer to the concept of corporate reputation in most of the studies and/or using the terms corporate image and corporate reputation interchangeably, without making an effort to identify the relationship between the two concepts. These views are evident in the differentiated school of thought, which is presented in the following section/paragraph.

2.2. The differentiated school of thought: corporate reputation as different to corporate image

Recently, several authors (Balmer, 1997; Bromley, 1993; Brown and Cox, 1997; Brown and Dacin, 1997; Fombrun, 1996; Fombrun and Shanley, 1990; Gray and Balmer, 1998; Grunig, 1993; Mason, 1993; O'Sullivan, 1983; Rindova, 1997;

Saxton, 1998; Semons, 1998; try to find other papers more updated) are considering the terms corporate reputation and corporate image as different concepts. Within this differentiated school of thought there seem to be three dominant views. As a reaction to the analogous school of thought's over-reliance on the corporate image concept, the first view considers corporate reputation and corporate image as different yet separate concepts, emphasising the negative associations assigned to the latter. On the contrary, the second and third views both consider the concepts as interrelated. The second view believes that a firm's corporate reputation is only one dimension towards the construction of its corporate image, while the third view explores the other side of the relationship and argues that a firm's corporate reputation is largely influenced by the multiple images held by its constituencies.

- Referring to the *first view*, contrary to perceptions from the analogous school of thought which regard corporate reputation as synonymous with corporate image, a number of authors are now considering the terms as totally separate (Brown and Cox, 1997; Brown and Dacin, 1997; Grunig, 1993; O'Sullivan et al., 1983; Semons, 1998). The following quote captures the essence of this debate: "I loathe the word image and Kotler is an image devotee - he tells his readers and audiences that "image is the set of beliefs, ideas and impressions that a person holds of an object". My Webster tells me that "an image is a reproduction or imitation of a person or a thing". If Kotler knew Latin, he would know that image is derived from imitari - imitation. We in PR must be concerned with that good, old-fashioned word reputation - not image (Scott Cutlip, cited in Grunig, 1993)." This view that organisations should be focusing on the management of corporate reputations and not of corporate

images is mainly based on the negative associations which a number of authors have assigned to the concept of corporate image (Balmer, 1997). According to Bernstein (1984) and Grunig (1993) the concept can mean falsehood or opposite to reality, and Olins (1989) also remarked that it implies manipulation. Bernstein (1984, p.13) notes that "if any word needs an 'image-job' it's image", a view which is supported by Schafhauser (1967, p. 51) who notes that "the term image-makers is generally seen as an insult rather than a compliment". Bernstein (1984) adds that a corporate image is manufactured and hence is not a true reflection of the company's reality. In addition, O'Sullivan (1983) suggests that although the original meaning of image has been equated with a visual representation of reality, now it commonly refers to a fabrication or public impression created to appeal to the audience rather than to reproduce reality. He concludes that the term therefore implies a degree of falseness since the reality rarely matches up to the image. The aforementioned negative associations assigned to the concept of corporate image have resulted in a transition of focus for many public relations academics, "away from image management, which is seen as firms taking superficial actions to make themselves look better, and toward reputation management, which is seen as firms taking substantive and responsible actions to gain the esteem of the public" (Rindova, 1997, p. 189)². Taking into consideration the aforementioned views, Brown and Dacin (1997) proposed the term "corporate associations" as an umbrella term

² Public relations practitioners also seem to be following this trend, with the example of Shanwick USA, among the world's largest agencies in its field, which has recently transformed itself from a public relations agency to a corporate reputation management firm (Semons, 1998).

covering all the information an individual holds about a company. Brown and Cox (1997, p. 35) suggest that "corporate associations for a particular company or organisation include cognitions, affects (i.e. moods and emotions), evaluations attaching to specific cognitions or affects, summary judgements, and/or patterns of associations (e.g. schemata CHECK) with respect to a particular company which are based on a set of memory inputs and/or current sensory perceptions". However, the introduction of a new term covering all the debatable concepts in the literature might not solve the ambiguity surrounding the concepts of corporate image and corporate reputation and does not clarify the interrelationships and hence the management implications of the two concepts.

- Contrary to the first view, the *second view* in this differentiated school of thought does not perceive a firm's corporate image as a separate concept but rather as related with its corporate reputation. By adopting Normann's (1984) perspective, corporate image should not be related to falsehood or imitations of reality. Hence the concept is not viewed in isolation and the way in which corporate reputation affects corporate image is explored (Barich and Kotler, 1991; Mason, 1993). Normann (1984, p. 72) accepts Boulding's (1973) interpretation of image as a mental representation of reality and adds that an image represents a model signifying our beliefs and our understanding of a phenomenon or situation. Taking into account that images represent people's own perceptions of reality, Normann (1984) argues that people act or choose not to act based on the reality that they perceive. He therefore believes that even "if the image is not an exact equivalent of reality, it is at least a social

reality" (Normann, 1984, p. 72). Taking this into consideration, Barich and Kotler (1991) and Mason (1993) have developed conceptual frameworks where evaluations or other higher-order concepts are included as components of a firm's corporate image. Barich and Kotler (1991) suggest that attitudes should be included in the conceptualisation of the corporate image formation process and believe that the term "image" represents the sum of beliefs, attitudes and impressions that a person or group has of an object. In their work they consider corporate reputation or favourable public attitude as a variable, which together with the level of public awareness, determines a firm's corporate image. Mason (1993), who thinks that corporate reputation is only one dimension of corporate image, also supports this view. Both theorists argue that corporate reputation and corporate image are different, yet interrelated, concepts. They suggest that a firm's corporate reputation influences the corporate images held by its stakeholders. Nevertheless, the authors fail to acknowledge the fact that different stakeholders may have different images of the same company, hence resulting in multiple corporate images. Also, the authors have not considered the extent to which this is a bilateral relationship, i.e. whether corporate images also influence a firm's corporate reputation.

- This side of the relationship has been mainly explored by writings in the *third view* of this differentiated school of thought (Balmer, 1996, 1997; Bromley, 1993; Fombrun, 1996; Fombrun and Shanley, 1990; Gray and Balmer, 1998; Rindova, 1997; Saxton, 1998), in which "corporate reputation is a snapshot that reconciles the multiple images of a company held by all its

constituencies" (Fombrun, 1996, p. 72). Corporate reputation is therefore defined as "the reflection of an organisation over time as seen through the eyes of its stakeholders and expressed through their thoughts and words" (Saxton, 1998, p. 396). Furthermore, Fombrun (1996, p. 3) suggests that "a reputation embodies the history of other peoples' experience with a service provider". He assigns the following key characteristics to the concept of corporate reputation (Fombrun, 1996, p. 72):

- ✓ a cognitive feature of an industry that crystallises a company's perceived ranking in a field of other rivals;
- ✓ created from the bottom up as each of us applies our own personal combination of economic and social, selfish and altruistic criteria in judging a company and its future prospects;
- ✓ a snapshot that reconciles the multiple images of a company held by all its constituencies. It signals the overall attractiveness of the company to employees, consumers, investors, suppliers and local communities.

2.3. Corporate reputation and stakeholders' views

Having reviewed the literature within the analogous and differentiated schools of thought, there seems to be greater support for the differentiated school of thought, showing the concepts of corporate reputation and corporate image as interrelated. Views within the analogous and differentiated schools of thought that consider corporate image and corporate reputation as identical (Bernays, 1977; Boorstin, 1961; Boulding, 1973; Budd, 1969; Crissy, 1971; Enis, 1967; Gates and McDaniel,

1972; Kennedy, 1977; Martineau, 1958; Schafhauser, 1967), or the former as imitation and the latter as the real thing (Brown and Cox, 1997; Brown and Dacin, 1997; Grunig, 1993; O'Sullivan et al., 1983; Semons, 1998) appear to be extreme, as justified by the majority of recent authors in the differentiated school of thought (Balmer, 1996, 1997; Barich and Kotler, 1991; Bromley, 1993; Caruana, 1997; Fombrun, 1996; Fombrun and Shanley, 1990; Gray and Balmer, 1998; Mason, 1993; Normann, 1984; Rindova, 1997; Saxton, 1998). There would seem to be a stronger argument that there is a dynamic relationship between corporate reputation and corporate image. There may also be scope to merge the second and third views within the differentiated school of thought, since they appear to be presenting the two sides of a bilateral relationship. In this relationship, corporate images that stakeholders form can be influenced by their overall evaluation of the company, i.e. its corporate reputation (second view within the differentiated school of thought) and at the same time a firm's corporate reputation is largely influenced by the corporate images that stakeholders form every day for the organisation (third view within the differentiated school of thought).

In an attempt to summarise the common elements among different definitions of corporate reputation reviewed in this section, the following characteristics are assigned to the concept of corporate reputation:

- it is a dynamic concept (Balmer, 1991; Barich and Kotler, 1997; Bromley, 1993; Caruana, 1997; Fombrun, 1996; Fombrun and Shanley, 1990; Gray and Balmer, 1998; Mason, 1993; Normann, 1984; Rindova, 1997; Saxton, 1998);
- it takes time to build and manage (Balmer, 1997; Gray and Balmer, 1998);

- there is a bilateral relationship between the concepts of corporate reputation and corporate image (Rindova, 1997): corporate reputations are largely dependent on the everyday images that people form of an organisation (Balmer, 1998; Bromley, 1993; Fombrun, 1996; Fombrun and Shanley, 1990; Gray and Balmer, 1998; Rindova, 1997; Saxton, 1998) based on the company's behaviour, communication and symbolism (Birkigt and Stadler, 1986), while at the same time corporate reputations can influence stakeholders' everyday images of a firm (Barich and Kotler, 1991; Mason, 1993);
- it crystallises a company's perceived ranking in a field of other rivals (Fombrun, 1996);
- different stakeholders may have different reputations of the same company based on their own economic, social and personal background (Bromley, 1993; Fombrun, 1996).

Therefore, the following definition can be adopted: *A corporate reputation is a stakeholder's overall evaluation of a company over time. This evaluation is based on the stakeholder's direct experiences with the company, any other form of communication and symbolism that provides information about the firm's actions and/or a comparison with the actions of other leading rivals.* (Gotsi and Wilson, 2001).

This section has attempted to explain the concept of corporate reputation by specifying its relationship with the construct of corporate image and by adopting a clear definition of reputation. The literature review has indicated that throughout the years definitions offered for the term corporate reputation by marketing academics

and practitioners could be broadly merged into two dominant schools of thought, based on the relationship that authors assign to a firm's corporate reputation and its corporate image. These include the analogous school of thought, which views corporate reputation as synonymous with corporate image and the differentiated school of thought, which considers the terms to be different and, according to the majority of the authors, interrelated. The literature review of recent writings in the differentiated school of thought supports the notion that there is a dynamic, bilateral relationship between a firm's corporate reputations and its projected corporate images. The recognition of these interrelationships implies not to consider a firm's corporate reputation as a static element of a company that can only be influenced and hence be managed through impressive logos and well planned formal communication activities. The corporate reputations that a firm has with its stakeholders must rather be regarded as dynamic constructs, which influence and are influenced by all the ways in which a company projects its images: its behaviour, communication and symbolism.

3. Review of the literature and hypothesis

The theoretical literature on disclosure, starting with the seminal work of Milgrom (1981), supports the idea that increased disclosure quality can be an effective means to avoid the adverse selection problem. Hence we expect that firms facing an adverse selection problem use non-accounting information to supplement their accounting disclosures.

Lang and Lundholm (1993) provide some evidence of a positive correlation existing between the level of adverse selection, measured by the correlation between returns and earnings, and a voluntary disclosure score.

Amir and Lev (1996) find that earnings and book values for firms with significant levels of intangibles assets tend to be excessively understated relative to their market values.

Gelb (2002) confirms this idea and shows that firms that obtain significantly higher analysts' ratings for their investor relations programmes or voluntary publications than for their annual reports, tend to have greater levels of R&D and advertising expenditures.

All these findings suggest that firms with higher levels of intangible assets perceive mandatory accounting disclosures as a relatively ineffective means to communicate with investors and therefore are more likely to try to improve the quality of the information provided through their annual report. However, it is an open question whether this communication strategy is effective in enhancing the image of the company.

There is an extensive literature that uses disclosure indexes to measure the impact of disclosure. The indexes constructed to measure disclosure vary considerably among different studies.

Firth (1979), Chow and Wong-Boren (1987), Raffournier (1991) consider only voluntary disclosure activity.

Singhvi and Desay (1971), Choi (1973), Barrett (1976), Cooke (1989), Giner (1997) adopt a wider perspective with both compulsory and voluntary disclosure being included in an index.

Indexes based on annual report information are more focused on the quality of compulsory disclosure, whereas indexes based on voluntary additional communication activity tend to measure disclosure quantity.

Botosan and Plumlee (2002), extending the work of Botosan (1987), study the effect of disclosure quality and quantity on the cost of equity capital. They find that better annual report disclosure decreases the expected cost of equity capital. However, more timely (voluntary) disclosure increases the expected cost of equity capital, whereas better (voluntary) investor relations have no effect on this cost. Hence better quality of annual report disclosure seems to be a more effective communication means than increased voluntary disclosure.

Sengupta (1998) deals with the relationship between disclosure quality and quantity, and cost of debt and finds a significantly negative correlation between these two variables. Given that he does not distinguish between annual report (quantity) and other (quality) disclosure, it is impossible to say which of these two possible components of the total disclosure score dominates.

Lundholm and Myers (2002) analyse the information content of increased disclosure quantity and quality. They show that a higher value of the disclosure score in a certain year is significantly linked with more future earnings news being included in current returns. This proves the effectiveness of disclosure in communicating news about the future of the company, relevant for the actual valuation in the stock market.

Hutton, Miller and Skinner (2001), instead of using a score measure of disclosure activity, analyse a database of press news and investigate the effect of these news on analysts' forecast revisions and stock returns. They find that announcement of negative earnings surprises have always a negative effect, whereas announcements of

positive earnings surprises have a positive effect only when supplemented with credible additional disclosures explaining the positive surprise.

The aim of this paper is to investigate the possible relationship between the quality of annual report disclosure and corporate reputation.

I expect to find a positive relationship between disclosure quality and reputation.

Therefore, I state the following hypothesis:

H₀: Corporate reputation and disclosure quality are positively correlated.

4. Data

4.1. Sample selection

The sample selection begins with the 345 world's most admired companies. 84 companies were eliminated because they were not in the S&P ranking. Unilever was added as it was considered as one company by Fortune and two by S&P (Unilever UK and Unilever Netherlands). The final sample comprises 262 companies.

Table 1 - Sample

Fortune World's Most Admired Companies	345
Companies not included in S&P T&D	(84)
Unilever (counted as two companies by S&P and one by Fortune)	1
<i>Final sample</i>	<i>262</i>

4.2. Dependent variable: corporate reputation data

To compile the lists on these pages, the Hay Group surveyed more than 10,000 directors, executives, and managers at 345 companies around the world. Each

respondent was asked to rank the other companies in his or her industry on nine attributes, and the average of those scores was used to compile the industry and country lists. Respondents were also asked to rank their top ten companies across all industries.

To be eligible, companies had to have revenues of at least \$8 billion in 2001. Three hundred and forty-five companies were evaluated in this year's survey, 202 of them based outside the U.S. Fortune divided those companies into 29 industry groups.

The Hay Group, which conducted the survey, sent out questionnaires in the fourth quarter of 2002. Respondents ranked their industry peers on a scale of one to ten, in nine categories:

- ❖ quality of management;
- ❖ quality of products and services;
- ❖ innovation;
- ❖ long-term investment value;
- ❖ financial soundness;
- ❖ ability to attract, develop, and retain talent;
- ❖ responsibility to the community and the environment;
- ❖ wise use of corporate assets; and
- ❖ global business acumen.

A company's overall ranking is based on the average of the scores in all nine categories.

4.3. Independent variable: transparency and disclosure data

I use a newly released dataset on corporate disclosures in my analysis, so I begin with a detailed description of this data set. In 2002, Standard and Poor's (S&P) released the results of their Transparency & Disclosure (T&D) survey for companies in various countries around the world. S&P describe the rankings as "an evaluation of the public disclosure practices of companies in various markets around the world."³ S&P have evaluated the disclosure score by examining company annual reports and standard regulatory filings for disclosure of 98 specific items. One point is awarded when information on an item is available. The results from the 98 questions are then converted into a percentage and translated into scores from 1 to 10 with a higher score indicating greater disclosure. A percentage of 91 to 100 would give the company a score of 10 and a percentage of 11 to 20 would give a company a score of 2.

The questions used for scoring are provided in Table 3. The questions are divided by S&P into three broad categories:

- ❖ Financial Transparency and Information Disclosure (35 items),
- ❖ Board and Management Structure and Process (35 items); and
- ❖ Ownership Structure and Investor Relations (28 items).

Almost all the items on the list correspond to either mandatory disclosures in the U.S., or perceived best practices in U.S. corporate disclosure. As a result, I believe that the scoring uses an implicit U.S. benchmark, and assesses the extent to which companies around the world have adopted U.S. disclosure practices.

³ The information in this section is drawn from Standard and Poor's (2002).

Financial Transparency and Disclosure (Financial) consists of 35 questions that try to assess whether information provided by the company will enable stakeholders to evaluate the financial condition and future viability of the company. These include information on the quality of accounting standards used in the preparation of financial statements (eg: U.S. GAAP or IAS), frequency of publication of financial statements (eg: quarterly or annual), extent to which aggregated and disaggregated disclosures are provided (eg: consolidated financial statements, segment data, information on affiliates in the firm owns minority stake, related party transactions), key accounting policies (eg: asset valuation and depreciation), disclosure on auditors (eg: identity, audit fees, and nonaudit fees), disclosure on business (eg: nature of business, physical statistics, corporate strategy), and management analysis and forecasts (eg: specific performance ratios, investment plans, earnings forecasts, industry trends).

Board and Management Structure and Processes (Governance) consists of 35 questions. These range from board composition (eg: number of directors, names and background information on directors, whether or not the directors are independent), board committees (eg: information on audit, compensation and nominating committees), board compensation (eg: directors' salaries), top management composition (eg: names, background), top management compensation (eg: salary levels, specifics of performance based compensation plans), and top management shareholdings.

