Corporate Governance & Responsibility

Presented by Anthony M. Santomero, President
Federal Reserve Bank of Philadelphia

Corporate Governance & Responsibility Seminar
Wilkes University, Wilkes-Barre, PA
February 24, 2003

The Issue of Corporate Governance

Recent headlines have brought the issue of corporate governance to everyone's attention. We have all seen the many stories about Enron, WorldCom, Adelphia, and other companies that were once mainstays of our economy and our business community. Television has brought us images of corporate executives, not being recognized for their civic contributions but being led away in handcuffs on allegations of malfeasance.

A common refrain in all these stories is that company executives were not acting in the best interest of their organizations, their shareholders, and their employees. A combination of inadequate monitoring, a breakdown in internal controls, and the systematic failure of both outside directors and outside auditors appear to have led to a less than desirable outcome.

Why Has This Happened?

Several reasons have been offered to explain why these corporate governance problems have recently gained the spotlight. Some have argued the origin of these problems was the mega-merger and takeover wave of the 1980s, when innovative compensation programs for top executives were established - including a significant increase in the use of stock options. While these programs were supposed to improve management's incentives to increase shareholder value, some see them as the seeds of our current problems.

These compensation programs expanded and covered more companies during the 1990s. For example, in 1990, equity-based compensation for CEOs was 5 percent of total compensation. By 1999, it was 60 percent. Stock options rose from 5 percent of outstanding shares in U.S. companies in 1991 to 15 percent a decade later. Meanwhile, the value of stock options in the largest 2000 companies in the U.S. more than tripled between 1997 and 2000.

Detractors argue that these changes in executive compensation tended to place more emphasis on **short-term** gains in a company's stock price, rather than on **long-term** performance. Then, the 1990s brought about rapid changes in technology, greater deregulation, and increased globalization of markets. This placed more pressures on companies' cash flows and made it more difficult to raise share valuations. The innovative compensation programs encouraged executives to take greater risk or to engage in more creative accounting to improve reported earnings. In effect, corporations shifted their business standards and were not held in check by either their corporate directors or others charged with guarding shareholder interests.

Another explanation of recent events focuses on the fact that long-term earnings forecasts for many companies were overly optimistic during the decade of the 1990s and generated unrealistic expectations. Proponents of this view point out that three- to five-year earnings forecasts for S&P 500 companies averaged almost 12 percent per year between 1985 and 2001. However, actual earnings growth over that period was 7 percent.

Some blame analysts and Wall Street for these overestimates of earnings. They argue financial firms promoted and retained those analysts with the most optimistic forecasts of companies' earnings. Interestingly, the bias to do so was especially pronounced among analysts employed by the underwriting firm.

Still another explanation of these scandals lays blame at the foot of the innovations in the field of finance. By this view, these innovations outpaced the ability of traditional accounting and auditing standards to monitor many corporations' activities. They allowed some executives to engineer creative accounting techniques to obfuscate earnings and conceal negative results. Consequently, investors and outside parties had more and more difficulty understanding the financial statements and the risk positions of these large, complex organizations.

Of course, all these suggested explanations received little attention when stock prices were rising rapidly during the bull market. The sharp declines in stock prices have led to greater awareness and concern.

In essence, the foundation of trust was breached between corporations and shareholders with regard to the meaningful disclosure of corporations' financial information. The outcome was a break between executives' pay and the corporations' performance. The whole process of reporting earnings and financial statements became tainted.

An Old Problem with Deep Roots

Although the problems outlined in these explanations certainly played some role in recent events - or even a major role - focusing on them gives the impression that corporate governance problems are a relatively new issue. I disagree. Rather than a recent development, such issues have deep roots. They are inherent in what economists call "the principal-agent relationship" in organizations.

The central dilemma here is one of conflicting interests. Much research has been devoted to how to provide incentives to the agent - or executive management of a firm, for the purposes of our discussion - to act in the best interests of the principals - the owners of the firm. In essence, the challenge of our form of capitalism is, and has always been, to construct a system of corporate governance so that company management acts in the best interests of shareholders.

This is what we have attempted to do in our structure of corporate governance. The oversight of the firm falls directly on the company's board of directors. In the end, the board bears ultimate responsibility for the company's performance. The board is supposed to implement methods to monitor and control management so that abuses are prevented or at least minimized. To do this, some members of the board of directors are outsiders - people who are not part of the management team of the company. These directors are supposed to act as an independent check on corporate management to ensure they act in the shareholders' best interest. American capitalism relies on the fiduciary concept to protect those who entrust their money to large - and often distant - corporations.

The Importance of Corporate Governance

Yet today, there is a sense that the model just described is not working well enough. A crisis of confidence in corporate America has resulted. Recent scandals have generated a lingering sense of uncertainty and vulnerability among investors. This has put pressure on companies' management, corporate directors, and regulators to address problems of accountability and control.

