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The Criminalisation Of Corporate Governance

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This paper discusses the recent criminalisation of corporate governance and discusses various solutions. The extradition of three British Bankers to the US shows that the repercussions of the Enron scandal, in which company executives were able to conceal billions of dollars of debt from shareholders. The most lasting impact of Enron has been felt via the US's Sarbanes-Oxley Act, which requires companies listed on the US Stock exchange to establish and manage an adequate internal control structure and procedures for financial reporting, and to obtain annual reports from its auditors about the effectiveness of these procedures. Ken Lay, Enron's former chief executive was convicted of fraud and conspiracy over the collapse of Enron and faced the prospect of spending his last years in jail died suddenly of an apparent heart attack at 64. Most accounting scandals have been blamed on corporate governance failures. To satisfy the public, and to reconstruct confidence in accounting, regulatory and disciplinary procedure is tweaked without scrutinising the conceptual, social and theoretical basis of accounting. By studying current and recent research studies this paper argues that accounting scandals are brought about partly by failures in accounting education, partly by greed acting as a motivator and several other reasons. Businesses cannot opt out of their responsibilities to society by subcontracting to legislation or government the responsibility for ensuring that the consequences of its market driven actions are acceptable. Suggestions for improvement include revising what is taught in accounting education, ending the unitary board structure and replacing it with a two tier board; non –executive directors not holding share options or cross holdings; proxy voting to be abolished and electronic voting to be encouraged; directors should not hold shares in companies that employ them. Corporate social responsibility measures should have their own performance measures and not simply be a public relations exercise. Companies should be more accountable and dedicated to serving the needs of society and concerned with public interest rather than self-interest. External regulation must be followed by making companies respond to long-term interest of stakeholders rather than short-term interests of the directors.

Field of Research: Management

1. Introduction

The Corporate Governance debate involves the relationships between the stakeholders in a company and those who manage its affairs, its board of directors. Monks & Minnow (1996) define corporate governance as:

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"The relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management led by the chief executive, and (3) the board of directors … Other participants include the employees, customers, suppliers, creditors and the community". One perspective is that good corporate governance should have as its objective the maximisation of shareholders wealth. Another broader perspective also called the stakeholder perspective of corporate governance focuses on companies being "socially responsible" and subordinates profit maximisation to other goals. The important question has to be for whom do directors govern? Do they govern for shareholders or for a broad range of stakeholders? Corporate governance issues arise because there in a conflict of interest or an agency problem and the fact that the conflict of interest or agency problem cannot be dealt with through a contract.

Corporate Governance or lack of it has been blamed on the recent scandals. The problem is that to satisfy the public and to restore confidence the regulatory procedure is tweaked without scrutinising the conceptual, social and theoretical basis of accounting. A common institutional response to scandals (Enron, WorldCom, Xerox, Tyco, Barings, Polly peck, BCCI, Arhold etc) has been to reconstruct confidence in accounting by tweaking the regulatory and disciplinary procedure, (Sikka and Willmot, 1995). In the US the Sarbanes-Oxley Act 2002 and the UK Companies Act 2006 have revised the regulatory regimes. The UK Companies Act 2006 contains two significant provisions for auditors. First, it replaces "joint and several "liability by "proportional "liability to be achieved by contract with the company and shareholders. Second "knowingly and recklessly" issuing a false or deceptive audit report will be a criminal offence subject to a fine.
As O'Brien(2004) points out, the malfeasance and misfeasance crises within corporate America have prompted a tripartite response from policymakers. Stringent legislation targeting somnambulant boards have been introduced. Enforcement departments have been strengthened and aggressive stances in the criminal prosecution of individual malefaction. He argues that this intervention has far reaching consequences, effectively criminalising standard Wall Street Practice. Why was corporate governance criminalised? This paper looks at the reforms in corporate governance and asks whether they are the right ones or something drastic has to be done. The reforms that have been introduced have been agreed on the basis of some ideas from regulators and some input from business leaders but have not been based on objective evidence. The paper argues that accounting education has to be reformed, and that most scandals have been brought about by greed. No amount of principles is going to stop someone without any principles from having their own way.
The following sections look at the role of, different views of corporate governance, the role of executive and non –executive directors, whether the reforms have been successful or not, and the role of greed in making the world go round. The paper concludes with the discussion section.