Ownership Structure and Investor Rights category (Ownership) consists of 28 questions regarding the composition of shareholdings in a company (eg: number and identify of shareholders who own 5% or more shares each, identity of top 10

shareholders, percentage of cross-ownership), description of the equity claims against the company (eg: description of share classes), details of shareholder rights (eg: procedure for putting proposals at shareholder meeting and the way shareholders nominate directors to the board).

The subsection scores are also derived in the same way as the overall scores, by awarding one point for each item disclosed, and zero otherwise, and summing up the total points for all the questions in each subsection.

Several comments on Standard and Poor's methodology in computing scores follow:

- ❖ First, while the scores could in theory measure the level of disclosure against a global benchmark, in reality they measure disclosure levels with respect to an implicit U.S. benchmark. This is substantiated by the fact that a vast majority of the 98 questions included in the scoring process are based on U.S. best practices. As a result, U.S. companies are on average have higher scores than other companies. The scores should therefore be used as an index of convergence to the U.S. disclosure practices, rather than as an absolute measure of disclosure level.
- ❖ Second, the scores measure whether or not a particular financial statement item or governance mechanism is disclosed, rather than evaluating the quality of the disclosure itself, or whether or not a particular governance mechanism is optimal. Furthermore, the study cannot control the accuracy of disclosure and it is not meant to identify forensically any disclosure that may be incorrect or fraudulent. The scores are, therefore, a *quantitative* assessment of

the disclosure practices of a company. They are not a qualitative indicator of the value of that information.

- ❖ Third, the items used for scoring do not distinguish between mandatory and voluntary disclosures in the sample countries. Therefore any analysis using these scores cannot discriminate between mandatory and voluntary disclosures.
- ❖ Standard & Poor's T&D study is based on the information disclosed in key public documents; it does not include all of the different types of company disclosure that may exist. Company web sites and other types of reports may provide additional information germane to stakeholders; however, for purposes of consistent, objective, global comparison, this study focuses on core public disclosure documents. S&P analysis focuses on annual reports only, with the exception of the U.S., France, and Japan, where other regulatory filings are evaluated as well, given the relative prominence of regulatory filings in these markets. A focus on annual reports facilitates analysis and comparison of companies around the globe. Some researches have identified annual reports as the principal communication device

available to companies⁴. Policymakers have also emphasized the importance of disclosing information plainly in annual reports⁵.

- ❖ Finally, while S&P analysts group the questions into sub-categories – financial, governance, and ownership – these categories do not appear to represent a “clean” grouping of questions. For example, some items classified under ownership category, such as number of shares outstanding, can also be thought of as a financial reporting item.

It must be noted that while T&D are key components of corporate governance, T&D rankings are not proxies for corporate governance.

⁴ For example, Botosan (1997) states: “Although the annual report is only one means of corporate reporting, it should serve as a good proxy for the level of voluntary disclosure provided by a firm across all disclosure avenues. This is because annual report disclosure levels are positively correlated with the amount of disclosure provided via other media (Lang and Lundholm (1993)). The annual report is the focus of my disclosure index because the annual report is generally considered to be one of the most important sources of corporate information.”

As another example, Knutson (1992, 7) states: “At the top of every analyst’s list (of financial reports used by analysts) is the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary of supplementary to it.”

⁵ On 9 July 2002, President George W. Bush said to Wall Street leaders “The SEC currently requires the annual disclosure of a CEO’s compensation. But that information is often buried in long proxy statement – proxy statements, and seldom seen – seldom seen – by shareholders. I challenge every CEO in America to describe in the company’s annual report – prominently, and in plain English – details of his or her compensation package, including salary and bonus and benefits. And the CEO, in that report, should also explain why his or her compensation package is in the best interest of the company he serves.”

Moreover, a briefing paper on executive compensation published by The Conference Board’s Commission on Public Trust and Private Enterprise in September 2002 reinforces this point by drawing conclusions that support corporate disclosure in more user-friendly formats. In particular the paper emphasizes the need for “conspicuous” disclosure that “should not only be in plain English, but in plain sight as well.”

Table 2 – Key characteristics of Standard & Poor’s Transparency and Disclosure benchmark

Objective

Standard & Poor’s provides a range of corporate governance analyses and services, the crux of which is the Corporate Governance Score (CGS). CGSs are based on an assessment of the qualitative aspects of corporate governance practices of a company. T&D rankings provide an objective assessment that complements, but does not replace, the CGS in an overall corporate governance evaluation of an individual company.

Transparent

The methodology for assessing T&D rankings is well-documented and publicly available. The list of questions and the universe of companies analyzed is also publicly available, and academic researchers have replicated the methodology in their independent research.

Verifiable

As the T&D rankings are objective and the methodology for their computation is transparent, practitioners and researchers can analyze sample companies and verify the T&D rankings.

Broad

T&D rankings parallel Standard & Poor’s CGS and provide a measure of transparency with three broad categories of corporate governance: ownership structure and investor rights; financial transparency; and board structure and processes. Previous measures have tended to focus on only one or two dimensions.

Practical

The methodology, with 98 questions in three categories and 12 sub-categories, is designed to balance the conflicting requirements of the range of issues analyzed and the tractability of the analysis. Standard & Poor’s consults leading academics and practitioners to maintain the comprehensiveness and practical usefulness of the rankings.

Flexible

The practical levels of aggregation in the T&D methodology allow investors and analysts to focus on specific issues of interest and/or match the level of T&D detail with the investment or analytical issue in focus.

Predefined global universe

The S&P’s T&D study covers approximately 1,600 companies. These include the S&P Global 1200 index and an additional 400 companies that represent the largest and most liquid S&P/IFCI companies in emerging markets. The S&P Global 1200 represents leading global companies and includes the S&P 500, 150 companies in Japan, and 350 companies in Europe. Taking the index constituents at the universe of analyses eliminates the potential of sample selection bias. Standard & Poor’s global indices cover more than 30 countries and are consistently defined across markets, enhancing researchers’ ability to compare T&D rankings across markets and sectors.

Table 3 – 98 Individual Transparency and Disclosure Questions

Ownership Structure and Investor Relations

DOES THE COMPANY IN ITS ANNUAL ACCOUNTS DISCLOSE.....

1. number of issued and outstanding ordinary shares disclosed?
2. number of issued and outstanding other shares disclosed (preferred, non-voting)?
3. par value of each ordinary share disclosed?
4. par value of each other shares disclosed (preferred, non-voting)?
5. number of authorised but unissued & outstanding ordinary shares disclosed?
6. number of authorised but unissued & outstanding other shares disclosed?
7. par value of authorised but unissued & outstanding ordinary shares disclosed?
8. par value of authorised but unissued & outstanding other shares disclosed?
9. top 1 shareholder?
10. top 3 shareholders?
11. top 5 shareholders?
12. top 10 shareholders?
13. description of share classes provided?
14. review of shareholders by type?
15. number and identity of shareholders holding more than 3%?
16. number and identity of shareholders holding more than 5%?
17. number and identity of shareholders holding more than 10%?
18. percentage of cross-ownership?
19. existence of a Corporate Governance Charter or Code of Best Practice?
20. Corporate Governance Charter / Code of Best Practice itself?
21. details about its Articles of Association. (e.g. changes)?
22. voting rights for each voting or non-voting share?
23. way that shareholders nominate directors to board?
24. way shareholders convene an EGM?
25. procedure for putting inquiry rights to the board?
26. procedure for putting proposals at shareholders meetings?
27. review of last shareholders meeting? (e.g. minutes)
28. calendar of important shareholders dates?

Financial Transparency & Information Disclosure

DOES THE COMPANY IN ITS ANNUAL ACCOUNTS DISCLOSE.....

29. its accounting policy?
30. the accounting standards it uses for its accounts?
31. accounts according to the local accounting standards?
32. accounts according to an internationally recognized accounting standard (IAS/US GAAP)?
33. its balance sheet according to international accounting standard (IAS/US GAAP)?
34. its income statement according to international accounting standard (IAS/US GAAP)?
35. its cash flow statement according to international accounting standard (IAS/US GAAP)?
36. a basic earnings forecast of any kind?
37. a detailed earnings forecast?
38. financial information on a quarterly basis?
39. a segment analysis (broken down by business line)?
40. the name of its auditing firm?
41. a reproduction of the auditors' report?
42. how much it pays in audit fees to the auditor?
43. any non-audit fees paid to auditor?
44. consolidated financial statements (or only the parent/holding co)?
45. methods of asset valuation?
46. information on method of fixed assets depreciation?
47. a list of affiliates in which it holds a minority stake?
48. a reconciliation of its domestic accounting standards to IAS/US GAAP?
49. the ownership structure of affiliates?
50. details of the kind of business it is in?
51. details of the products or services produced/provided?
52. output in physical terms? (number of users etc.)
53. characteristics of assets employed?
54. efficiency indicators (ROA ROE etc.)
55. any industry-specific ratios?
56. a discussion of corporate strategy?
57. any plans for investment in the coming year(s)?
58. detailed information about investment plans in the coming year(s)?
59. an output forecast of any kind?

60. an overview of trends in its industry?
61. its market share for any or all of its businesses?
62. a list/register of related party transactions?
63. a list/register of group transactions?

Board and Management Structure and Process

DOES THE COMPANY IN ITS ANNUAL ACCOUNTS DISCLOSE.....

64. a list of board members (names)?
65. details about directors (other than name/title)?
66. details about current employment/position of directors provided?
67. details about previous employment/positions provided?
68. when each of the directors joined the board?
69. classification of directors as an executive or an outside director?
70. a named chairman listed?
71. detail about the chairman (other than name/title)?
72. details about role of the board of directors at the company?
73. a list of matters reserved for the board?
74. a list of board committees?
75. the existence of an audit committee?
76. the names on the audit committee?
77. the existence of a remuneration/compensation committee?
78. the names on the remuneration/compensation committee)?
79. existence of a nomination committee?
80. the names on the nomination committee?
81. the existence of other internal audit functions besides the Audit Committee?
82. the existence of a strategy/investment/finance committee?
83. the number of shares in the company held by directors?
84. a review of the last board meeting? (e.g. minutes)
85. whether they provide director training?
86. the decision-making process of directors' pay?
87. the specifics of directors' pay (e.g. the salary levels etc.)?
88. the form of directors' salaries (e.g. cash, shares, etc.)?
89. the specifics on performance-related pay for directors?
90. the decision-making of managers' (not Board) pay?

91. the specifics of managers' (not on Board) pay (e.g. salary levels etc.)?
92. the form of managers' (not on Board) pay?
93. the specifics on performance-related pay for managers?
94. the list of the senior managers (not on the Board of Directors)?
95. the backgrounds of senior managers disclosed?
96. the details of the CEO's contract disclosed?
97. the number of shares held by the senior managers disclosed?
98. the number of shares held in other affiliated companies by managers?

The results from the 98 questions are converted into a percentage and then translated into deciles as follows:

Percentage	Decile
91 – 100	10th
81 – 90	9th
71 – 80	8th
61 – 70	7th
51 – 60	6th
41 – 50	5th
31 – 40	4th
21 – 30	3rd
11 – 20	2nd
1 – 10	1st

4.4. Dummy variables: countries and industries

Table 4 – Industries

Industries by Fortune	Industries used in the analysis
Aerospace and Defence	1. Aerospace and Defence
Airlines	2. Transport
Beverage Consumer food products Household and personal products	3. Consumer goods
Chemicals Energy Metals Petroleum refining Mining, crude-oil production	4. Chemicals/Energy
Commercial banks Megabanks Insurance	5. Financial
Computer software Computers Computers, Office equipment	6. IT
Delivery	7. Delivery
Electronics Semiconductors Semiconductors and other electronic components	8. Electrical/Electronics
Engineering construction Industrial and farm equipment Motor vehicles Motor vehicles parts	9. Engineering
Entertainment	10. Media/leisure
Food and drug stores General merchandisers Specialty retailers	11. Retail
Forest and paper products	12. Forest and paper products
Network and other communications equipment Network communications Telecommunications	13. Telecoms
Pharmaceuticals	14. Pharmaccuticals

The analysis has been carried out considering the industry “14. Pharmaceutical” as a benchmark.

Table 5 – Countries

1. UK
2. Europe – Non-UK
3. Asia Pacific and Emerging Asia
4. Japan
5. Latin America
6. US

The analysis has been carried out considering US as a benchmark.

5. Methodology and empirical results

I define Fortune scoring as the dependent variable and the following as independent variables:

- S&P Ownership
- S&P Financial
- S&P Governance

I also use the following sets of (0,1) variables (or dummy variables):

- Industry and
- Country.

The econometric technique used is a stepwise regression method. Stepwise regression is a sequential process for fitting least squares models, where at each step a single explanatory variable is either added or deleted from the model in the next fit.

Table 6 provides the result from testing the null hypothesis that a better quality of disclosures on Ownership Structure, Financial Information and Governance processes increases a company reputation.

Table 6 – Stepwise regression – Equation for single company reputation versus S&P Ownership, Financial and Governance

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3,481	,539		6,463	,000
S&P Governance	1,455E-02	,003	,296	5,014	,000
Industry 3: Consumer goods	,877	,200	,246	4,391	,000
UK	-,566	,201	-,162	-2,818	,005
S&P Financial	1,792E-02	,007	,143	2,398	,017

a Dependent Variable: Fortune ranking
 Note: Sample size = 262
R² (adj.) 18.9%

Table 6 shows that S&P Governance is significant more than S&P Financial. It shows also that belonging to the UK, *ceteris paribus*, implies a worse reputation compared to the US, while belonging to industry “consumer goods” is an advantage with respect to industry “pharmaceutical”.

The regression accounts for 18.9 per cent of the variation in reputation.

I run the same regression using S&P overall scoring instead of the three subsets. The results are summarized in Table 6.

Table 7 shows that S&P overall scoring of T&D is significant. It shows also that belonging to the UK or to Japan, *ceteris paribus*, implies a worse reputation

compared to the US, while belonging to industry “consumer goods” is an advantage with respect to industry “pharmaceutical”.

The regression accounts for 18.3 per cent of the variation in reputation.

Table 7 – Stepwise regression – Equation for single company reputation versus S&P overall T&D scoring

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	4.162	.443		9.391	.000
S&P T&D scoring	2,575E-02	.007	.246	3,871	.000
Industry 3: Consumer goods	.884	.200	.248	4,428	.000
UK	-.588	.202	-.168	-2,916	.004
JAPAN	-.463	.166	-.174	-2,785	.006

a Dependent Variable: Fortune ranking
 Note: Sample size = 262

R² (adj.) 18.3%

6. Conclusions

The aim of this paper was to check whether disclosure quality is a significant determinant of corporate reputation. To test this hypothesis I used a sample of 262 companies included in 2003 Fortune world’s most admired companies. For these companies I had a disclosure quality index developed by Standard & Poor’s.

Disclosure quality is a crucial determinant of corporate reputation. Moreover, non-financial information such as information on board and management structure and processes seems to be more important in determining corporate reputation compared to traditional financial information.

Given some limitation of the model developed (i.e.: firm size or profitability have not been taken into account), these findings are clearly preliminary. Nevertheless, they show that the study of the reputation consequences of disclosure quality may be an interesting field for future research.

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1. Introduction

The last half of the 1990s was a period in which the economy expanded at a rate in excess of long term growth rates, due principally to investments in technical change resulting from new Internet and communications products. The promise of these products had beneficial effects across industry and trade, so that there was a balloon-like increase in share prices through much of the economy. By 2000 share price increases had, according to many financial analysts, developed into an authentic "bubble"; but this was not long lasting, and inventory accumulation and other over investments brought the economy down by the end of 2001.

For shareholders, prices in Internet and communications stock could no longer be based on aggressive expectations of rates of growth of earnings far in excess of those of the last few years. While share prices by the end of 2002 had declined by more than 25 per cent, those of the new Internet and telecom companies declined by at least twice that percentage. With share price growth cut off, and cash flow from product sales declining, new Internet-based companies slid rapidly into insolvency. The largest companies in the economy, with stronger but still declining market demands, cut back on operations to levels that could be sustained by reduced cash flows and borrowings in debt markets. Their share prices declined, as prospects for future earnings were reduced in both the high-tech and investment sectors of the economy as a whole. The American economy went into one of its periodic slowdowns, not quite a recession, but this time marked by virtual collapse of these previously "high expectations" sectors. Part of the collapse was due to a new phenomenon that overtook what was essentially a business cycle process: a number of the largest corporations subject to this slowdown made extraordinary efforts to

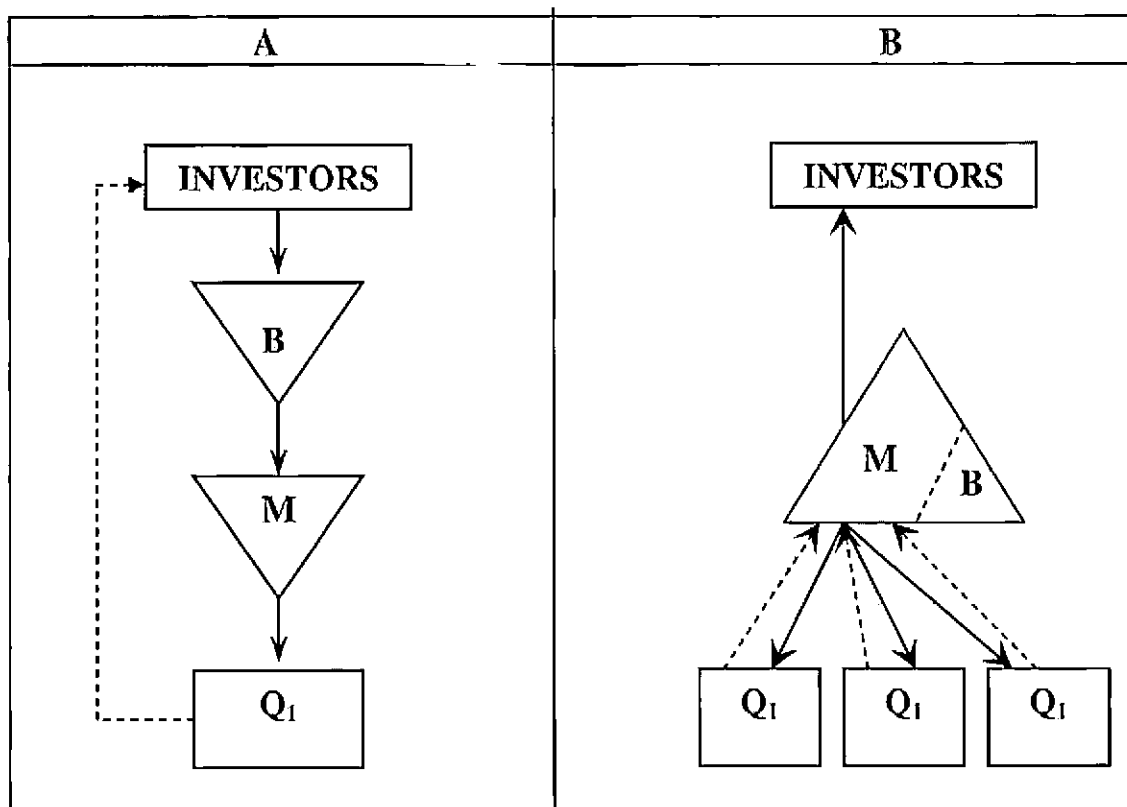
forestall the negative effects on their share prices; these efforts not only involved short-term reductions in operations but, in a surprisingly large number of cases, involved misleading and even fraudulent financial reports. In instances where this succeeded, for a limited period, in sustaining the artificially-high share prices, management cashed in its options and shares.