To restore public confidence in the integrity of corporate America, companies must demonstrate a strong commitment to the development and enforcement of rigorous standards of corporate governance. These standards must encompass the relationship between a company's board of directors, its management, and its shareholders. They must require corporate leaders to be faithful to shareholder interests and act with both competence and integrity.

At a very basic level, trust is at the heart of the free enterprise system. But the current state of public trust in American corporations is not good. According to a recent poll, 77 percent of the public believe CEO greed and corruption caused the recent declines in the stock market. In addition, polls suggest much of the public rejects the view that the scandals were isolated incidents within a system in which most corporate leaders are good and honest people.

Yet, the continued success of our economic system requires the confidence and trust of investors, employees, consumers, and the public at large. In short, there is much work to be done.

What Is Being Done?

We know that as corporations grow larger and more complex, it becomes more difficult for boards of directors to monitor activities across the company. Directors cannot be expected to understand every nuance of or oversee every transaction. They should look to management for that.

Nonetheless, the role of a corporate board of directors is quite substantial, and directors are required to be highly knowledgeable. They must know - understand - the nature of the firm's business, its financial performance, and the nature of the risks facing the firm's strategic plan. Collectively the board should have knowledge and expertise in areas such as business, finance, accounting, marketing, public policy, manufacturing and operations, government, technology, and other areas necessary to help the board fulfill its role. They must set the tone for risk-taking in the institution and establish sufficient controls so its directives are followed. They also have the responsibility to hire competent individuals who possess integrity and the ability to exercise good judgment. Members of the audit committee, in particular, must be independent and have knowledge and experience in auditing financial matters. This is no small task.

Recent events have been a loud wake-up call, focusing attention on the need to heighten our commitment to proper corporate governance and improve both accountability and control. In response, a number of measures have been taken or proposed by various groups to bolster confidence in our corporate system.

Recognizing that boards have come under increased scrutiny, the **New York Stock Exchange** recently appointed a Corporate Accountability and Listing Standards Committee. The committee has come up with a number of recommendations to improve corporate governance. One proposal is to increase the role and authority of independent directors by having them make up a majority of a company's board. The committee also recommends that companies adopt corporate governance guidelines and a code of business ethics and conduct. In addition, the committee has suggested shareholders be given more opportunity to monitor the governance of their companies. They must vote on all equity-based compensation plans and have access to the company's corporate governance guidelines.

The **Conference Board Commission on Public Trust and Private Enterprise** has also made recommendations on best practices. It recommended that executive compensation be performance-tied and zero-based and stressed the importance of independent directors being able to retain outside consultants. The commission also suggests that the Federal Accounting Board (FAB) and the International Accounting Standards Board (IASB) come up with standardized definitions of revenues in order to achieve true parity in determining executive compensation based on company performance. Finally, it recommended that America's senior executives should be subject to much longer-term holding periods for company stock and higher ownership requirements.

A consensus is now also growing concerning some needed changes to certain underlying accounting standards and their application. The U.S. **Financial Accounting Standards Board (FASB)** is considering how to improve accounting standards for special-purpose entities. This is in response to the growth of securitization and the added complexity securitization has introduced into financial reporting.

A pilot program is under way to standardize financial reporting data and make them available to investors via a web site hosted by **Nasdaq**. Going forward, technology will be instrumental in improving transparency in financial reporting by making corporate financial information easily available.

Congress has also responded. The newest legislation about corporate governance, the **Sarbanes-Oxley Act**, addresses the wave of recent events that shook public confidence. The act seeks to protect investors by improving the accuracy and reliability of corporate disclosures. Among its major provisions is the establishment of a new private-sector regulatory regime in which the SEC handpicks an oversight board to monitor standards and conduct in the accounting industry. Sarbanes-Oxley also emphasizes the need for a wall of independence between auditors and firms. In addition, and perhaps most controversially, the act seeks to strengthen corporate responsibility by creating a structure for holding individuals and companies criminally and/or civilly accountable for their actions. CEOs and CFOs are now required to certify quarterly and annual reports to ensure proper disclosures.

While some may disagree with any of these proposals, it is important to realize that those involved and responsible have begun to take action to address the perceived problems of corporate governance. I expect our panel will speak to these issues and of the burdens these proposals place on affected organizations.

Corporate Governance in Bank Regulation

It should be pointed out that the non-financial sector is not alone in its search for better corporate governance. The requirement of trust and confidence in corporate America is analogous to the trust and confidence issues that the Federal Reserve faces in its role as the regulator of the U.S. banking system. Let me touch on some of the parallels and briefly describe how we have addressed them.

Of course, banks have shareholders, too. Their business involves making loans to customers who are expected to repay. Bank management has a good deal of information about the quality of the loan portfolio. The question facing bank managers and their directors is how much information to provide to shareholders. As stewards of the public trust, bank regulators and supervisors ask the same questions.

But beyond this, a bank's relationship with its depositors is another example of the principal-agent problem. Depositors depend upon bank regulators and supervisors, as well as deposit insurance, to keep their money safe in spite of the opaque nature of bank assets. As a result, we have substantial interest in the ways in which corporate governance is performed in the regulated banking sector, and we have incorporated these concerns into our regulatory and supervisory model.