2. Re-forming Education

The quality of education has a bearing on the scandals because, “ by propagating ideologically inspired amoral theories, Business Schools have freed students from any sense of ethical responsibility “ The Times, 2 October 2003.
“We as a business school faculty – need to own up to our own role in creating Enrons… it is our theories and ideas that have done much to strengthen the management practices we are so loudly condemning. If managers were seeking ever-more inventive ways of boosting share prices, paying themselves over the odds and off loading the costs to society they were doing what business school courses taught them.” The Observer, 28 March 2004.
The main purpose of accounting and finance programmes of study should be to teach students to learn independently. Therefore accounting syllabi should not concentrate for the most part on preparation for professional examinations. Students should learn ways and methods that would help them to study more effectively and use these effective learning methods to continue to learn throughout their lifetimes.
Students must be active participants in the learning process, not simply submissive recipients of information. They should identify and solve problems that their solutions lie beyond ordinary forms and formulae and require use of several information sources.
Learning by doing should be stressed. Team work and working in groups should be encouraged. Creative use of technology is essential. Accounting classes should not focus only on accounting knowledge. Ways of teaching that expand and strengthen basic communication, intellectual and interpersonal skills, skills, which would allow them to quickly, fit into a working environment.
The use of business support tools, especially spreadsheets, electronic communication, all are now commonly used by small or large enterprises. Their use in the accounting curriculum has to be considered by major accountancy bodies and higher education.
Albrecht and Sack (2000):

3. Views of Corporate Governance

Moxey (2004) argues that while recent corporate governance failures in the USA and Europe have undermined trust in capital markets and in business, major reforms have been introduced that have been agreed on the basis of ideas of regulators with some input from leaders in business. These have not been based upon objective evidence of what does and what does not work. . His research shows that while some directors seemed to view corporate governance as a wasteful and time-consuming exercise intended to satisfy regulatory requirements, others saw that corporate governance is also about wealth creation and has intrinsic value. The survey was completed by 91 of the 1,650 chairmen and finance directors from the top 1,000 listed companies ranked by market value a response rate of approximately 5.5 %. (21% were from FTSE 100 companies, 31% from FTSE 350 companies and 48% from companies outside FTSE350 but in the top 1,000).

Under both Cadbury (1992) and the revised Combined code (2006), Non Executive directors (NEDs) should have an important role in helping to create wealth and it is a

cause for concern that only 37% of respondents considered that they do, while 30% did not. Only 27% of respondents from FTSE 100 firms agreed that 'NEDs, play an important role in the organisation's ability to generate wealth' compared with 41% of those from the FTSE 350 and 38% of those from outside the FTSE 350. There was strong agreement that Independent NEDs play an important role in establishing effective corporate governance practice': 79% of respondents agreed and only 3% disagreed with this statement. The revised Combined Code introduced new and more demanding criteria for establishing whether or not an NED is independent. Of those respondents who agreed that 'it is difficult to appoint truly independent NEDs' the highest proportion (35%) was from companies outside the FTSE 350. While 94% agreed that 'independent of mind (i.e. objectivity and integrity) is more important than independence in appearance (i.e. meeting the compliance criteria)', only 1% disagreed. Higgs (2003) recommended that boards should comprise at least 50% independent NEDs and this is now a requirement for FTSE 350 and above. The results of this survey show that this will lead to:

- NEDs becoming less involved in the business (30%)
- An adverse effect on team work and decision making (55%) and
- Other directors having to leave the board in order to meet the requirement (43%)

This thus defeats the purpose. If NEDs become less involved in the business, and this has an adverse effect on team work and decision making, the purpose of having NEDs in a board is not being fulfilled.