The question is why was reform governance not there to stop the misrepresentation clearly not in the interest of the shareholders, that is, "Where was the board of directors?" When management of these corporations went beyond coping with reductions in markets to self-survival action plans that drove the corporation into illegal practices did the board of directors know or could have known, and have prevented management from proceeding as it did.

I argue that the real problem does not stem simply from management initiatives that were reckless, self-serving or fraudulent, but from the "broken engine" of the corporation which has allowed an excessive number of company collapses. The "broken engine" argument (see John Plender, *Going off the rails: Global capital and the crisis of legitimacy*, 2003) is based on certain characteristics of the corporate form of enterprise. Since inception, corporations have been founded on state charters that specify not what is to be produced but how responsibility for the use of investor capital is to be recognized. Investor capital, in general, under state law is to be used to maximize profit returns, and the board of directors is responsible for making sure that these profits accrue to the investor. For numerous and diverse investors the board serves as an agent that appoints and monitors management to achieve this result.

In practice, it has not worked out that way. Between 1960 and 1990, this system was, in general, disoriented, with the board serving as a source of support in the pursuit of management's goals. The CEO dominated both management and the board, serving as the board chairman, and appointing the board of directors to assist. It was the CEO, not the board, who determined corporate strategy as well as how earnings were to be "distributed" among all stakeholders.

Figure 1 – The focus of decisions



Note: A and B are scenarios of corporate conduct, with B in the triangle indicating board of directors initiatives, M indicating management initiative, and Q indicating product line results.

Source: MacAvoy and Millstein (2003)

In the original pre-1960 governance system depicted by panel A, Management, M, was given responsibility by the board, B, to implement plans in the interest of

investors. But by 1960, board power had atrophied, resulting in management firmly in charge, with the same governance structure but a *de facto* configuration of practices and conduct similar to that depicted in panel B. The board was a supplementary source of ideas and support for management, who dealt with the investor as well as with buyers and competitors. The devolution of the board to a position that was advisory to management in increasingly diverse operations took place gradually as CEOs retired and new CEOs in the replacement process took the initiative. In the interests of the newly independent, expansive CEO, major acquisitions were undertaken and product lines extended to Q₂ and Q₃. To present a perception of high and stable growth, Q₁, Q₂ and Q₃ generated earnings that became unconnected to current cash flow, and were “managed” by smoothing peaks and troughs by means of reserve accounts from year to year. While the result in panel A was profit to shareholders, the result in panel B was funds for expansive diversification, increased executive compensation, and, last, discretionary dividends. Looking back over 30 years, the “break” in the corporate engine was that the board of directors was not functioning as agent for investors. As a result, management need not and was not using investor capital to achieve the earnings levels possible at the time. This fault began to be fixed by the late 1980s and early 1990s with the independent directors asserting control; but the collapse of numerous major corporations in the early 2000s raises the question as to whether the new director initiative achieved the required results, and, if not, then what further reforms are necessary.

In section 2, I will conduct an inquiry into whether what was “broken” can be fixed further by reviewing how we got where we are. This begins with how corporations

were governed prior to the 1990s, how governance was transformed during that decade and what caused the change. I consider why a strong or “professional” board was put in place in some corporations but not in others. I will not only consider how this organisation of directors is structured but also their conduct and responsibilities.

Section 3 consists of a review of literature on board structure and process and its relationships to financial performance.

In section 4, I analyse the implications of alleged fraudulent or misleading accounting leading to the loss of investor confidence in the capital market and the implications for standard setters.

In section 5, I argue that governance reforms should be based on the role of the board and the role of management. These two roles require the duties of two different people; that providing adequate board leadership requires a separate chairman to focus on supplying critical information to directors now lacking, and that directors should use the information to make “good faith” decisions that require management to operate only in the interests of the corporation and its shareholders.

2. The governance problem: an historical perspective

2.1. Shareholders theory vs stakeholders theory

Any discussion of weaknesses in governance has to begin with an explanation of the corporation's ultimate purpose. Is its goal today primarily and exclusively to enrich its shareholders? Or is its purpose broader - to create value not only for its shareholders but also serve interests of its employees, customers, suppliers and the communities in which it operates? The 1980s and 90s were about short-term performance, judged narrowly by quarterly results. In the years ahead, society will be

looking to companies to have a broader focus on all stakeholders. (“A new year; a new agenda”, Jeffrey Garten, Dean of the Yale School of Management, *The Economist*, 4 January 2003). Should enterprises seek only to maximize shareholder value or strive to serve the often conflicting, interests of all stakeholders? Guidance to seek an answer can be found in exploring two visions of the enterprise. The first one, known as the shareholder theory, is based on the primacy of the shareholders, while the second one, the stakeholder theory, claims that other stakeholders deserve consideration, too. According to the former, the board of directors primarily have a duty to maximize shareholder returns, while the latter claims that a board of directors’ duty is to balance the shareholders’ financial interests against the interests of other stakeholders such as employees, customers and the local community, even if it reduces shareholder returns.

The shareholder theory asserts that shareholders provide capital to a company; the board of directors is supposed to use corporate funds only in ways that have been approved by the shareholders. As Milton Friedman wrote in 1962, “There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it (.....) engages in open and free competition, without deception or fraud.”

On the other hand, the stakeholder theory asserts that the board of directors has a duty to both the corporation’s shareholders and “individual and constituencies that contribute, either voluntarily or involuntarily, to a company’s wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers” (Post, Preston and Sachs, 2002) such as its customers, employees, suppliers

and the local community. According to the stakeholder theory, the directors are agents of all stakeholders and have two main responsibilities:

- to ensure that the ethical rights of no stakeholder are violated; and
- to balance the legitimate interests of the stakeholders when making decisions.

The objective of a corporation is, thus, to balance profit maximization with the long-term aim of remaining a going concern.

The fundamental distinction between the two approaches is that the stakeholder theory demands that interests of all stakeholders be considered even if it may not maximise profits or wealth of the company. In other words, under the shareholder theory, non-shareholders can be viewed as “means” to the “ends” of profitability; under the stakeholder theory, the interests of all stakeholders (i.e. shareholders and non-shareholders) are viewed as “ends”.

The last few years saw a good deal of corporate executive behaviour that was at best disruptive to the free flow of commerce and, at worst, illegal. Few would dispute that such behaviour should be discouraged. The real question is whether a corporation should prescribe, and therefore reward, behaviours that are actually detrimental to society. Many strident critics of the shareholder theory claim that as executives are charged with maximizing shareholder value and are given large incentives to do so through stock options or other scheme, they will respond by embracing whatever manipulations are necessary to achieve that goal.

This argument relies, however, on an incomplete and somewhat misrepresentative interpretation of the shareholder theory.

In fact, while the mantra of maximizing shareholder value was indeed chanted by many in the economic and financial communities in the late 1990s until the scandals

hit in 2000s, it is not at all clear that such a goal is completely consistent with the intent of the shareholder theory. Management should concern itself with increasing corporate wealth and dividends through profitability than mere increasing share price in the stock market through legally permitted manipulations or fraudulent behaviours.

The pursuit of profit should be done legally, ethically and without deception, and there is little room for the kind of overtly illegal behaviour alleged in many recent financial scandals.

Finally, it should be remembered that many of the executives undertook actions that were more for their own benefit rather than of the shareholders. For example, Enron Corp. CFO Andrew Fastow, who created a partnership that was bankrolled with Enron stock and populated with very risky ventures, “stood to make millions quickly, in fees and profits, even if Enron lost money on the deal,” according to the Washington Post (28 July 2002). Actually Enron lost more than \$500 million from these and other initiatives and filed bankruptcy. Similarly, several other executives, including Kenneth Lay and Jeff Skilling of Enron, Garry Winningk of Global Crossing Holdings Ltd. and Scott Sullivan of WorldCom Inc., also benefited from bonuses and stock options at the same time that their companies’ shareholders were suffering losses. Such behaviour is inexcusable, since the basic premise of the theory is that executives should act primarily or predominantly in the shareholders’ interests and not in their own.

“Yet business leaders in the past have been too short-term in their orientation, with great damage to shareholder culture. They need to think longer term. Yes, they should focus on shareholders; that’s not in question. But how they do that, how they

create long-term sustainable value, is the issue. And to do that, they have to take more account of their employees, their customers, their suppliers, and the health of their communities – and yes, the global economy, too” (Jeffrey Garten, *The Economist*, 4 January 2003).

What I wish to emphasise is that profits are a result of satisfying the needs of these stakeholders. As David Packard, the cofounder of Hewlett-Packard said, “Profit is not the proper end and aim of management – it is what makes all of the proper ends and aims possible.”

What follows is that investors should have in place as their agent a board of directors to achieve the largest possible residual profit consonant with fully meeting contract requirements, legal requirements, and appropriate ethical considerations⁶.

2.2. Merger activities as examples of managerial self-interest

In the first half of the 20th century, corporate ownership was increasingly divorced from control. Shares, which in the 19th century had largely been concentrated in the hands of owner-managers, became more widely dispersed as companies floated on stock markets and became larger. This phenomenon, which was described by Adolph Berle and Gardiner Means in *The Modern Corporation and Private Property*⁷ in 1932, resulted in managers becoming less accountable. In the absence of significant blocks of shares commanding large numbers of votes, no-one was in a position to fire the managers if they underperformed. In conventional economic literature this conflict of interest between shareholders and management is referred to as principal-

⁶ See MacAvoy and Millstein (2003), *The Recurrent Crisis in Corporate Governance*, page 12, footnote 3.

⁷ Two years later Yale Professor W.O. Douglas reiterated the Berle and Means central argument: W.O. Douglas, “Directors who do not Direct”, *Harvard Law Review*, 47 (1305) (1934).

agent problem. The conflict arises because agents usually cannot be relied on to manage other people's affairs or money as well as they would manage their own. Berle and Means warned that management can be expected to serve as agent for itself rather than for investors, shifting the resources of the corporation to its own agenda, whether that is to expand activities for the sake of size alone, or to protect jobs, or to increase its own compensation. Berle and Means's fear was supposed to be dispelled by making leadership in more focused organizations sweep away those who did not perform and replace them with those who would. Thus, by the 1940s and 1950s it had become apparent that the market within the corporation for control functioned imperfectly. In many cases, the process of replacing the deviant leadership swept away good management and led to mismanagement. In other cases reorganization resulted in the more efficient use of assets, but the costs of the transition were significant and the consolidation of operations was itself stretched over years before completion.

More fundamentally, an acquisition process emerged and merger activity increased to such an extent that it became the largest "wave" of takeovers on record. Mergers have been justified by the theory of diversification, which held that control of a variety of businesses in a single corporation would lessen the risk of insolvency for the corporation during economic downturns. The corporation in effect was a diversified portfolio of assets spread across markets affected differently by downturns or upturns in the business cycle.

Jae H. Song⁸ investigated 54 conglomerate acquisitions in manufacturing and mining completed in the 1974-76 period and found that the acquiring firms were buying firms with stronger rates of growth of sales revenues; in fact, the weaker the sales growth rate of the acquiring company, the stronger that of the acquired company. He also found that the acquiring firm had lower rates of return on assets and a tendency to acquire firms whose returns on assets were higher than theirs, as if to maintain a level of profitability by acquisition.

Some part of this activity could be explained as a process by which to obtain optimal financial leverage.

As indicated by Lewellen⁹ and Lintner¹⁰, an acquiring firm may have had *latent* debt capacity which could be used to finance the acquisition of a less levered firm. As a result of the acquisition, the acquiring firm uses the acquired's potential to borrow. This explanation, however, did not answer the question as to why it was not equally or more effective simply to issue debt and buy back shares in the existing enterprise, without undertaking the transaction costs involved in a takeover.

Weston and Mansinghka¹¹ argued that many corporations entered into the conglomeration process through merger as a financial strategy, involving removing assets from existing markets and operations with depressed earnings and placing them in higher earnings opportunities elsewhere.

⁸ Jae H. Song, "Diversifying Acquisition and Financial Relationships: Testing 1974-1976 Behavior", *Strategic Management Journal*, 4(2) (April-June 1983), 97-108.

⁹ Wilber G. Lewellen, "A Pure Financial Rationale for the Conglomerate Merger", *Journal of Finance* (May 1971), 521-37.

¹⁰ John Lintner, "Expectations, Mergers and Equilibrium in Purely Competitive Securities Markets", *American Economic Review* (May 1971), 101-11.

¹¹ J. Fred Weston and Surenda K. Mansinghka, "Test of the Efficiency Performance of Conglomerate Firms", *Journal of Finance* (September 1971), 919-36.

The more persuasive argument was provided by Dennis Mueller in *A Theory of Conglomerate Mergers* published in 1969¹². His position was that merger history demonstrated that “managers maximize the growth in physical size of their corporation rather than their profits or stockholder welfare”. He went on to argue that a wealth of behavioural evidence indicated that the financial rewards which managers received were tied to growth of their companies, not to earnings for investors. “Managerial salaries, bonuses, stock options and promotions tend to be more closely related to the size, or the changes in size, of the firm than to its profits. Similarly the prestige and power that managers derive from their occupations are directly related to the size and growth of the company and not to its profitability”.

While Mueller was unable to test this hypothesis, he did survey the merger history of that time to “make some judgment” as to whether the growth maximization hypothesis was more plausible. He found that mergers in 1966 were proceeding at roughly nine times the rate that had immediately preceded the Second World War and 2½ times the level of the 1946-47 high merger period. The dollar value of the assets of acquired firms increased between 1951 and 1966 from \$201 million to over \$4 billion, with most of that increase consisting of assets in conglomerate mergers. Most relevant to his hypothesis was the finding that the proportion of firm growth from mergers was higher the larger the firm. The tendency of large firms to grow more from merger implied that growth maximization was the goal in that period. Considering the alternative, Mueller found it implausible that “managers with no

¹² Dennis C. Mueller, “A Theory of Conglomerate Mergers”, *Quarterly Journal of Economics*, 83(4) (November 1969), 643-59.

familiarity with the company's operations could recognize its opportunity for profits better than the firm's own managers and stockholders”.

By the late 1980s, investors had begun to recognize that responsibility for corporate behaviour that conflicted with their interest lay with managers who were not sufficiently focused on increasing earnings. The largest investors, in large part, began to turn to the board of directors. By the late 1980s, institutional investors - primarily public pension funds - had begun to demand publicly that, over and above advising and supporting management, boards hold managers accountable for merger and other aspects of performance¹³. As shareholders they had come to expect that directors of major corporate institutions would critically analyze the results of a year's operations and hold management responsible.

In the 1970s and 1980s, it became clear that weak governance was associated with declines in both earnings performance and in the corporation's position within its industry. So-called “managerial capitalism”, by which managers bypassed boards of directors, focussed on employee problems, community enhancements, and/or strategies to perpetuate the corporation rather than efficiency gains to increase returns on investment had not prevailed¹⁴.

With conglomeration, those practising managerial capitalism were spread more broadly, and in many ways thinner, across the product landscape. Performance of US

¹³ Ira M. Millstein, speech to Council of Institutional Investors (CII) (1987).

¹⁴ For a description of the rise of the professional manager in the USA, see Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (1977). As other commentators have noted, in the post-Second World War era professional managers were “virtually deified” by scholars such as Chandler and Neter F. Ducker, while the role of the board was virtually ignored. See, e.g., James Gillies, *Boardroom Renaissance: Power, Morality and Performance in the Modern Corporation* (1992), 4-7 (describing how boards were viewed as a legal fiction).

corporations declined relative to that of German and Japanese corporations operating under different systems of governance¹⁵. The American conglomerate corporation produced lower quality, and less innovative, products, limiting the opportunity for profitable additional investment.

Millstein and MacAvoy used the conglomerate example as a surrogate for weak boards allowing management's self interest to dominate in disregard of shareholder value. Management's interest in size and scope, as distinguished from shareholder value, led other major icons not classified as conglomerates to serious decline. By the early 1990s, many of the largest corporations were faltering. For example, IBM, General Motors, and Sears – which, in 1972, had respectively ranked first, fourth, and sixth in the world in total value of outstanding shares – were no longer represented in the 1992 top twenty largest companies, ranked by stock value. Together they had reportedly lost a total of \$32.4 billion of market valuation in 1992 alone¹⁶. These three companies went through a cycle that was to be repeated by many other large manufacturing enterprises. With management-dominated strategies the corporations had invested in low-return growth and diversification to expand the size and scope of core activities. The resulting low-level returns to investors had begun to put boards under increasing pressure from¹⁷:

- (i) institutional shareholders, primarily the large public pension funds¹⁸;

¹⁵ Carol J. Loomis, "Dinosaurs?", *Fortune*, 3 May 1993, 36.

¹⁶ I. Millstein and P. MacAvoy, "The Active Board of Directors and Performance of the Large Publicly Traded Corporation", *Columbia Law Review*, 98 (June 1998), 1,283, 1,285. A dominant managerial system acting without true accountability was held partially to blame.

¹⁷ See MacAvoy and Millstein (2003), pages 18 c 19.

¹⁸ See, e.g., "Thinking More About Institutions", *Institutional Investor* (November 1990), 176 (survey of 700 investor relations officers, finding that the courting of institutional investors has never been more intense); Amy L. Goodman, "Institutional Investors Come of Age", *Insights*, 4(2) (December 1990) (reporting that an assembly of 100 private institutional money managers, who had in the past been prepared to sell rather than vote against management, were now focused on proxy activism and

- (ii) takeover firms¹⁹; and
- (iii) judicial interpretations of fiduciary duties²⁰.

2.3. The emergence of the role of the board of directors in the 1990s

As governance changed during the early 1990s, arguments as to the increased authority and responsibility of the board of directors began to appear regularly in the business press. It was said that monitoring of management had to be aimed at detecting and responding to performance problems before they developed into crises. The board's role had to expand beyond monitoring managers to more substantive areas including strategic planning and providing incentives for managers that were linked to corporate performance.

Such a position was based on the concept of "professionalism" in the boardroom at the core of "reformed" governance.²¹ Senior management is responsible for the

shareholder rights); CalPERS, *Company Responses to Request for Board Governance Self-Evaluation – Final Report* (May 1995) (CalPERS's survey and scorecard of the corporate governance practices of the 300 largest companies in its portfolio); Russell Reynolds Associates and The Wirthlin Group, *Redefining Corporate Governance: 1995 U.S. Survey of Institutional Investors*, 3-7 (finding increased investor activism prompts changes in board composition, compensation and activism); Wirthlin Worldwide and Russell Reynolds Associates, *Setting New Standards For Corporate Governance: 1997 U.S. Survey of Institutional Investors*, 3 (corporate governance examination was given "impetus by a number of high-profile cases that demonstrated what could happen when boards were insufficiently vigilant in their oversight duties"); Stuart L. Gillan and Laura T. Starks, "A Survey of Shareholder Activism: Motivation and Empirical Evidence", *Contemporary Finance Digest*, 2 (Autumn 1998), 10-34 (finding that as the equity ownership of investment advisers, investment companies, bank trust departments, insurance companies, foundations and pension funds increased from 24 per cent of the market in 1980 to just under 50 per cent by the end of 1994, they became more active participants in the governance of their corporate holdings); and Gillan and Starks, "Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors", *Journal of Financial Economics*, 57 (2000), 275-305 (an empirical study of increased shareholder activism on the part of institutional investors over the past 15 years).

¹⁹ See, e.g., Michael J. Barclay and Clifford G. Holderness, "Control of Corporations by Active Block Investors", *Journal of Applied Corporate Finance* (Fall 1991), 68 (study of 106 block trades of common stock during 1978-1982, finding "considerable evidence that block purchasers or their representatives play an active role in firm management" and that "turnover among top managers and directors after the trades substantially exceeded what is normal for public corporations").

²⁰ See MacAvoy and Millstein, note 23, page 19 which quotes a series of Delaware court decisions in the 1980s concerning the contours of the business judgement rule in the context of board response to a change of control situation emphasized the role of informed independent directors.

enterprise's efficiency, and thus its competitiveness. Boards of directors are responsible for hiring, compensating monitoring and planning the succession of senior management. Viewed from this perspective, as fiduciaries for owners, boards are responsible in effect, for the corporation's performance. Professionalism is the process of taking on and delivering upon that responsibility.

This more penetrating involvement in decision-making authority begins with participating in the formulation of corporate strategy. The strategy is approved, by the board or, if not, it is rejected and returned to management – a decision that would be regarded as showing disapproval of management conduct. When the plan is approved, it is implemented on a schedule to be determined by management. This process varies but, in the end, management has the primary responsibility for developing and articulating strategy, as well as the knowledge of operations necessary to execute the plan effectively in a competitive environment. Beyond approving or disapproving the management's proposal, the role of the board has been to set acceptable performance levels in reference to the strategic plan and then evaluate management accordingly.²²

There has been growing boardroom interest in assuming a more active role in the strategic process.²³ If the board is to determine the merits of management's strategic and business plans, including the likelihood of realizing the intended results, then it should, at the very least, determine for itself the capacity of specific operations to

²¹ Ira M. Millstein, "The Professional Board", *The Business Lawyer*, August 1999, "The Responsible Board", *The Business Lawyer*, February 1997; " Director Professionalism", Report of the NACD Blue Ribbon Commission (1996, update and reprinted 2001).

²² Gordon Donaldson, "A new tool for boards: The strategic Audit", *Harvard Business Review*, July-August 1995, page 99.

²³ *Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy* (September 2000); *Report of the NACD Blue Ribbon Commission on Director Professionalism* (November 1996, reissued 2001).

generate the returns expected to be in keeping with the strategy. The board should be able to assess the strategies of existing and potential corporate rivals, and the impact that changes in the external environment – economic, social, and political – could have on performance under this strategy and that of rivals. This assessment should be grounded in a board consensus on the characteristics of the organization – its assets, liabilities, and structure – that affect performance²⁴. These conditions require that the board be part of the strategy development process, in order to satisfy itself that management is proposing the preferred choice of a series of possible courses of action. The board should identify benchmarks that might indicate a change in expected results, such as developments that may take place (for example, in the market) after implementation of the plan has begun and may require that the plan be modified.

Monitoring management performance based on strategic directive constitutes a major escalation of board activity. The board's monitoring function had been traditionally focused on management presentations of current month and quarter revenues and operating costs. This information has been presented by management in more detail, but at the same level of content, as contained in the corporation public financial statements. Accordingly, the information available to the directors has been more current, but certainly not more analytical than that available to stock analysts. But this interpretation of financial performance measures would not be sufficient for the board to monitor the corporation's long-term performance against the strategic plan; extrapolating monthly data series to generate forecasts of future performance does not allow the board to accurately anticipate problems to come. If the board is to

²⁴ Sharon Oster, *Modern Competitive Analysis*, 1994.

evaluate corporate performance beyond the level achieved by the typical stock analyst it needs sharper tools and more information.

The need for tools for measuring plan performance seems obvious. If the plan calls for doubling the production of nuts and bolts, the board should have measures of nuts and bolts production; but if the plan calls for increasing market share, then the board should have accurate measures of market share not only in physical units but also in revenues and earnings. If the plan calls for “becoming global”, then the board must define the term and measure the elements of globalisation that would be earnings-related. The board has to call for measurable performance elements, obtain the relevant information regularly, and then evaluate results in those terms. The board should not rely solely on historical data, or on how management describes its own performance in qualitative terms. It has to assess whether management has positioned itself for what may be coming in the next periods by assessing the strengths of forthcoming plans and programmes in terms of their realism and implications.

Measuring the ability of management to produce future wealth in these terms requires a high order of sophistication. A corporation's future depends on, among other things, its current stock of scientific and technical knowledge and its reputation with suppliers, customers and investors, as well as its present and future market competitive position.²⁵

The board could also review and assess financial analyst appraisals of current and future performance. Analyst studies are responsive to interests of the investor, and

²⁵ Council on Competitiveness, *Capital Choices: Changing the Way America Invests in Industry* (1992), page 84; and The Conference Board, *Commission on Public Trust and Enterprise: Findings and Recommendations* (2003).

rely on indicators of performance relevant to those interests, even though they are widely perceived to be biased in favour of selling shares. Whether forecasts of future performance from such sources are accurate enough to guide the board's assessment varies from case to case; but aligning its position against that of management, and also that of the analysts on near and long-term performance, could be the board's contribution.²⁶

Surveys on the activism and focus of board/management relations are revealing.²⁷ It is clear that by the end of 1990s "professionalism" in the boardroom was structurally coming into place. It should be asked whether it was also beginning to determine conduct. Before answering this question, I will examine whether strong governance – with professionalism-dominating board practice – results in better corporate performance.

²⁶ Following a submission to the NYSE and NASDAQ by the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees, the NYSE and NASDAQ adopted new listing requirements that further institutionalized the role and independence of the audit committee *vis-à-vis* management.

²⁷ Korn/Ferry International reports the following information (*Board Meeting in Session: 23rd and 28th Annual Board of Directors Studies*):

1. Two-thirds of respondents' boards (67 per cent) had a formal process for evaluating the CEO in 2001, the same percentage as in 1994.
2. The number of directors who reported that their boards had full-board performance evaluations increased to 42 per cent in 2001 (up from 26 per cent in 1994).
3. 75% of directors reported that their boards had written guidelines on corporate governance in 2001 (up from 59% in 1995, the first year this aspect was reported in this survey).

Similarly, a National Association of Corporate Directors (NACD) survey in 2001 found that board independence and the board's participation in strategy formulation had increased. Moreover, according to the survey, boards were undertaking more rigorous CEO and self-evaluations (NACD, *Public Company Governance Survey*, November 2001).

The Conference Board's 1996 study, *The Corporate Board: A Growing Role in Strategic Assessment*, documented recognition of the legitimacy of board involvement in strategy formulation. In a ten-country study, 51 per cent of respondents stated that their boards had a greater role in strategy than they did three years earlier, and nearly 49 per cent stated that the board was "actively engaged in the choice of strategic options".

3. Literature review on the relationship between board structure and financial performance

3.1. Board “independence” and corporate performance

The “effectiveness” of boards has been the subject of numerous investigations by analysts and financial experts. They have not resulted in a consensus position. The studies have centred on major events such as corporate takeovers, restructurings, or replacements of the CEO. A substantial body of work has developed regarding the relationship of these events, and how they were addressed in the context of corporate governance. But this body of work has been too narrowly focused for any general findings on the governance performance relationship. The initial difficulty in generating conclusive empirical results stems from the failure to develop a proxy for board “independence”. Most studies have relied on some measure of board composition, such as the number of outside versus inside directors, to indicate “independence”. However, these surrogates are not associated with reform practices and shed little light on the conduct of an independent board.

Because of the importance of personal interaction in the activity of a board, the simple tallying of the affiliations of individual board members provides insufficient information to assess whether or not that board is active and independent. This position is supported by Shivdasani and Yermack,²⁸ who found that the CEO's involvement in the selection of directors negatively affected the independence and quality of the nominee. An accurate appraisal of board independence is not based

²⁸ Anil Shivdasani and David Yermack, “CEO Involvement in the Selection of New Board Members: An Empirical Analysis”, *Journal of Finance*, 54, 1999.

simply on the composition of the board, but on observations of the board taking specific actions and following certain rules of practice.

However, the difficulty has been that of isolating observable determinants of behaviour. Agrawal and Knoeber²⁹ identify seven mechanisms for control: shareholdings of insiders, institutions, and large blockholders; use of outside directors; debt policy; the managerial labour market; and the market for corporate control. They find substantial interdependence among these determinants in a large sample of firms, but suggest that using one of these control sources to explain some measure of firm performance would be misleading.

Similarly, Rediker and Seth³⁰ found that there were strong substitution effects present among various aspects of governance conduct. They identified substitution between monitoring by outside directors and large shareholders, as well as monitoring by inside directors in determining the performance of management.

Of central concern, however, are incentives to actively monitor management in the interest of shareholders. Much research has focused on determining adequate incentives for directors to develop a strong governance system.³¹ The authors of these papers acknowledge that directors respond to both monetary and non-monetary incentives, such as reputation, increased networking opportunities and forms of

²⁹ Anup Agrawal and Charles R. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders", *Journal of Financial and Quantitative Analysis*, 31, 1996.

³⁰ Kenneth J. Rediker and Anju Seth, "Boards of Directors and Substitution Effects of Alternative Governance Mechanisms", *Strategic Management Journal*, 16, 1995.

³¹ E.Fama, "Agency Problems and the Theory of the Firm", *Journal of Political Economics*, 88, 1980; E.Fama and Michael Jensen, "Separation of Ownership and Control", *Journal of Law and Economics*, 26, 1983.

psychic income. On the other hand, having a reputation for being a director that does not make trouble for CEOs can be potentially valuable as well.³²

One set of events in which setting appropriate director incentives is imperative is in board decisions on takeover proposals. Harford finds that directors of targeted companies who are likely to lose that particular board seat following the takeover are also less likely to acquire additional seats on other boards in the future.³³ With the expectation that a takeover will result in a loss of income and position for individual directors, Harford suggests that bonuses similar to management “golden parachutes” should be employed to incentivize directors to be receptive to takeover bids. But more relevant than severance packages is the compensation directors receive during their tenure on the board; the compensation package can be constructed in a way that neutralizes the bias against takeovers. Director stock ownership, rather than monetary compensation, has been widely proposed as being important for aligning director and shareholder interests. Indeed, a shift to stock awards has been taking place; from 1992 to 1995 in a sample of large firms, the percentage with incentive-based compensation for directors rose from 48 per cent to 70 per cent. By 1995 such stock-based awards accounted for over one third of total director compensation. Significant correlation has been found between the amount of stock owned by outside directors and firm performance (based on a variety of measures). Higher share ownership of both corporate insiders and outside directors also has a positive correlation with both earnings performance and market value of the company's common shares.

³² Benjamin E. Hermalin and Michael S. Weisbach, “Boards of Directors as Endogenously Chosen Institutions: A Survey of the Economic Literature”, available at <http://www.nber.org/papers/w8161>

³³ Jarrad Harford, “Takeover Bids and Target Directors’ Incentives: Retention, Experience and Settling-Up”, *University of Oregon Working Paper* (2000).

Taken together, these studies indicate that director stock ownership may be used to align director and shareholder interests.

However, it can be argued that the excessive greed of recent years have demonstrated that stock options have led directors to concentrate on their own interests and not the shareholders'.

3.2. The impact of "strong governance" on corporate performance

There are other steps that have been taken to strengthen the "strong governance"³⁴. There is evidence that small board size may be an element of effective corporate governance. Yermack³⁵ reports that there is a significant negative correlation between board size and Tobin's q (stock market value divided by the replacement value of assets); and Barnhart and Kosenstein³⁶ confirm those results.

In other research on CEO-Chairman duality, however, there have been mixed results. Of four recent analyses of the separation of CEO and Chairman, two find improved corporate performance, while the other two find no effect on performance.

1. In the first study by Brickley, Coles and Jarrell, stock market valuation does not differ between samples of firms with split and consolidated CEO and Chairman roles.³⁷
2. Similarly, Baliga, Moyer and Rao report no significant stock price effects from such a separation, and no improvement in long-term earnings performance.³⁸

³⁴ MacAvoy and Millstein (2003), page 35.

³⁵ David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors", *Journal of Financial Economics*, 40, 1996.

³⁶ Scott W. Barnhart and Stuart Rosenstein, "Board Composition, Managerial Ownership, and Firm performance: An empirical Analysis", *Financial Review*, 33, 1998.

³⁷ James A. Brickley, Jeffrey L. Coles and Gregg Jarrel, "Leadership Structure: Separating the CEO and Chairman of the Board", *Journal of Corporate Finance*, 3, 1997.

These studies are both based on the premise that current stock prices reflect past board behaviour, and not future expectations.

3. On the other hand, Pi and Timme report that banks having non-chairman CEOs with large stock ownership have higher returns on assets³⁹.
4. Further, Rechner and Dalton find that splitting the roles of CEO and Chairman leads to a more effective board⁴⁰.

3.3. Shareholders activism and corporate performance

Shareholder activism as a process for improving board and thus corporate performance has been widely recommended. Pressure has been applied by institutional investors from time to time to improve board structure and achieve board independence.⁴¹ Such activism ultimately improves investor returns; nonetheless, Roberta Romano concludes that such activities have had little or no effect on targeted firms' performance and that investors would be well served if they moved their attention elsewhere. "For a large portion of the governance structures that are the focus of shareholder activism, such as independent boards of directors, limits on executive compensation, and confidential proxy voting, there is a paucity or utter absence of data that demonstrates that such devices improve performance".⁴²

Bernard Black is similarly negative about the impact of investor activism on firm performance, concluding that American shareholder activism to date has had "little

³⁸ B. Ram Baliga, R. Charles Moyer and Ramesh S. Rao, "CEO Duality and Firm Performance: What's All the Fuss?", *Strategic Management Journal*, 17, 1996.

³⁹ L. Pi and S.G. Timme, "Corporate Control and Bank Efficiency", *Banking and Finance*, 17, 1993.

⁴⁰ Paula L. Rechner and Dan R. Dalton, "CEO Duality and Organizational Performance: A Longitudinal Analysis", *Strategic Management Journal*, 12, 1995.

⁴¹ Diane Del Guercio and Jennifer Hawkins, "The Motivation and Impact of Pension Fund Activism", *Journal of Financial Economics*, 52, 1999.

⁴² Roberta Romano, "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance" working paper available via <http://papers.ssrn.com> (2000).

effect on firm performance"⁴³. However, where Romano sees these efforts as ineffective due to the pursuit of unproven and inherently ineffective initiatives to achieve board independence, Black takes the position that ineffectiveness is due to the fact that these initiatives are simply too limited to have any real impact, noting that in general, "they don't conduct proxy fights and don't try to elect their own candidates to the board of directors"⁴⁴.

These legal studies are in contrast to empirical studies on the behaviour of large pension plans. CalPERS and four other similar funds sponsored 18 per cent of all corporate governance proposals submitted between 1987 and 1993. These efforts have had a significant effect on targeted firm governance⁴⁵.

Carleton, Nelson and Weisbach analysed correspondence between TIAA-CREF and 45 firms contacted regarding governance "faults" identified between 1992 and 1996. During this period TIAA-CREF was able, either through private negotiation or proxy vote, to reach agreement with 42 of the targeted companies.⁴⁶

Further evidence exists of the impact of shareholder activism regarding governance issues. The emergence of active institutional investors such as TIAA-CREF is associated with firms reducing board size and the proportion of inside directors.⁴⁷

But this process is aimed at forcing the boards of directors to act, rather than

⁴³ Bernard S. Black, "Shareholder Activism and Corporate Governance in the United States" in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and The Law* (1998).