It is implied in a number of sources that the main problem for corporate governance failings is lack of trust in capital markets and those involved in them. (Conference Board, 2003). The main reform in the USA is the Sarbanes-Oxley Act (United States of America Congress 2003) .The Act requires company executives to personally attest to the authenticity of company accounts or suffer the consequences. According to Section 302, criminal sanctions apply and fines may be as much as £5m each as well as 10 years in prison for knowingly filed false accounts. The Act also requires the directors to disclose "all significant deficiencies in the operation of internal controls and any fraud."

Muth and Donaldson (1998) report that where there are fewer independent non-executive directors and where the roles of chairman and CEO are combined there is better financial return for shareholders. This goes against the argument that there should be more independent NEDs and that the role of chairman and CEO should be split. This could be contrasted with Dulewicz and Herbert (2003), in their analysis of 86 UK listed companies found statistically significant differences on performance, cash flow return on total assets (CFROTA), between those companies with a separate chairman and chief executive and those where the roles were combined, with the latter performing less well. This supports one of the main principles of corporate governance and contradicts Muth and Donaldson. They found no evidence to support the principle that boards should have a majority of independent directors.

In another research study conducted by MORI for the Higgs review on the Review of the role and effectiveness of non-executive directors (MORI 2003), a total of 605 interviews were completed with directors of UK listed companies. Quotas were set to

achieve interviews with 75 chairman, 250 executive directors and 275 non-executive directors.
Nearly half the non-executive directors of UK listed companies have been appointed through personal contact with a board member (48%), one in five were selected through a head-hunter (22%) and one in nine (11%) were nominated by an investor, bank, stockbroker or venture capitalist. Only four percent of non-executive directors were appointed through formal interview and only one per cent answered an advertisement. This raises serious questions about the independence of NEDs.
Two-thirds of non-executive directors have never received any training for their role. Chairmen are far more likely to discuss company business with their company's investors than are the non-executive directors. Of the 3,908 individuals holding non-executive posts in UK listed companies, over 80 per cent of them (3,150) hold only one such post. Contrary to popular belief that there is a lot of cross holding, 9% (351) hold two non executive posts only; 2% (91) hold three non-executive posts only; 1% (21) hold four non-executive posts only and 13 hold 5 – 7 non executive posts only. 282 (7%) hold non-executive and executive posts.

4. Voting rights

The Cadbury Committee observed that voting rights represent an asset, which should be used, (Cowe, 2001). The government argued that shareholder votes should be a key element of effective corporate governance. National Association of Pension Funds (NAPF) launched an inquiry in 1998. The nine-month investigation concluded that there were practical problems, which hamper shareholders' efforts to exercise their ownership rights at annual meetings. It concluded that cultural change was also needed, so that institutions would regard voting as a routine element of their fiduciary responsibilities. The inquiry found that only 40- 45% of shares were typically voted at annual meetings and set a target of 60%. There is one view that proxy voting should be abolished as some chairmen misuse it.

5. Executive Directors and Non Executive Directors

While a distinction between executive and non-executive directors is drawn, this has no significance in company law. A non-executive director does not devote all his or her working time to the company and receives a fee. An executive director devotes his or her entire working time to the company, is an employee of the company and has a significant personal interest in the company as a source of income.
While regulators and code makers believe NEDs can be effective in ensuring that the board of a company acts in the interests of the company RE Polly Peck International plc (No 2) [1994] 1 BCLC 574 shows how unrealistic it is to expect NEDs to control a determined and powerful managing director. In the UK and USA, NEDs participate in regular board meetings equally with executive directors but meet separately in the remuneration and audit committees. In Germany and the Netherlands they (NEDs) form a separate board known as the supervisory board, (the executive directors forming the management board). The two-tier structure is mandatory for public companies and a supervisory board has a statutory function.