⁴⁴ Bernard S. Black, "Shareholder Activism and Corporate Governance in the United States" in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and The Law* (1998).

⁴⁵ Diane Del Guercio and Jennifer Hawkins, "The Motivation and Impact of Pension Fund Activism", *Journal of Financial Economics*, 52, 1999.

⁴⁶ Willard T. Carleton, James M. Nelson and Michael S. Weisbach, "The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF", *Journal of Finance*, 53, 1998.

⁴⁷ Yilin Wu, "Honey, CalPERS Shrunk the Board", working paper available via <http://papers.ssrn.com> (2000).

releasing them from management control so that they become independent and active boards.

3.4. The impact of reform efforts on current governance practice

According to Millstein and MacAvoy "the empirical evidence seems to suggest, contrary to Black and Romano, that reform efforts are having some impact on current governance practice. While this does not negate Romano's claim that such efforts have not affected firm performance, a critical evaluation of the studies upon which her opinions are based is warranted. Most institutional investor efforts are conducted in private so that studies of public data are biased, having been based on only those instances where private negotiations failed. In other words, the data is marred by a classic selection bias. And, finally, the empirical research has uncovered some correlation between performance and board activism. For example, Cotter, Shivdasani and Zenner found that tender offer targets with majority outsider boards realized approximately 20 per cent higher stock price returns between 1989 and 1992 than targets without such boards. This finding is ambivalent, since targets with outsider boards should have higher offer prices because they are better managed, but acquirers with strong governance should offer a higher takeover price premium to targets with insider boards for the opposite reason. Shareholders receive a higher premium in management buyouts if the firm has a majority of outsiders on its board. Tender offer bidders with a majority of outsiders on the board earn roughly zero price returns on average, while bidders without such boards suffer statistically significant losses on average. This appears to be because bidders with a majority of

outsiders on the board offer lower takeover premium, thereby preventing a final bid subject to the curse of paying too much.”⁴⁸

Regarding takeover defences, a number of studies find no significant correlation between the proportion of outside directors and the likelihood that the board will engage in takeover defences.⁴⁹ When firms adopt “poison pill” defences, the stock market reaction is significantly positive if the firm has a board consisting of a majority of outside directors, and significantly negative if it does not.⁵⁰ While these findings suggest that shareholders of firms with boards dominated by outsiders fare better in takeovers than those of firms with boards dominated by insiders, there is no convincing evidence that greater board independence (as measured by proportion of insiders to outsiders) correlates with greater firm profitability or faster growth.⁵¹ Further, from 1985 to 1995, low-profitability firms increased the proportion of outsiders on the board; but an increase in the proportion of non-affiliated directors on their boards was not accompanied by improved profitability.⁵² More generally, changes in board composition do not necessarily produce significant changes in firm performance over time, given no significant correlation between board composition and various measures of firm performance.⁵³

⁴⁸ MacAvoy and Millstein (2003) pages 37 and 38.

⁴⁹ Paul Mallette and Karen Fowler, “Effects of Board Composition and Stock Ownership on the Adoption of ‘Poison Pills’”, *Academy of Management Journal*, 35, 1992.

⁵⁰ James A. Brickley, Jeffrey L. Coles and Rory L. Terry, “Outside Directors and the Adoption of Poison Pills”, *Journal of Financial Economics*, 35, 1994.

⁵¹ Sanjai Bhagat and Bernard Black, “The Uncertain Relationship Between Board Composition and Firm Performance”, *Business Lawyer*, 54, 1999.

⁵² Sanjai Bhagat and Bernard Black, “Board Independence and Long Term Firm Performance”, working paper available via <http://papers.ssrn.com> (2000).

⁵³ See Barry D. Baysinger and Henry N. Butler, “Corporate Governance and the Boards of Directors: Performance Effects of Changes in Board Composition”, *Journal of Law, Economics and Organization*, 1, 1985; B.E. Hermalin and M. S. Weisbach, “The Effects of Board Composition and Direct Incentives on Firm Performance”, *Financial Management*, 20, 1991; Hamid Mehran, “Executive Compensation Structure, Ownership and Firm Performance”, *Journal of Financial Economics*, 38, 1995.

Attempts to link specific board governance to corporate performance have thus produced inconclusive results, mainly because these studies have been based on a methodology that links one or very few elements of board structure to measures of corporate performance, such as stock price, or to a single corporate event, such as a CEO firing. The early studies found that the percentage of non-management directors on a board correlated positively with frequency of CEO replacement, and positive response to takeover bids. However, when examined with other factors included, it became difficult to establish such relationships.

3.5. A new approach for determining the effect of “strong governance” on corporate performance

MacAvoy and Millstein claim that no set of structural characteristics of a board can be expected to correlate with better corporate performance without further analysis of its implications for board conduct. Ambivalent results from empirical studies on the link between structural aspects of governance and corporate performance do not however disprove a link between board conduct and investor returns.

They further note that the strategic, managerial, and organizational determinants of corporate performance are complex and interrelated. Merger or acquisition activity may cancel other determinants, such as board activism. An unexpected turn of the business cycle, or changes in product demand, can reverse the performance rating of a corporation in less than a year. Moreover, looking at the corporation from outside, it is difficult to determine whether active boards have actually been making decisions that could improve managerial performance. Given these complications, MacAvoy

and Millstein conclude that it is understandable that previous attempts to determine whether board activism improved performance were inconclusive. Therefore, they have developed a different approach to defining governance conduct and to measuring performance.

In their study they looked at board independence from a behavioural rather than structural perspective.⁵⁴ They started observing that certain changes in board practice brought activism to the boardrooms of some large corporations that focused on processes that monitored and incentivized management to deliver on strategies that enhance returns to shareholders. Although the only certain way to know whether that takes place is to be present in the boardroom, they hypothesized that certain elements of board process indicate that such activism is present: that is, the presence of such process, not structure, can be used to identify reform governance. They identified those boards that embrace a culture of professionalism distinct from management and that have asserted control over processes to monitor and control management. They tested the hypothesis that the existence of those boards can be associated with better management and corporate performance where performance is measured by economic value added (i.e. operating earnings in excess of the costs of capital). Well-governed corporations versus those that do not appear to follow the activist practices and procedures should generate higher economic value added.

They examined 128 large publicly traded US corporations and determined whether the board in each case is active or inactive in the governance process⁵⁵. This sample

⁵⁴ Paul W. MacAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance*, (2003), pages 43-65.

⁵⁵ MacAvoy and Millstein assumed that the board is independent when one of the following indicators is present:

was created by utilizing the responses received by the California Public Employees Retirement System (CalPERS) and CalPERS grading of these responses, to letters it sent to 300 of its portfolio companies asking whether they had board guidelines.

In order to measure performance, they use a form of economic value added, EVA™ “because it provides a metric for a company's ability to ‘generate economic profits and, thereby, create wealth directly for shareholders’. (...) As an indicator of corporate performance, this metric offers a number of advantages” although this measure of corporate performance is also subject to a number of limitations.

Given that board performance is not the sole determinant of economic performance, MacAvoy and Millstein identified the effects of other determinants and attempt to control for them. The most important are the economic performance of a firm's industry and the life-cycle position of the firm within that industry.

They found that “an active board aligned with shareholder interests would attempt to enhance value for shareholders. It is unrealistic to think that singular changes in board structure alone, without accompanying activist practices and policies in place, would make that kind of affect on corporate performance possible. Thus, we have identified a surrogate for board's incentivizing and monitoring management performance in the ‘graded’ responses to the CalPERS survey. Those corporations in which the A+ grade as a surrogate for professional board behaviour was present, had

-
- the presence of independent board leadership, through a non-executive chair or a lead director, able to act without relying solely on initiatives from management;
 - directors meeting periodically without management to provide the opportunity to evaluate management against the plan for corporate performance;
 - the establishment of rules or guidelines establishing an independent relationship between the board and management as to how to conduct the business of the corporation. (*The Recurrent Crisis in Corporate Governance*, 2003, page 45).

superior corporate performance as measured by earnings in excess of costs of capital over the industry average.

There appears to be a substantial and statistically significant correlation between an active, independent board and superior corporate performance. Moreover, we believe that the superior performance is a result of activist corporate governance. However, we recognize that a correlation between governance and performance does not prove causation but, even without proof of causation, it can be inferred that managers willing to assume the risks associated with a professional board are better able to generate higher returns to shareholders. On the other hand, could the causation go the other way? It seems to us less likely that good corporate governance is the choice of managers that on their own initiative have the corporation performing extraordinarily well⁵⁶.

At the conceptual level, a change in governance with the installation of an active, independent board of directors results in a newly refocused management formulating superior competitive strategies and implementing these strategies for better financial results.

In pursuit of causality between governance and economic performance MacAvoy and Millstein have developed the further hypothesis that changes in governance precede changes in economic value added. For the subset of the companies that received an A+ grade in corporate governance, they tried to find for the period 1989-95 an event that initiated a reform in governance practices⁵⁷.

⁵⁶ Paul W. MacAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance*, (2003), pages 62-63.

⁵⁷ Such events, for example, would include

- the discharge of a CEO and then the appointment of a new CEO;
- a restructuring of the board of directors; or

They found that “corporations with better governance systems, A+ graded according to company responses to CalPERS generated significantly more excess returns over the 1990s than similar corporations with not better governance systems. A subset of these better governed corporations after governance reform increased these excess returns. Good governance has improved economic performance where it has been adopted among the largest corporations in the mid- to late 1990s”⁵⁸.

4. The role of fraudulent and misleading accounting in the governance crisis of 2000s

Before assessing the role of governance, it should be asked why there was only limited movement towards universal adoption of governance reform in the last half-decade. For those companies with weak governance, reform promised financial gain. There is a good deal of evidence that well-governed companies are worth more than badly governed companies. McKinsey found that investors were willing to pay 18 per cent more for a well-governed company in the US or UK, 20 per cent more in Germany or Japan and 27 per cent more in Colombia or Indonesia. A study by Gompers, Ishii and Metrick⁵⁹ found US companies with stronger shareholder rights enjoyed higher market to book valuations.

There is also evidence that share prices of well-governed companies tend to perform better over the long run. The Gompers study found that buying companies with the strongest shareholders rights and selling those with the weakest would have delivered

➤ a restructuring of governance in the face of a potential takeover.

⁵⁸ Paul W. MacAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance*, (2003), page 65.

⁵⁹ Paul Gompers, Joy Ishii and Andrey Metrick, “Corporate Governance and Equity Prices”, *Quarterly Journal of Economics*, Vol. 118, Issue 1, February 2003, page 107.

8.5 per cent annual outperformance in the 1990s. A similar result – 12 per cent outperformance for companies with high corporate governance ratings – emerges from a European Corporate Governance Institute working paper on Germany by Wolfgang Drobetz, Andreas Schillhofer and Heinz Zimmermann⁶⁰.

According to MacAvoy and Millstein, “companies could gain more than 200 basis points of annual EVATM by letting independent boards of directors do the task assigned to them in the corporate charter. A ‘governance premium’ could be shared with management in option and stock awards through the increase in share price. Management as well as investors could gain from reform. This inducement is stronger if the management-dominated corporation is only generating average earnings in its industry, and that industry is expanding at 2-3 per cent per year (...). Under such conditions, internal cash flow in a leading company is insufficient to generate investment for expansion at a higher rate than that of the industry. And the greater the opportunity for implementing a superior strategy, especially in a company

⁶⁰ However, the Gompers study measures corporate governance largely on openness to takeover. The evidence for a correlation between share price performance and governance measures such as the size and independence of boards is weaker and more controversial. Dulewicz and Herbert of Henley Management College find that, while splitting the roles of chairman and chief executive improves the performance of UK companies, increasing the number or proportion of non-executive directors leads to worse performance. See Victor Dulewicz and Peter Herbert, “The priorities and performance of boards in UK public companies”, *Corporate Governance: An International Review*, April 1999, Vol. 7, Issue 2, page 178.

Still less obvious is the proposition that targeting companies with corporate governance deficiencies – shareholder activism – delivers value. An activist institution may be successful in forcing companies to change their corporate governance structures. That success will, however, be of merely psychic satisfaction to the institution’s end-investors if it does not translate into improvements in operating performance and share price performance. A 1996 study by Smith found a positive effect on the share prices of companies targeted by CalPERS – but none on their operating performance. A similar study by Sunil Wahal of the targets of nice activist investors, however, found the returns were “approximately zero”.

Yet shareholder activism is expensive. Fund managers have spent heavily on hiring governance experts, yet they might have done better – as Gompers and Drobetz suggest – to have sold the companies whose governance they disliked. And even if activism did deliver returns, these would be shared with other free-riding shareholders.

with a less than compelling previous earnings record, the stronger the case for governance reform”⁶¹.

Nevertheless, the reversal of roles between management and the board of directors requires management to surrender authority⁶².

However, CEOs, as individuals, act in their economic self-interest (otherwise, there is no “agency problem”). The central issue has been to align self-interest with that of shareholders. Jensen and Meckling⁶³ specified the problem in striking detail, that decision rights were controlled by management. The work of numerous analysts has focused on management payment systems that align management incentives to use these decision rights in the interests of investors.

4.1. CEO compensation and corporate performance

The granting of stock shares and options by the early 1990s was seen as the means for aligning managerial with shareholder interests. If corporate executives are major shareholders, then the actions they take to improve share price in their self interest would positively affect all shareholders.

⁶¹ Paul W. MacAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance*, (2003), pages 68-69.

⁶² As reported in Richard M. Clurman's *Who's in Charge?* (1994), Donald S. Perkins, former CEO of Jewel Companies, had a checklist for CEO candidates starting with: “If you had a choice, would you even have a board? Would you tolerate a board strong enough to say no to you and evaluate your performance?” If the candidate provided negative answers to these questions the board would have to give way on governance reform.

⁶³ Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, *Journal of Financial Economics*, 3 (1976), 305-60.

Mehran⁶⁴, in a sample of 153 manufacturing firms in 1979 and 1980, found better returns to equity the greater the percentage of executive compensation based on returns to equity and the greater the percentage of shares held by managers.

With the premise that excessive corporate diversification in the previous decade was the result of managerial control of governance, Denis, Denis and Sarin found a strong negative correlation between diversification and equity ownership of top management.⁶⁵

Moreover, Mehran et al. found, after examining 30 voluntary liquidations from 1975 to 1986, that higher levels of share ownership by management were associated with reductions in diversification. Voluntary liquidation, associated with inefficient diversification, was positively related to the percentage of shares held by the CEO and also positively related to the extent of CEO stock options.⁶⁶

This was not to conclude, however, that new compensation-based incentive plans were sufficient to cause management to undertake strategies solely in the interests of investors. Jensen and Murphy asked whether the impact of management decisions on stock values was of the same order of magnitude as on management compensation. In 1990 they found that CEO wealth changed by only about \$3.25 for every \$1,000 change in shareholder wealth.⁶⁷ Such a trivial change in CEO wealth questioned the effectiveness of this compensation mechanism in generating investor-centred performance. They concluded: "The empirical relation between the pay of top-level

⁶⁴ Hamid Mehran, "Executive Compensation Structure, Ownership, and Firm Performance". *Journal of Financial Economics*, 38 (1995), 163-4.

⁶⁵ David J. Denis, Diane K. Denis and Atulya Sarin, "Agency Problems, Equity Ownership and Corporate Diversification", *Journal of Finance*, 52 (1997), 135-7, 158.

⁶⁶ Hamid Mehran, George E. Nogler and Kenneth B. Schwartz, "CEO Incentive Plans and Corporate Liquidation Policy", *Journal of Financial Economics*, 50 (1998), 320.

⁶⁷ Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top-Management Incentives", *Journal of Political Economics*, 98 (1990), 225, 226.

executives and firm performance, while positive and statistically significant, is small for an occupation in which incentive pay is expected to play an important role". "The relentless focus on *how much* CEOs are paid diverts public attention from the real problem – how CEOs are paid. In most publicly held companies, the compensation of top executives was virtually independent of performance before the early 1990s. On average, corporate America pays its most important leaders like bureaucrats."⁶⁸

4.2. Mechanisms for reforms of management compensation

Jensen and Murphy listed three mechanisms for reform:

1. requiring CEOs to become owners of substantial shares of outstanding stock;
2. structuring salaries, bonuses and stock options to provide not only rewards for superior performance but also penalties for poor performance; and
3. making real the threat of dismissal for poor performance.

In the early 1990s they found that "the realities of executive compensation are at odds with these principles."

Hall and Liebman developed new evidence, however, in the mid-1990s that indicated the growing importance of stock-based incentives. Using data up to 1994, they found that that increased use of stock options resulted in CEO compensation that was much more sensitive to performance.⁶⁹ Where Jensen and Murphy found a small change in CEO wealth for a change in firm value, from a hypothetical executive decision, Hall and Liebman demonstrated that CEO wealth changed "by many millions of dollars for changes in firm value that are not at all uncommon".

⁶⁸ Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay, But How", *Harvard Business Review*, 3 (May-June 1990), 138-53

⁶⁹ Brian J. Hall and Jeffrey B. Liebman, "Are CEOs Really Paid Like Bureaucrats?", *Quarterly Journal of Economics*, 113, 1998.

While stock ownership had become more of an incentive for CEO-shareholder decision alignment, it was not the only incentive to be considered important. Management career advancement tied to performance was thought to be at least potentially effective in motivating managers to work for gains to investors. Fama argued in the early 1980s that financial incentives were not necessary since the managerial labour market disciplined managers through promotions based on performance.⁷⁰

Holmström developed this further, but found that while promotion as a disciplining device could be substantial it was not effective in motivating managers to work hard in later years of their careers.⁷¹ Gibbons and Murphy did not disagree in finding that career enhancement had incentive effects: “the optimal package had to provide a combination of implicit incentives from career concerns and explicit incentives from compensation”.⁷²

In practice, however, companies did not implement the Jensen and Murphy three-part combination in the 1990s.

Hall and Liebman⁷³ note that “relative pay” was not significant so that variations in executive returns had been driven mostly by ups and downs in the stock market. The value of options in the executive compensation package should have been based on how well that corporation's share performed relative to those of counterpart corporations. In general option prices were not adjusted in compensation packages to

⁷⁰ E. Fama, “Agency Problems and the Theory of the Firm”, *Journal of Political Economics*, 88, 1980.

⁷¹ Bengt Holmström, “Managerial Incentive Schemes – A Dynamic Perspective”, in *Essays in Economics and Management in Honour of Lars Wahlbeck*, 1982.

⁷² Robert Gibbons and Kevin J. Murphy, “Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence”, *Journal of Political Economics*, 100, 1992.

⁷³ Brian J. Hall and Jeffrey B. Liebman, “Are CEOs Really Paid Like Bureaucrats?”, *Quarterly Journal of Economics*, 113, 1998.

a market or industry stock price index to eliminate the effects of general price runups. This was an obvious adjustment that boards failed to address. To speculate, if it had been addressed, then the adoption of options tied to firm performance with strike prices net of market fluctuations would have made it more likely that management would not take on high risk projects in an effort to sustain that company's stock price as the market declined.

MacAvoy and Millstein argue that in the 1970s and 1980s, in the so-called "first crisis" in governance, corporate diversification was carried to excessive lengths, at costs to investors that should be designated as a product of the agency problem. A stock ownership plan for managers that faced that problem would have been one that caused management to resist acquiring one more company; as shown by Denis, Denis and Sarin, there was a negative relationship between diversification and equity ownership of officers and directors.⁷⁴ But that relationship was not properly established.⁷⁵ There were possible missteps. There is evidence outsider dominated boards paid CEOs more. One explanation is that companies with strong governance were not allowing management to incur large expenditures on perquisites, from airplanes to corporate retreats, with the result that a package on record had more cash income and bonus but less record non-cash compensation.⁷⁶ However, other studies suggest that measures of board composition, such as the proportion of outsiders, are misleading indicators of whether there is strong governance.

⁷⁴ David J. Denis, Diane K. Denis and Atulya Sarin, "Agency Problems, Equity Ownership and Corporate Diversification", *Journal of Finance*, 52 (1997), 135.

⁷⁵ MacAvoy and Millstein. page 72: "in our personal experience with boards, and particularly compensation committees, management resisted hedging of options in their compensation packages in order to eliminate the effects of stock market wide price changes."

⁷⁶ Richard Cyert, Sok-Hyon Kang, Praveen Kumar and Anish Shah, "Corporate Governance, Ownership Structure and CEO Compensation", working paper, 1997; Brian K. Boyd, "Board Control and CEO Compensation", *Strategic Management Journal*, 15, 1994.

One study looked at the relationship between CEO compensation and the “quality” of board composition, and found that firms with “poor quality” governance tended to pay their CEOs more: that is, CEO compensation increased as the number of directors appointed by the CEO increased, and as the number of directors over the age of 69 and the number of “busy” directors increased.⁷⁷ If this relationship dominated incentive compensation then the process of governance reform was not advancing in the 1990s. Surely, if CEOs were in general paid more in companies with weak governance systems, by amounts that were significant, then reform of governance was firm-specific only.

4.3. CEO firings and stock price reaction

To the same effect, passive boards were slow to fire CEOs, tending to make that decision only after poor corporate performance; in fact, only very poor performance for an extended period of time led to measurably shorter CEO tenure.⁷⁸ Even then, the question was whether firings in the 1990s themselves were an important signal of emergence of strong governance. There have been a number of studies of stock price reaction to announcements of CEO firings: if CEO discharge led to an increase in stock prices then it might be inferred that governance reform was in the process of development. However, the statistical relation between firing and stock price change was difficult to interpret since announcements of discharge convey what is often

⁷⁷ J. Core, R. Holthausen and D. Larker, “Corporate Governance, CEO Compensation, and Firm Performance”, *Journal of Financial Economics*, 51, 1999.

⁷⁸ Jerold B. Warner, Ross L. Watts and Karen H. Wruck, “Stock Prices and Top Management Changes”, *Journal of Financial Economics*, 20, 1988.

conflicting information to investors about the performance of the firm.⁷⁹ Scott and Kleidon develop evidence that investors treated CEO firings as positive, and that they increased share values;⁸⁰ and Denis and Denis find evidence that, on average, firm performance improved after a CEO was replaced. More specifically, they report that forced resignations of top managers followed significant declines in operating performance and were then themselves followed by improvements in operating performance.⁸¹

However, interpreting this pattern of behaviour is problematic when the corporation has a board of directors with a structure implying that it could be active and independent. Weisbach reports that boards with at least 60 per cent non-affiliated directors were more likely than other boards to fire a poorly performing CEO.⁸² Yet others found no significant correlation between board composition and CEO tenure either during the low-merger period of 1989-93 or during the high-merger period of 1983-88.⁸³ But Geddes and Vinod, after controlling for other factors in board composition, found that firms with a higher proportion of outside directors replaced CEOs at a higher rate than other firms.⁸⁴ This reverses the causality between executive turnover and reform governance: if it took strong-form governance to initiate a firing, then a firing does not lead to better governance.

⁷⁹ Sanjai Bhagat and Bernard Black, "The Uncertain Relationship Between Board Composition and Firm Performance", *Business Lawyer*, 54, 1999.

⁸⁰ Kenneth E. Scott and Allan W. Kleidon, "CEO Performance, Board Types, and Board Performance: A First Cut", in Theodore Baums et al. (eds), *Institutional Investors and Corporate Governance*, 1994.

⁸¹ David J. Denis and Diane K. Denis, "Performance Changes Following Top Management Dismissals", *Journal of Financial Economics*, 50, 1995.

⁸² See Michael S. Weisbach, "Outside Directors and CEO Turnover", *Journal of Financial Economics*, 20, 1988.

⁸³ Wayne H. Mikkelson and M. Megan Partch, "The Decline of Takeovers and Disciplinary Managerial Turnover", *Journal of Financial Economics*, 22, 1997.

⁸⁴ Richard Geddes and Hrishikesh D. Vinod, "CEO Age and Outside Directors: A Hazard Analysis", *Review of Industrial Organization*, 6, 1996.

These mixed findings regarding the performance of governance systems can be supplemented by evidence that incentive structures have been important with regard to board decision-making, particularly on CEO firings. The greater the dollar value of outside directors' equity holdings, the more likely it was that CEO turnover took place in a poorly performing company.⁸⁵ Further, when directors had incentive-based compensation, and ongoing performance of the firm was poor, then the likelihood of CEO turnover was greater.⁸⁶

Farrell and Whidbee find that while some directors were likely to leave, following the removal of a poorly performing CEO, those outside directors with substantial stock ownership and no close ties to the outgoing CEO tended to stay on the board.⁸⁷ To explain this phenomenon, they observe: "Removing a poorly performing CEO... is one of the most observable signs that outside directors can send to shareholders and labor markets about their effectiveness as directors."

What follows is that strong boards instituted incentive systems for management with new emphasis on options and shares, and these strong boards evaluated the results of operations so as to lead to the discharge of managements that performed poorly. But weak boards also did some of the same, except they probably over-compensated management. The most acceptable way of doing so was with excessive options, a highly desirable result for the recipients in a fast-rising stock market where options receive the full benefit of the market increases. Weak boards also did, indeed, fire

⁸⁵ Sanjai Bhagat, Dennis C. Carey and Charles M. Elson, "Director Ownership, Corporate Performance, and Management Turnover", *Business Lawyer*, 54, 1999.

⁸⁶ Tod Perry, "Incentive Compensation for Outside Directors and CEO Turnover", paper available via <http://papers.ssrn.com> (2000).

⁸⁷ Kathleen A. Farrell and David A. Whidbee, "The Consequences of Forced CEO Succession for Outside Directors". *Journal of Business*, 73, 2000.

managers but frequently with full retirement compensation and too late to be of benefit to the performance of the corporation.⁸⁸

Whether incentive systems for management to bring performance in line with investors interest were generally effective cannot be determined, but the levels of options and shares in compensation packages were out of line by the end of the decade.

The general position of those seeking reform in governance was to seek linkage of executive pay incentives to corporate performance through more options and shares. There was increased external pressure to discharge CEOs in poorly performing companies, which brought about more managerial turnover and more change to a strong form of governance. But the strongest evolutionary process was the shift to stock prices to reward performance as options became the dominant element in executive compensation. The attention of senior management, particularly those with a five-year time frame, focused on when the stock price would be at its highest and what to do to prolong the period in which it was at that level.

This evolutionary process went off track in the second half of the 1990s given how “cheap” options became in rising share markets. The relative performance of a corporation to its competitors was lost for determining rewards in the compensation package. As a result performance took on new elements of risk in the largest corporations: as managements carried out complex financial transactions to take positions on future earnings that enhanced share prices. Management also used its

⁸⁸ Paul W. MacAvoy and Jean W. Rosenthal, *Cost Containment Strategies and Nuclear Plant Safety: The Experience at Northeast Utilities* (forthcoming), quoted by MacAvoy and Millstein (2003), page 75, footnote 33.

large degree of freedom in reporting earnings from period to period to enhance share price. With the guidance of the “gatekeeper” – the outside auditor – transfers of previous revenues from reserve accounts to current period operating revenues allowed “smoothing” of income within a very wide range. Current payments for services were booked as operating costs or investments, whichever provided more support for a positive income statement. If a down period was in the offing, management reduced reserves for an additional year of earnings to be capitalized in share price.

Of course, to do all this was not a straightforward exercise. The extremes are taken as misleading the investor for the sake of propping-up current share price. The board of directors in a strong governance regime would decline to undertake much of this exercise on the grounds that the audit committee should not approve any such procedures for which it would be censored by investors at a later date. The gatekeeper may find that this range of applications of “managed earnings” practice not consistent with generally accepted accounting practice. But the passive board and conflicted auditor had the tendency to go along with broader accounting “smoothing” initiatives from a management that had become focused on extending the current high stock price for just one more full accounting cycle.

4.4. Financial engineering at Enron and the implications for standard setters

The recent history of Enron, its collapse amid allegations of executive greed and corruption and the subsequent fallout in terms of investigation and regulatory response have been extensively documented. However the focus has been on the more newsworthy aspects of the saga, the appearance of top management at Senate

and Congressional hearings, the demise of Enron's auditors Andersen following their prosecution for the destruction of documents, the arrest of key executives on charges of fraud, rather than on the implications for accounting and financial reporting of the manner in which Enron systematically manipulated the picture shown in its financial statements. In part this is because the knowledge of the manipulations is not complete and in part perhaps inevitably because technical accounting issues are of less general interest than failings in corporate governance, inflated executive compensation packages, and allegations of theft and malpractice. However, the accounting practices are inextricably tied up with the history of Enron enabling and facilitating its exponential growth in the 1990s and for a time allowing it to stave off what was, with hindsight, its near inevitable collapse.

In this section I will focus on certain aspects of Enron's accounting which allowed it to maintain growth in earnings per share and retain its credit rating. I seek to place these accounting issues within a wider framework both conceptual and in terms of the practical considerations confronting standard setters.

Borderline accounting procedures were used to sustain the level of revenues and income reported on financial statements in a period when managements were redeeming their personal holdings of options, leaving shareholders to sell later after reporting had been corrected and share prices had fallen.

This section is organised as follows. Following a brief historical introduction, certain distinctive features of Enron's accounting are reviewed, in particular:

- the use of mark to market accounting;
- the use of non-consolidated entities to keep assets and liabilities off balance sheet;

- the recognition of revenue from sales to structured finance entities;
- the recognition of revenue and cash flows from artificial 'sales' to compliant financial institutions;
- the transactions between Enron and a number of non-consolidated entities designed to maintain earnings in the final two years before the collapse.

The accessible public record as to the accounting detail has emerged somewhat unevenly. The Powers report published in February 2002 extensively documented a number of the transactions between Enron and certain of its exotically named special purpose entities (SPEs), for example Chewco, the Raptors, LJM1 and LJM2. However, the focus was on investigation of specific transactions which impacted earnings and in particular those which enabled certain individuals to benefit improperly therefrom. Similarly the SEC litigation with respect to Andrew Fastow, Enron's erstwhile CFO focuses only on those transactions where it alleges personal impropriety. It is only with the release of the second interim report of the Examiner in Bankruptcy that we have a much more complete picture of the extent to which Enron went to manage its earnings, cash flows and key credit ratios for the immediate purpose of maintaining both its stock price and its investment grade credit rating. This report is complex and voluminous running to over 2000 pages including the Appendices and in the attempt to highlight certain aspects in this section some of the detail will inevitably be lost and some aspects omitted - for example the means whereby Enron was able to show such a low taxation charge in its reported financial

statements (and also to generate pre tax income by manipulation of the US rules relating to taxation and to business combinations⁸⁹).

Background

As noted above, the history of the growth and fall of Enron is now familiar territory and consequently it is necessary to trace it only in outline here. Until its spectacular demise Enron was one of the fastest growing and apparently most successful US corporations. It was formed by merger in 1985 its core business then being the transportation of gas by pipeline. In the late 1980s and early 1990s Enron began to take advantage of the deregulation of the utilities industries to participate in and promote markets for the supply of oil and gas. It also expanded worldwide into the UK and Europe, South America and India. In the late 1990s the primary engine of Enron's growth and apparent profitability was what was termed in the corporation's financial statements as 'wholesale services'.⁹⁰ These included not only the buying and selling of contracts for the supply of power but also strategic investments, whether from start-up or by acquisition, in energy and technology related businesses. Unfortunately Enron's operating performance came under pressure because of increased competition in the market for future contracts and also because many of its overseas projects were unsuccessful. As one analyst put it (ex post): "All of the attempted diversifications proved to be fiascos. By 2000, Enron ended up with \$10-\$15 billion (about one-third) of its real asset base mostly dead in the water."

⁸⁹ Senator Max Baucus the ranking democrat on the Joint Committee of Taxation which reported on 13 February 2003 stated that the report paints 'a sordid picture of Enron's accounting practices, tax structures and executive compensation.'

⁹⁰ Income (before interest, minority interests and taxes) from Wholesale Services rose by 133% from \$968m to \$2,260m between 1998 and 2000 whereas income from gas transportation and electricity generation combined increased just 15% from \$637m to \$732m.

Although the rapid appreciation of many of its 'hi-tech' investments allowed Enron to mask this lack of success elsewhere, when the hi-tech bubble burst Enron suffered accordingly. From a high of \$90 in August 2000 there was a slow but persistent slide in its share value prompted by concerns as to the quality of Enron's earnings and the solidity of its balance sheet, and no doubt exacerbated by significant stock sales by senior executives. This became a headlong fall after the resignation of the CEO in August 2001, followed by the reporting of a \$618m quarterly loss in October 2001, the news that the SEC was investigating possible conflicts of interests, and the admission in November 2001 that profits had been overstated by \$600m since 1997. The associated adverse publicity led to increased margin calls by counterparties to its trading contracts. Haemorrhaging cash and having failed in its attempt to merge with its smaller Houston based competitor Dynegy Enron filed for bankruptcy on 2 December 2001.

Mark to market accounting

'Mark to market' accounting involves recording assets at fair values in the balance sheet with any corresponding gains and losses being taken to the profit and loss statement. In its extreme form in which all assets and liabilities are valued at market value with associated gains and losses being taken through the profit and loss account it is equivalent to measures of economic income based on maintaining capital values measured in terms of net present value of future cash flows. Whereas the US has traditionally been seen as a champion of historical cost accounting in the 1990s mark to market accounting became increasingly prevalent. Enron, and in

particular Jeff Skilling the man credited with masterminding the transformation of Enron from a pipeline operator into an innovative creator and operator of energy and commodity markets, lobbied hard to be allowed to use mark to market accounting in relation to its contracts for future supply of energy.

In 1992 Skilling (later CEO) succeeded in persuading federal regulators to permit Enron to use mark to market with respect to its natural gas trading - which was not previously permitted for energy companies. His reaction was reported thus: "He won approval over the objections of some SEC staffers. That day he gave an elated shout and a cheer went up in the office"⁹¹.

Through the 1990s Enron, without further reference to the SEC, extended its use of mark to market to cover its other commodity trading activities, investment partnerships, its own 'merchant investments' (for example holdings in new or start up ventures), and non-commodity trading. By the end of 2000 approximately 35% (\$22.8 billion) of Enron's reported \$65.5 billion of assets were accounted for on a mark to market basis. Although the majority of these assets within its price risk management book were effectively hedged by offsetting liabilities, where markets were thin or where Enron was participating on both sides of the transaction the scope for generating earnings by means of inappropriate valuations was clear and indeed as a former Enron trading software manager noted after the collapse: "When we marked to market, we were truly controlling our revenue. That was how your business model was set up said.... You could always meet [Wall Street's] expectations."

⁹¹ <http://www.washingtonpost.com/ac2/wp-dyn/A14229-2002Jul28?start=27&per=27>

The Enron financial statements disclosed the extensive use of mark to market accounting in the accounting policy notes both with relation to trading activities – which Enron termed price risk management activities - and in relation to investments held with a view to subsequent disposal which Enron termed merchant investments. With reference to price risk management the relevant note in the 2000 annual accounts stated⁹²: “Enron engages in price risk management for both trading and non-trading purposes. Instruments utilized in connection with trading activities are accounted for using the mark to market method...

Changes in the assets and liabilities from price risk management activities result primarily from changes in the valuation of the portfolio of contracts, newly originated transactions, and the timing of settlements relative to the receipt of cash for certain contracts. The market prices used to value these transactions represent management’s best estimate. But it does appear that Enron used mark to market in relation to trading contracts in a manner a long way removed from that traditionally associated with broking houses dealing in securities in deep and highly liquid markets, and in a manner much closer to an economic income perspective in which assets of all types are valued on the basis of the present value of their prospective associated cash flows. This inevitably entailed the use of management forecasts and valuations, frequently supported by opinions obtained from large accounting firms. The accounting policy note with reference to merchant investments makes clear this reliance upon a range of valuation methods: “The merchant investments made by Enron and certain of its unconsolidated affiliates...are carried at fair value and include public and private equity, government securities with maturities of more than

⁹² <http://www.enron.com/corp/investors/annuals/2000/ar2000.pdf>

90 days, debt and interests in limited partnerships. The valuation methodologies utilize market values of publicly-traded securities, independent appraisals and cash flow analyses.”