6. Two tier Boards?

The UK practices the unitary board system of governance. Both executive and non-executive directors have the same legal responsibility as directors. This has to be contrasted with the two-tier board practiced in continental Europe. This is characterised by the presence of a supervisory board made up of shareholder representatives and representatives of the work force. The supervisory board appoints members of the management board and supervises their actions. The management board runs the company's day-to-day activities. In the unitary system the non-executive directors provide the control and monitoring role. The board is collectively responsible for promoting the success of the company by leading and directing the company's affairs.
Some suggest that what is really happening in Britain is that we are moving towards almost a two-tier board structure where the main board, which includes the non-executives and the chairman is spending more of its time on corporate governance issues and the day to day running of the company is usually done by an executive committee which is doing many of the jobs which the board used to do. This committee is in reality a committee of the chief executive. Chambers (2004) asks whether such a company would do as well without a main board – with all the decision taking, all the oversight and all the accountability being entrusted to the executive? Morrison's is quoted as an interesting case. Their 2003 and 2004 annual reports showed that they had no non-executive directors, nor an audit committee, nor a usual remuneration committee. Management looked after everything. Yet the board met in full on over twenty occasions in each of those two financial years. This is despite the Combined Code (2003) stating that, "the board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking". "There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business…. The roles of chairman and chief executive should not be exercised by the same individual."

When NEDs were first mooted as being the key to good corporate governance and should be a significant presence on the board, Tiny Rowland famously said that non-executive directors were little more than baubles on a Christmas tree.
"The fact that just 20 MPs and peers occupy nearly 200 seats on corporate boards sums up the non-executive directorship at its worst: a sinecure for the superannuated politicians requiring an occasional glance at the books and an appetite for lunch.
That may be a crude caricature. But too often non-execs are recruited for their ability to open doors rather than look out for shareholders. Stronger corporate governance requires higher quality non-execs who are willing to stand up for management" The Financial Times, 13 August 2002, Editorial page 16. This begs the question whether a NEDs has enough independence to stand up to an autocratic CEO? None the less, NEDs are not and never can be universal panacea. They are not full time executive directors and cannot have the same detailed knowledge of the company as executive directors. They add value to the board and within the unitary board system of corporate governance practiced in the UK NEDs have a crucial part to play in the corporate governance process.

Peasnell, Pope and Young (2004) examine whether the incidence of earnings management by UK firms depends on board monitoring. The focused on two aspects of board monitoring: the role of outside board members and the audit committee. Their results show that if pre-managed earnings are negative or below previous year's reported earnings, the actual reported earnings contain less positive abnormal working capital accruals if the proportion of outsiders on the board is relatively high. They found little evidence that outside directors influence income-decreasing abnormal accruals when pre-managed earnings are high. They found no evidence that the presence of an audit committee directly affects the extent of income-increasing manipulations to meet or exceed these thresholds.
Higgs (2003) suggested four main roles for NEDs

1. Strategy: NEDs should constructively challenge and contribute to the development of strategy
2. Performance; NEDS should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance
3. Risk: NEDs should satisfy themselves that financial information is accurate and that financial controls and system of risk management are robust and defensible
4. People: NEDs are responsible for determining appropriate level of remuneration of executive directors and have a prime role in appointing and where necessary removing, senior management in succession planning.

Both Cadbury and Hampel identify tension between the two elements in the role of NEDs: Monitoring executives' activity and contributing to the development of strategy

While Higgs (2003) raised the agenda for boardroom effectiveness, Tyson (2003) provides another piece of the jigsaw by highlighting how a range of different backgrounds and experiences among board members can enhance board effectiveness and by exploring how a broader range of non-executive directors can be identified and recruited.

Experts on corporate governance agree that the best boards are composed of an appropriate mix of different skills experience and knowledge.

7. Greed is Go(o)d?

This paper argues that most corporate governance scandals arise out of greed. Around 1600 AD Pope Gregory the Great formulated the Seven Deadly Sins: these are: Anger, avarice, envy, gluttony, lust, pride and sloth.
Greed has become more acceptable in Western culture, where the desire to acquire wealth is an important part of capitalism.

For example, Catholic teachings say that greed "if kept within the bounds of reason and justice and resisted triumphantly in its ordinate" can be "positively meritorious". The logic of this is that the desire for possessions is natural for humans. If one offends God or one's neighbour however by using unjust or illicit means to acquire things, one has committed a grievous sin.
Greed is good only as long as it creates profits and productivity in a capital society

Greed can be for power or brought about by fear. The greed of power is greed for things to achieve, wield and display which can then be used to intimidate or bribe others, reinforce one's illusions about what is important or to build up a feeling of success.
Fear is a poor motivator for virtue but an excellent one for greed. The stock market could crash and we could lose our jobs. This could drive us to carry out transactions we would not do otherwise. It has been suggested that fear and greed are two things that drive people and corporations in financial markets. If one is paid by the profits one makes, one also knows that one will lose one's job if money is not made in one year. Big corporations in the 1950's and 1960's offered secure pensions and other benefits to a large stable workforce and were far more egalitarian than they have become in recent times. Top executives might earn 20 or 40 times as much as their lower paid employees but that gap has now exploded to more like 400 times the lowest pay. Many companies pay their high flyers large sums of money because they believe that it is pay that ensures their success. When the water companies in the UK that were publicly owned were privatised the CEOs doubled or trebled their salaries because that then was the going rate even though the work they did was the same. When pay is being negotiated, chief executives should be paid by people who had power to negotiate with them and knowledge to negotiate with them and then they are able to arrive at a free market evaluation of what the person in worth. Monks (2002) describes that we are now in a rigged market where all the compensation consultants owe their living to CEOs. All board of directors are picked or approved by CEOs. "It is a contrived situation and the contrivance has gotten to the point of absurdity". As the Tyson Report pointed out, "the perception of a possible conflict between NED compensation and NED independence may be a possible constraint on the selection of NED candidates from non-traditional talent pools. This view was shared by Higgs,(2003): "… it is important that a non-executive director is not so dependent on the income from their role or shareholding as to prejudice independence of judgement, and I would expect boards to take this into account in determining independence."

While greed is described as a motivator, the desire to make a lot of money is one of the motors of economic growth. Is this the reason for the corporate scandals? This has already led to a mass of regulation, which will try to dampen it down so that they can't make decisions. These regulations will also increase bureaucracy and make companies less efficient and flexible. Self-interest or public service is another question that has been posed. Some suggest that these work in a cycle. Like in the 1930's when the system involved a loss of a lot of money but many leaders of the community become disgraced.
While a director no longer has to be a shareholder, he or she is still a trustee for the shareholders. Subject to legal, regulatory and contractual obligations, directors should act in the interests of the shareholders and no director should make a personal gain at the shareholders expense from his or her office as a director of the company. As far back as 1932 Berle and Means in the USA suggested that it is unrealistic to believe that shareholders of large public companies may have any control over their directors and they and others suggested that the profits of a business should reward those who undertake entrepreneurial functions rather than the shareholders who passively contribute capital. The increase in Institutional shareholders has recently seen power being returned to the members.

8. Discussion and Conclusion

Is criminalisation of corporate governance the right way forward? It cannot be denied that Companies should be more accountable and dedicated to serving the needs of society and concerned with public interest rather than self-interest. External regulation must be followed by making companies respond to long-term interest of stakeholders rather than short-term interests of the directors. Too much power must not be in too few hands. A suggestion would be to end the unitary board structure and replace it with a continental two-tier board. The second tier or supervisory board to consist of elected non-executive directors, employees and consumers. Non-executive directors should not hold share options or cross holdings. Proxy voting whereby company directors can cast vast number of votes must be stopped. Electronic voting must be encouraged. Pay has to be revised. No director must receive a huge multiple of the average wage in a company. Directors should not hold shares in the companies employing them. Internal audit must be strengthened and report to the audit committee. Corporate Social responsibility, social and environmental accounting should be more than a public relations exercise and must have performance indicators disclosed.

This paper has reviewed evidence on the role of corporate governance reform, the role of executive and non-executive directors, the role of voting of both institutional and ordinary shareholders and the role of greed in corporate management. It concludes by making suggestions for reform.

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