Examples of the manner in which the use of mark to market accounting exposed Enron to significant volatility in its income statement and also of the manner in which Enron used mark to market accounting to generate earnings and, in association with the use of structured finance vehicles, operating cash flows abound and some are detailed below.

Many of Enron’s investments in new start up ventures were initially highly successful in the heady days of the hi-tech boom. For example in March 1998 Enron invested \$10m buying 5.4m shares at \$1.85 each in a privately held internet service provider Rhythym Net Connections. Rhythyms went public on 7 April at \$21 a share and by the end of the trading day the shares had reached \$69. In May 1999 Enron’s holding was worth \$300m and was marked to market accordingly (although Enron were locked-in to the end of the year)⁹³. The Powers report documents other such investments, for example Avici and The New Power Company, where prices rose and then fell at an alarming rate and it was the desire to lock in the mark to market gains on these ventures which led to many of the transactions with hand picked SPEs, transactions of which the Powers report was highly critical and which are discussed further below.

An example of recognition of income with regard to a standard trading contract, but one in which Enron was effectively participating in both sides of the deal may be seen in the contract relating to the future supply of natural gas to the Cuiaba power

⁹³ Powers report page 77.

station in Brazil, a power station in which Enron held a 65% interest. Deconsolidation of this interest⁹⁴ enabled Enron to record mark to market revenue of \$34m and \$31m in the third and fourth quarters of 1999 in relation to its gas supply contract, notwithstanding that the building of neither the power station nor the pipeline supplying the gas had been completed.⁹⁵

Another example, which illustrates, in slightly unusual circumstances, the greater willingness of Enron to employ mark to market accounting when it resulted in increases in asset values and earnings than when the opposite applied may be seen in the accounting for Enron's 50% interest in a merchant investment fund JEDI held since 1993 and accounted for on an equity basis. JEDI used mark to market accounting for its investment holdings from 1996 onwards and this meant that changes in their value were directly recorded in the income statement of Enron. JEDI held 12 million shares in Enron and as these rose in value the Enron income statement benefited accordingly. For example in the first quarter of 2000 Enron recorded \$126m from the appreciation of its own stock held by JEDI. Generally accepted accounting practice normally does not permit entities to show gains from the appreciation of the value in their own stock and consequently perhaps as a result of pressure from the auditors the decision was taken (apparently in the first quarter of 2000) that in future such gains would not be recorded. This decision appears to have been implemented in the first quarter of 2001 when, according to the Powers report Enron would have been required to record a loss of \$90m as a result of the decline in value of its shares. It is suggested that on the advice of Andersen this loss was not

⁹⁴ Further details of the manner by which this deconsolidation was achieved are given below.

⁹⁵ Powers 2001 page 137.

recorded on the grounds as the intention was not to record increases then decreases should not be recorded either. Perhaps with some understatement the Powers report concluded: "We do not understand the basis on which Enron recorded increases in value of Enron stock held by JEDI in 2000 and prior years, and are unable to reconcile that recognition of income with the advice apparently provided by Andersen in 2001 concerning not recording decreases in Enron stock value."⁹⁶

A final example, documented in the Bankruptcy Examiner's report, illustrates the lengths to which Enron went as its financial circumstances worsened to recognise income and cash flows via marking to market.

In July 2000 Enron announced a 20 year exclusive deal with Blockbuster, an entertainment company, to supply videos on demand. As the Examiner's report notes this announcement was aspirational in nature as Enron did not have the technology to deliver videos on demand on a commercial basis and Blockbuster held no rights over such videos. Notwithstanding this a 45% interest in the contract was sold, via a subsidiary, to an unconsolidated SPE for \$57m based on an Andersen supplied valuation for the contract of \$120-150m. This enabled Enron to recognise \$53m in earnings and \$57m in operating cash flow.

In March 2001 the exclusive agreement with Blockbuster was terminated and a new press announcement as to an intention to initiate discussions with various parties for the purpose of delivering movies, games, television programming and music via the Enron Intelligent Network. Although the 45% interest had been sold to the SPE,

⁹⁶ Pages 59-60.

Enron had executed a total return swap which entitled it to all the future proceeds from the activity sold. Enron marked this swap to market (thereby effectively continuing to mark to market the 'sold' asset within its accounts). On the basis of this announcement this swap was written up by a further \$58m. Based on initiating discussions on wider access to the 'Enron platform' the total return swap within the FAS 140 structure was written up by a further \$58m. Again this swap was 'monetised', i.e. it was 'sold' to another unconsolidated SPE on a similar basis to which the original asset had been sold, thereby enabling income and cash flow of \$58m to be recognised. No contracts for the delivery of movies, games, television programming or music emerged and by late summer 2001 Enron decided to shut the business down. As the Examiner in bankruptcy noted:

Thus, within the space of about one year, this investment which resulted in Enron reporting \$111 million of gain and \$115 million of funds flow from operations in the fourth quarter of 2000 and the first quarter of 2001, proved to be worthless.⁹⁷

Revenue Recognition and Cash Flow

Enron's rapid expansion made it a voracious consumer of cash. Furthermore the extensive use of mark to market accounting, whereby revenues were normally recognised ahead of the anticipated cash flows, meant that, without careful management, a significant gap would develop between reported earnings and cash flows which would in turn impact analysts' and credit rating agencies' perceptions. One means of closing this gap was to monetise assets by means of 'sales' to debt financed SPEs in circumstances in which the debt was directly or indirectly the

⁹⁷ Page 32

responsibility of Enron (and in which Enron retained the risks and rewards of ownership of the asset) thereby changing cash flows from financing activities into cash flows from operating activities.⁹⁸ Another was to enter into the forward sale of commodities to entities associated with investment banks together with an associated contract to buy back the commodities from the banks on terms which effectively ensured the bank a rate of return on the transaction equivalent the appropriate rate of interest on borrowing. The importance of these contracts to Enron can be gauged by the following excerpt from the report of the Bankruptcy Examiner: “Perhaps more than any of the six techniques, prepays were the quarter-to-quarter cash flow life blood of Enron. Through their use, Enron recorded \$4.016 in borrowing at 31 December, 2000 as liabilities from price risk management activities rather than debt. But perhaps more importantly, the prepays accounted for \$1.527 billion, or over 50%, of Enron’s reported 2000 funds flow from operations.”

The prepay contracts involved a sale of gas or electricity for delivery at a future date by Enron to a SPE set up by a financial institution. Payment would be received in advance the SPE receiving the funds from the financial institution on account of its own prepaid forward contract with the bank. Enron and the financial institution would simultaneously enter into derivative contracts whereby Enron would agree to pay a fixed price for the amount of the commodity that it had agreed to deliver to the SPE, plus an interest factor, in exchange for the financial institution’s agreement to pay the market price for the commodity at the times of the scheduled deliveries under Enron’s prepaid forward contract with the SPE. As the Bankruptcy Examiner noted: “Neither Enron, the bank nor the SPE had the risk of price fluctuation on the

⁹⁸ As in the Blockbuster example above.

commodity. Enron was exposed to a floating price risk, having agreed to deliver the commodity to the SPE at specified times in the future, but had eliminated that risk by agreeing to receive the floating price from the bank in exchange for a fixed price. The bank had no commodity risk because, while it was to receive the floating commodity price from the SPE, it had eliminated the risk by agreeing to receive a fixed price (plus an interest element) from Enron in exchange for giving Enron the floating price. The SPE had no commodity price risk because it simply passed what it received from Enron to the bank.

Although the individual transactions between Enron and the SPE and the financial institution may appear to have involved the assumption of risk and could therefore be categorised as price risk management activities clearly viewed in their entirety because of the circular nature of the transactions this apparent assumption of risk was entirely illusory. The importance of these transactions to Enron can be seen in the fact that between 1992 through 2001 at least \$8.6 billion in cash was obtained through these transactions of which over \$5 billion was still outstanding at end June 2001. The transactions produced operating cash flow equal to virtually all Enron's net operating cash flow in 1999 and 32% of its net operating cash flow in 2000.

The manner in which these contracts were seen both within and outside Enron may be gauged from the perception of William Brown, an operating officer with lead responsibility for setting up two of the contracts to a value of \$1.132 billion, that the amount of any given prepay transaction was determined by the targeted cash flow Enron wanted to show the rating agencies, that of Andrew Fastow, Enron's Chief

Financial Officer, that the prepay transactions were a device to bring cash forward to match earnings, and that of a managing director at one of the counterpart financial institutions involved that these transactions were giving 'oomph to revenues'.

These prepay transactions appear to have been primarily for the purpose of raising cash without it being reflected as financing in the cash flow statement and as long term debt in the balance sheet rather than to manage earnings. However, in circumstances in which Enron was unable to use mark-to-market accounting (or perhaps when it would be difficult to justify the valuation) required then Enron appears to have been prepared to enter into arrangements whereby assets were 'sold' to friendly financial institutions on the basis of guaranteed subsequent repurchase. One such scenario detailed in the SEC complaint against Andrew Fastow was that relating to the 'sale' of a share in three power generating barges which Enron owned in Nigeria and which had a contract to provide energy to the Nigerian government. After failing to negotiate a commercial sale the SEC allege that Enron, through Andrew Fastow and the Treasurer, approached a financial institution which was accustomed to do business with Enron and 'pressurised' it to purchase a \$28m share allowing Enron to record \$12m revenue in its results for the fourth quarter and also to show \$28m as funds flow. In fact the financial institution was only required to invest \$7m the remainder being provided by an interest free loan from Enron. The SEC allege that to induce the financial institution to invest the money Fastow guaranteed that they would not lose money and would be taken out of the deal within six months. They were to receive an up-front fee of \$250,000 and a 15% annual return on the money invested.

Notwithstanding an internal memorandum expressing concern that to enter into the transaction proposed could be construed as aiding and abetting in the fraudulent manipulation of Enron's income the financial institution went ahead with the deal. Six months later its interest was duly purchased on the basis of the agreed terms by LJM2 an Enron SPE set up by Fastow and with which the SEC allege that there was an agreement whereby any losses incurred in consequence of its dealings with Enron would be offset by gains on other deals.⁹⁹

Non-consolidation and Special Purpose Entities (SPEs)

In common with many other US companies Enron had significant prior experience with the use of SPEs, taking advantage of the greater freedom and discretion they allowed with regard to reporting earnings and also enabling large amounts of debt exposure to be kept off balance sheet thereby improving Enron's gearing ratios. The initial justification for the use of the off balance sheet entities was the high asset intensity of Enron's projects in relation to power stations, pipelines etc and the slow build up of earnings from these projects. Keeping them on balance sheet would both show lower returns on invested capital and put at risk Enron's all important investment grade credit rating. However, over time Enron expanded its use of SPEs to involve them in a variety of transactions including the sale and leaseback of property and other assets and also the hedging operations referred to below.¹⁰⁰

⁹⁹ More precisely the allegation is that the agreement spanned the three LJM entities.

¹⁰⁰ Powers report page 36.

The use of such off balance sheet financing became commonplace in corporate America in the 1990s but Enron were extremely aggressive in their use of SPEs. Apparently at the time of its collapse Enron had approximately 3,500 off balance sheet vehicles in existences - nearly ten times as many as any other large US corporation – and very substantial amounts of assets and liabilities were being kept off balance sheet. At the annual meeting of one such SPE a graph was presented showing the growth in total assets of Enron as revealed in its annual reports from 1991 to 1999 and the combined total of assets of Enron and its unconsolidated affiliates. This graph shown as Appendix 1 shows that whereas reported assets rose from just under \$10 billion in 1991 to rather more than \$33 billion in 1999 the combined total rose from just under \$14 billion to a little more than \$60 billion over the same time period.

The majority of these SPEs were debt financed and a presentation made by Enron to its bankers late in 2001, as it struggled to raise the funds to avoid bankruptcy, showed additional debt of \$25 billion as compared with the balance sheet figure of \$13 billion making \$38 billion in total. This was analysed as follows:

Category of debt	Amount as at 30 September 2001
	\$ million
FAS 140	2,087
Minority interest	1,690
Prepays	4,822
Share trusts	3,352
Equity Contracts	304
Structured asset	1,532
Unconsolidated affiliates	10,733
Leases	<u>596</u>
Total	25,116

Not all of this debt was necessarily at recourse to Enron – although a great deal of it was – but clearly the use of SPEs contributed significantly to the ability of Enron to keep assets and debt off its balance sheet.

The growth in the use of SPEs and in particular those which were highly debt financed, followed, and perhaps to an extent led, an evolution over time in SEC staff practice which allowed the presumption that ‘better’ financial reporting required consolidation of such entities to be over-ruled in circumstances where a ‘substantial’ capital investment by independent owners was at risk – three percent of the total capital being the minimum acceptable – and where the independent owner exercises control. In practice Enron designed the structure of a number of its SPEs to be at the very border of acceptable practice both in terms of the 3% rule and also in terms of the highly subjective issue of where control actually lay. An example of the nature of such an SPE can be seen in the construction of Chewco a partnership formed in 1997

to buy out Calpers 50% interest in JEDI. A simplified version of the Chewco structure is set out below¹⁰¹:

	\$m	\$m
Asset 50% holding in JEDI at cost		383.5
(the remaining 50% of JEDI was owned by Enron)		
Liabilities:		
Bank loan (from Barclays) guaranteed by Enron	240	
Loan from JEDI	<u>132</u>	
		<u>372</u>
		11.5
Equity		11.5

The equity was owned by partnerships controlled by Michael Kopper and his partner. Michael Kopper was at that time an Enron employee and subordinate of Andrew Fastow Enron's CFO. However, Kopper and partner only contributed approximately \$125,000 the remaining \$11.4m of the funding of the partnerships came from Barclays by means of a financial instrument designed so as to appear as debt in Barclays' books and equity in Chewco's.

In fact, for reasons which are not clearly explicable, Enron failed to actually comply with three percent rule, perhaps marginally arithmetically¹⁰², but more substantially because a guaranteed deposit retained by Chewco meant that only approximately half of Barclays 'equity' investment was at risk. It was the realisation that the structure did not comply with even the minimum acceptable requirements which caused the

¹⁰¹ For a more detailed description of the formation and ownership structure see Powers (2001) pages 44-54.

¹⁰² Powers (2001) page 52, footnote 12.

restatements following retrospective consolidation of both Chewco and JEDI in November 2000.

However even where the venture was more conventionally structured Enron operated at the edge of what would appear to be acceptable accounting practice. The mark to market gains recorded on the supply of natural gas to the Cuiaba power station could only be realised if Enron deconsolidated its interest in the power station project – a project in which Enron owned 65% of the equity and had the right to nominate three of the four directors. In order to achieve this in September 1999 Enron sold 13% of its interest and gave up the right to nominate one director to LJM a partnership managed by Andrew Fastow.¹⁰³ LJM did not take up the right to nominate a director purportedly because of fears as to potential liability attaching thereto. Although Enron retained a majority shareholding it argued that it did not have control on the grounds that if the nominee of its Brazilian partner – with whom it was apparently in dispute - declined to attend board meetings there was no quorum and therefore Enron was unable to direct the activities of the company.

Raptors

The transactions which Enron entered into with certain of its SPEs during and after the hi-tech bubble are central to the Powers report and are extensively documented therein. These were entered into primarily to lock in mark to market gains achieved as the price of certain assets owned by Enron soared and as far as was possible to protect Enron when values began to fall inexorably. Essentially Enron would fund

¹⁰³ This sale was however accompanied by an oral agreement to repurchase the stake from LJM at a profit if necessary and in August 2001 Enron did indeed repurchase the 13% interest for \$13.75m as compared with the original purchase price of \$11.3m notwithstanding that the market value of the project had declined in the meantime. (SEC)

SPEs with its own stock or rights to future stock at a discount and the SPEs would write various forms of options or hedges on the volatile assets owned by Enron. In the case of the Raptors the usual form of derivative was a 'total return swap' whereby if the price of the underlying asset went up the gain went to the SPE and if the price went down the loss fell on the SPE. Three of the four Raptors were funded with rights to purchase its own stock held by Enron which were provided to the SPE at a discount. One of the Raptors was funded with stock of the entity which the Raptor was set up to price protect.

Conducted on an arms length commercial basis with suitably capitalised entities these transactions would have been unexceptionable. In fact the Powers report details a number of aspects of the transactions indicating that the terms were not at arms length and, according to the SEC, in part fraudulent as profits were skimmed off by Fastow and his associates. However, as the price of Enron stock began to fall in late 2000 the main concern for Enron was whether the SPEs in question – which had very little, if any, genuine outside capital - had the credit capacity to perform on their contractual obligations. Enron's initial response was to provide the first Raptor (which held derivative contracts with a notional value of \$734m) a costless collar on the Enron share price whereby any gains on its holding above a certain price level, \$116, would revert to Enron but if the Enron share price fell below \$81 the loss would fall on Enron not the SPE. Similar arrangements were made with the two other Raptors funded by Enron stock.

By November 2000 Enron had entered into derivative contracts with three of the Raptors amounting to \$1.5 billion and at the end of 2000 the value to Enron of the

swaps was slightly over \$500 million (offsetting corresponding mark to market losses on the underlying assets). As at the year-end two of the Raptors had negative credit capacity and in order to avoid having to make a provision, Enron arranged a 45 day cross guarantee agreement essentially merging the credit capacity of all four Raptors.

In the first quarter of 2001 the situation continued to deteriorate and an additional concern was that the rights to the stock that had previously been sold to the Raptors was conditional upon the Enron share price being above \$50 on 31 March 2003 not much below the \$55 at which Enron shares were trading late in March 2001. Faced with a potential provision of \$504m, Enron engaged in a restructuring of the Raptors. This entailed an agreement to provide up to 18m shares to the Raptors if necessary to make up for any shortfall, in return for which notes payable by the Raptors to Enron increased \$260m, and by the sale of Enron shares, to be delivered in four years time at a discount of 23% to the market price at the time of sale, in return for which notes payable by the Raptors to Enron increased \$568m. In the outcome Enron provided only \$36m in its first quarter accounts. It was not until the third quarter of 2001 that Enron recognised the failure of the Raptors scheme as an economic hedge and reported a \$710m pre tax loss relating to the Raptors. As the Powers Report noted: "Enron's use of the Raptors allowed Enron to avoid reflecting almost \$1 billion in losses on its merchant investments over a period spanning just a little more than one year¹⁰⁴ (from the 3rd quarter of 2000 through to the 3rd quarter of 2001)".

¹⁰⁴ Page 132.

The overall impact

The combined effect of the mixture of artificial transactions and accounting practice designed to test the very limits of GAAP can be seen in the estimates made by the Bankruptcy Examiner of the extent to which the various transactions under investigation distorted earnings, cash flows and balance sheet recognition of assets and liabilities in the final set of audited accounts prepared by Enron:

	Net Income	Funds flow from Operations	Total Assets	Debt
As reported	<u>\$979.0</u>	<u>\$3,010.0</u>	<u>\$65,503.0</u>	<u>\$10,229.0</u>
Adjustments for:				
FAS 140 transactions: (‘sale’ of assets to unconsolidated SPEs)	(351.6)	(1,158.3)	812.5	1,353.4
Tax transactions	(269.1)	(60.6)		
Non-Economic Hedges	(345.7)		(867.0)	(150.0)
Share Trusts (non- consolidation vehicles)	29.7	(418.0)	(4,178.0)	4,871.0
Minority Interests (debt represented as minority interest)				1,740.0
Prepay transactions		1,527.0		4,016.3
Total adjustments	(936.7)	(3,163.9)	(4,123.5)	11,830.7
Total after adjustments	\$42.3	(\$153.9)	\$69,626.5	\$22,059.7
Adjustment as % of amount originally reported	(96%)	(105%)	6%	116%

Implications for accounting standard setting

The examples given above are illustrative of the manner in which Enron sought to manipulate its earnings, cash flows and the gearing picture shown in the balance sheet. Some would argue that Enron was an isolated example but although it may have been extreme in its use of financial engineering there is a wealth of evidence that suggests that for many other US corporations financial statements were seen as a means to satisfy the expectations of analysts and credit rating agencies rather than as

an attempt to provide meaningful information to investors and the capital markets more generally. Such evidence may be found in the string of SEC litigation releases many of which focus on revenue recognition issues. It may also be found in the willingness of financial institutions to offer advice or participate in schemes designed to enhance earnings or to improve balance sheet presentation but for which there was an economic cost in terms of negative cash flows¹⁰⁵. The implications of the widespread use of financial engineering under a financial accounting regime which has for many years taken pride in having the most detailed and stringent accounting standards in the world – as evidenced by the requirement for foreign corporations listed on US stock exchanges to produce statements reconciling their financial numbers to those that would hold under US GAAP and by the reluctance of IOSCO, the international body representing security exchanges – are considerable. Here we shall briefly consider two aspects of US standard setting which may be seen to have facilitated such manipulations in particular the use of mark to market accounting and the reliance on a rules rather than a principles based accounting standards regime.

Mark to market. The debate as to the use of mark to market or fair value accounting in the balance sheet and the related issue of how to report gains or losses arising from such accounting treatment is long standing, ongoing and extensive and it is not the intention here to rehearse the arguments for and against in detail. As the Bankruptcy examiner noted the issues raised by Enron are more practical than theoretical in nature: “In fact the proper use of MTM [mark to market] accounting for assets and

¹⁰⁵ A striking example of this is the \$73m in fees (\$40m to Bankers Trust) and \$131m in taxation which it would not otherwise have paid which Enron incurred by means of the use of essentially artificial taxation related transactions in order both to create pre tax income and to reduce the deferred taxation.

liabilities subject to frequent price fluctuation, and related disclosures of value at risk, arguably, provides more relevant and reliable information than would historical cost. Setting aside valuation abuses, the problem was not that Enron used MTM accounting but rather that Enron resorted to financial engineering to address the effects of MTM accounting.”

Enron justified its initial use of mark to market accounting to the SEC on the grounds that trading in natural gas futures was directly analogous to the work of a broker or trader in financial futures and that consequently it was appropriate to use mark to market accounting. However, problems arose when Enron extended mark to market to cover activities in markets which were incomplete and in situations where the parties making the trade were not necessarily at arms length – as for example in the Cuiaba project in which Enron was essentially negotiating both sides of the deal. Although, as in the Braveheart transaction, Enron frequently sought to obtain valuations or appraisals of future cash flows to support its mark to market practices (normally from accounting firms or their consultancy arms the Bankruptcy examiner was critical of these valuations. For example in the Braveheart transaction the Andersen valuation and the use to which it was put was referred to in the following terms: “While a venture capitalist might find the analysis informative in assessing whether to make a seed investment in a speculative start-up situation, given the underlying facts, the Examiner questions whether it was appropriate for a public company to transfer this contract to a structured finance vehicle, assign it a speculative value and recognise that amount currently as income and cash flow from operating activities.”

In the Eli Lilly transaction Enron took upfront as revenue and cash flow the anticipated net cash flows from a 15 year energy management agreement for which Enron would be paid according to the savings made by the customer. Again a form of appraisal was provided by KPMG Consulting albeit one based upon acceptance of extrapolation of projected cost savings in the first three years of the agreement provided by Enron. These extrapolated cost savings were then discounted at a rate falling between that for BB+ and BBB bonds. Again the Bankruptcy Examiner was critical: "Discount rates used in cash flow appraisals reflect the risk inherent in receiving the future cash flows. To apply a discount rate based on investment grade bonds to account for the risk inherent in achieving anticipated energy savings over a 15-year period indicates the appraiser accepted as 'reasonable without further due diligence' that the application of Monte Carlo simulation to anticipated energy savings removes all but the credit risk from the transaction."

This questionable method for determining the cash flows and discount rates illustrates the creativity of Enron's valuation methodologies as applied to assets for which there was no readily available market price.

Principles vs rule based standard setting: Again the arguments as to whether accounting standards should be written at a high level based on underlying principles which then may be applied to the detail of specific transactions or whether they should engage as far as possible with that detail by means of a prescriptive rule based approach are long standing and ongoing. At present, and largely because the scale of financial engineering revealed in the UK and continental Europe has been far less than that uncovered in the US there is no doubt that the principles based view is in

the ascendancy. Detailed rules are seen as encouraging an avoidance culture and also artificial transactions being entered into designed specifically to evade or take advantage of those rules. Enron abounds with evidence to support this view, for example in the manner in which it constructed SPEs to avoid consolidation, the structuring of its prepay transactions so as the individual elements appeared to involve the transfer or acceptance of risk, the purchase of two aeroplanes so as to enable the write off of deferred tax assets (and the subsequent recording of substantial gains on disposal of the assets which had been purchased for \$46m and written down to zero). As the Bankruptcy examiner notes: "Enron devoted substantial time and resources to engineering its SPE transactions to satisfy the complex GAAP rules."

And in reference to the FAS 140 transactions (the 'sale' of assets to a non-consolidated SPE while continuing to mark to market the return swap on the asset) the Examiner notes: "Enron carefully designed its FAS 140 technique with advice from Andersen and Enron's lawyers, with the goal that the asset transfer would qualify for sale treatment under GAAP despite the fact that sale treatment did not reflect the economic substance of the transaction. In fact, Andersen discussed the basic template for the FAS 140 technique with SEC staff accountants in 1999, who indicated that non-consolidation of the SPE and sale treatment were consistent with existing GAAP."

Furthermore, there was quite substantial disclosure by means of notes to the accounts of a number of the transactions and devices referred to above. For example note 8 *Minority Interests* to the 2000 financial statements sets out the structure of the major

minority interest financing vehicles and reports that the contribution of the third parties was 'invested in highly liquid investment grade securities (including Enron notes) and short term receivables.' Likewise the existence of nearly \$10 billion dollars of long term debt in the associates was disclosed in note 9 *Unconsolidated Equity Affiliates*. Note 15 *Commitments* discloses that Enron is a guarantor of approximately \$1,863 million of liabilities of unconsolidated equity affiliates and other companies. Note 16 *Related Party Transactions* disclosed that Enron entered into transactions with limited partnerships 'whose general partner's managing member is a senior officer' and that derivative transactions with these partnerships enabled Enron to recognize 'revenues of approximately \$500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities.' However, notwithstanding the attempts to comply with GAAP and the disclosures made, it is hardly conceivable that the Enron accounts could be seen as satisfying the test for true and fair set out by David Tweedie (now chair of the IASB) in an article published twenty years ago: "The basic question to be posed by both director and auditor [is]: 'if I were on the outside and did not have the detailed knowledge of the company's trading performance and ultimate financial position...would I be able to obtain a clear and unambiguous picture of that reality from these accounts?' If the picture is poorly painted, or worse fails to represent reality, then the directors have failed to meet the paramount principle of financial reporting – to show a true and fair view.'"

5. Reform of corporate governance: a proposal

What should be inferred from the collapse of Enron (and of many other corporations both in America and Europe)? Should not the board of directors have intervened, to inform shareholders of correct revenues and earnings, or to require management to correct misleading statements? This challenge to boards of directors was the reverse of that in the first crisis in governance. In the earlier crisis, management used shareholder returns to over-build the corporation, and depress share prices. In this period management used marginal and unacceptable financial accounting practices to sustain artificially high share prices. What went wrong in the governance process that allowed these results to be realized?

Corporate governance systems should generate information and decision responsibility for the board of directors to prevent management from perpetrating fraud in financial statements. Advisers have a threshold role as “gatekeepers”, in order to detect the unravelling process and reveal it at an early stage. The outside audit firm should be able to detect fabricated income statements in ongoing reviews of operational and financial accounting. It should make it clear when auditing practice is close to the edge of, if not outside, generally accepted accounting principles (GAAP). Once determined, it, together with “inside” gatekeepers, such as the controller and inside audit staff, should be involved in determining irregularities. And they should inform the board audit and executive compensation (i.e., performance) committees about their process of detection and what they find.

What went wrong at Enron to distort this process? “The Board received substantial information about Enron's plans and activities and explicitly authorized or allowed

many of the questionable strategies, policies and transactions now subject to criticism”¹⁰⁶.

What could have been done if it had in place an active board of directors, informed and able to anticipate the implications of each of the major steps in the strategy? Two years before bankruptcy, as the board was informed of expansions in trading activities, it could have required the audit committee to undertake risk management in such activities and to discuss with the board their assessments of the solvency and liquidity position of the corporation inclusive of off-balance-sheet activities. An active and independent board could have focused its periodic appraisals of management performance on risk management, based on analytical briefings on future cash flows from shifting out of energy production into trading electricity, gas, fibre-optic trunk-line space, and water supplies.

In other words, strong governance by the Enron board of directors, armed with substantive information on the implementation of complex programmes to change the nature of the corporation, could have led to board decisions that at the least would inform shareholders as to the nature of the new Enron.

It is still possible that, even with “strong governance”, a management with expertise in complex financial transactions could bypass the board, with practices that reduced equity value but increased management returns. However, “the board ‘could have known’ and then the board ‘could have acted’. ‘Could have known’ can be transformed to ‘knew and acted’. Substantial improvements in information systems in governance can and will lead boards to monitoring corporate performance so as to

¹⁰⁶ US Congressional Report, *The Role of the Board of Directors in Enron's Collapse*, page 13. Basically, as illustrated in the previous section, there were two main areas (revenue recognition and off-balance-sheet transactions) each having separate implications for further reform on corporate governance.

prevent irregularities that mislead investors. And 'could have acted' can be reduced further, to minimal levels, if the board is motivated to act aggressively against even the appearance of irregularities"¹⁰⁷.

5.1. Chairman of the board and CEO: two separate roles

The faults in governance and ensuing corporate performance in two different eras, the 1980's conglomeration and the 1990 stock price bubble, provide the basis for proposals that will enable boards to monitor management more effectively in market downturns as well as upturns.

The first important initiative is for the board to develop an identified independent leadership, by separating the roles of chairman of the board and CEO and appointing an independent director as chairman. Independent leadership is critical to positioning the board as an objective body distinct from management and, in particular, to the board's ability to:

- identify the issues it should focus on including, in particular, the strategic issues of importance;
- obtain the information it needs to assess management's performance against its chosen strategy, including the overall conduct of the business; and
- prevent any management efforts to obfuscate important issues or information needed thereby hindering the board's ability to fulfil its responsibilities. This is intended to further support effective management as much as to ferret out bad decisions and poorly functioning systems.

¹⁰⁷ MacAvoy and Millstein (2003) page 94.

Although “Sarbanes-Oxley's requirement that the CEO and CFO certify the accuracy of company accounting statements, and their own responsibility and assessment of internal controls, mandates ‘conduct’, (...) this ‘conduct’ requirement does not extend to the board. We would add a requirement that the board determine to its own satisfaction that management's certification was based on an appropriate process. The board of directors should be required to take some responsibility to assure itself that management's certification has been accomplished with care and diligence. This is a missing step in the Sarbanes-Oxley Act”¹⁰⁸. If, for example, boards support management strategies that involve complex hedging and financial accounting practices having the potential to mislead stockholders and enable managers to usurp corporate assets, then boards should have to acquire the knowledge and monitoring skills to understand and approve the process used by management to certify that all is well. This would reinforce the board's interest in ensuring that it has all the information necessary to provide informed oversight which should be a key element in the reforms of corporate governance.

Detection is problematic given the sophistication of new and innovative hedging and risk management techniques. A variety of techniques to manage earnings are available for a management team that seeks to artificially prolong “good news” on operating performance. Given the sophistication of many of these techniques, when they are detected, the imposition of penalties costly to out-of-control management is often delayed, which means that the board response now is further delayed, given that boards meet infrequently and decisions are made by consensus.

¹⁰⁸ MacAvoy and Millstein (2003) page 99.

If the board is to monitor management effectively and hold it responsible for results, it must obtain the information it needs on an “early warning” basis. Relying solely on a single person (serving in the capacity of both CEO and chairman) to determine when to raise tough issues and how to package the information required for the board's evaluation is of questionable prudence. In fact, it is contrary to human nature to expect total objectivity from the CEO regarding his or her performance relative to strategies he or she has helped to formulate. Accordingly, the chairman of the board of directors must be independent of management – even if only to ensure that the board has the information necessary to provide informed oversight. The chairman has to present herself or himself as the agent for the board, in setting the agenda and obtaining necessary information for the board's deliberations on the performance of the CEO in implementing the corporate strategy.

5.2. The role of the board: additional proposal for reform of corporate governance

After the proposal that the roles of chairman and CEO have to be separated, other proposals are essential to enable the board to carry out its role.

- First, priorities must be sufficiently formalized for boards to be sure that management has adopted reliable procedures to determine the accuracy of all public financial statements. This requires board members to know not only cash flow versus earnings, but also how and from which information system these estimates were derived, as well as the roles played by internal and external auditors in the validation of the information from which the estimates were derived.

- Second, evaluations of management performance must be made by the board, as it always has been. However, the board should test and measure management against benchmarks linked to existing corporate strategies, which themselves have to be developed by the board in concert with management. Board compensation committees should grant bonus awards only for the superior performance of that company relative to its competitors and options where strike prices are net of the effect of market wide value increases.
- Third, boards should assure themselves of the integrity of management, and compensation arrangements should reward extraordinary performance of dedicated leadership. When the share price is, say 100 and not 50, and both board and management know it is over-valued, then concern for integrity should be heightened.
- Fourth, boards should establish procedures to familiarize themselves with alternative strategies and innovative products, and structure their meetings so that issues central to the performance of the company are given sufficient time for the board to consider options, and not simply listen to reports. Then, to further their access to information, the board should hire separate consultants or advisers it deems necessary in order to carry out its responsibilities.

In addition to boards doing all this under the threat of regulatory and judicial pressure, change will come if shareholders, particularly institutional shareholders, press for these reforms in board conduct and the media continues to reveal

transgressions and wrongdoing in cases centring not only on management but also board performance.

5.3. The independent chairman of the board

A board needs a leader, separate and independent from management, whose primary function is to help the entire board design and carry out its processes and thereby obtain the information that it needs to adequately protect against the misuse of resources and the squandering of investor's capital.

The ideal board is comprised of many different types of people, with each individual director chosen with regard to the specific attributes, experience and expertise he or she offers the company. One member of the board, independent of the CEO, must have the primary responsibility of, and devote the time necessary to, getting the other directors informed, by helping them focus on the issues that are important to the shareholders, and on the risks facing the corporation. Coordination, integration, communication, and moulding a group of disparate individuals into a mutually supportive team working to foster management's success requires leadership. And the need for the function of leadership in the boardroom is undeniable.

There is another element of the chairman's role: the "key quality" of the separate chairman is that required of a good coach whose satisfaction derives from the achievements of those he or she coach. The role of the chairmen is to support their chief executives, and to enjoy their success and whatever reflected glory goes with it.¹⁰⁹ "The main objective of the Chairman is to help the CEO to be successful."¹¹⁰

¹⁰⁹ Adrian Cadbury, *Corporate Governance and Chairmanship*, Oxford University Press, 2002, page 178.

¹¹⁰ Russell Reynolds Associates, *Effective Boards*, 2002, page 13.

Because board members and challenges to the corporation change, the role of the chairman does not remain fixed. Given the time and experience that leading a board requires, assigning the task of board leadership to the CEO almost inevitably means that the quality of board leadership will suffer. Leading the board is a job and it is thus difficult to imagine how one person, in a complex business, can do both jobs – leading the board and CEO-ing the business – without one of those important jobs being neglected.

Recently, the UK government commissioned Derek Higgs to lead a review of the role and effectiveness of non-executive directors in the UK. The report was issued in January 2003 and contains a summary of the role of the chairman. He is responsible for:

- leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda;
- ensuring the provision of accurate, timely and clear information to directors;
- ensuring effective communication with shareholders;
- arranging the regular evaluation of the performance of the board, its committees and individual directors, and
- facilitating the effective contribution of non-executive directors and ensuring constructive relations between executive and non-executive directors.¹¹¹

Finally, it can be said that the CEO will manage the company, and the chairman will lead the board's activities. The board cannot function without leadership separate from the management it is supposed to monitor. On behalf of the shareholders, the

¹¹¹ Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, 20 January 2003.

board must be enabled to obtain the information necessary to monitor, in good faith, the performance of management in all respects. It has a responsibility to do so. And it must be empowered with the opportunity to fulfil this responsibility.

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