The primary focus of the Federal Reserve's approach to supervision and regulation is ensuring an institution's safety and soundness. The Federal Reserve's examiners also ensure compliance with banking laws and regulations, including consumer-protection laws and regulations.

Historically, a major focus of banks and their regulators has been on whether they accurately report their financial condition and appropriately assess the quality of their assets. Beyond this, supervisors have long been concerned about the quality of internal controls. During the past 15 years, the Fed's supervisory program has been broadened to focus on banks' overall risk-management systems, comparing them against both regulatory standards and industry best practices.

The Fed's risk-assessment process analyzes the nature and extent of risk to which a financial institution is exposed and assesses how well the institution is identifying, controlling, and managing risks. It requires integrated, enterprise-wide risk management that considers all areas of risk, including credit risk, market risk, liquidity risk, operational risk, legal risk, and reputational risk. The idea is to identify not only the type of risk and its level but also its direction and whether the bank has means to effectively control each risk.

The Fed also wants to ensure that the bank has a strong internal audit function and that it also receives a thorough, complete, and independent external audit. To accomplish all this, Fed examiners conduct on-site examinations and provide institutions with continual off-site monitoring and analysis as economic conditions and the bank's financial condition change.

In 1991, Congress broadened the scope of banks' assessments of risks and controls. Since then, bank managers are required, at least annually, to step back from other duties and evaluate risks and internal controls. In addition, external auditors must attest to management's results of this self-assessment of risks and internal controls. The results are reported to the audit committee of the bank's Board of Directors. Incidentally, the audit committees of banks' boards have been required to be independent of management for a long time - something that is now being stressed for all corporations. In fact, this approach to risk-assessment and internal controls is also the one followed by all of the Federal Reserve Banks for several years.

Ensuring a broad-based assessment of risks and internal controls has served the banking industry well in recent years. For instance, despite the economic downturn in 2001, most banks continue to be in good health.

But There Are Limits

The Fed's experience, therefore, suggests some success with the evolving model of better corporate governance. Nonetheless, it is important to remember that the process is still evolving. Much work remains to be done. It is important to remember that proposals to improve corporate governance must take into account not only the expected benefits of new standards and regulations but also their expected costs to both the corporations and the economy as a whole.

Good intentions do not always prevent unintended consequences - which is why a forum such as this one can be very helpful in illuminating the potential pitfalls of well-intended proposals. Some unintended side effects might include high compliance costs, ambiguous liabilities, or reduced innovation. This is particularly true when various proposals about corporate governance have been arising at both the state and federal levels.

Disclosure should never be so onerous as to make the cost of compliance prohibitive or impractical. Regulations and standards of any sort - whether by regulators, government, trade groups, or the companies themselves - should not excessively impede the ongoing process of innovation. Rather, we must ensure an environment conducive to markets that are effective and efficient, safe and sound.

I expect we will also hear more on this from our panel members, both from an accounting professional's perspective and from a CEO's perspective.

Is There a Better Way?

But before we turn the program over to our panelists, let me comment on the ongoing debate over the use of principles versus rules in the effort to improve corporate governance. One criticism of the past approach to corporate governance is it tended to focus on the development of fairly specific *rules* of behavior rather than insisting on adherence to certain *principles* of behavior. Most of the proposals we now debate to improve corporate governance are new rules.

However, the problem with rules, particularly accounting-based rules, is that innovations in the financial system can open loopholes in rules. When loopholes open, inappropriate or unethical actions that are not specifically prohibited by the rules can take place. Basically, this is what happened in many of the corporations that made news headlines in the past year or two.

A credible case can be made that we should focus on principles instead of rules. That is, we should establish key principles against which corporate decisions should be held accountable, regardless of whether a certain type of behavior is prohibited. This way, when innovations make old rules obsolete, corporate leaders and their financial executives would have to consider not only whether some action would violate a rule but whether it would violate a principle.

There are strong arguments for developing principles-based standards - in addition to our reliance on traditional rules-based standards. However, the challenge is to establish a set of principles that are sufficiently clear and concise. This may not be an easy task, and the result may be substantial litigation, rather than simplification and clarity. As was said earlier, it is important to consider both the costs and benefits of new standards, as well as the unintended consequences that may result. In the end, rules can not replace ethics and an exemplary "tone at the top."

Nonetheless, whichever way regulation evolves, disclosure and transparency are imperative to adequate corporate governance. Such disclosure need not be identical across all industries and companies. The information available to the public should be what is necessary for them to evaluate a particular firm's risk profile. That is why principles-based accounting has some appeal. Companies should take action to ensure their financial statements divulge what is truly essential for investors to understand the business and make informed decisions.

Conclusion

Let me conclude with this. Good corporate governance is critical to the health of the corporate system, our financial system, and our economy. Our economy will be stronger if corporate decisions are made with competence and integrity, and if shareholders and the public can appropriately assess the profitability and riskiness of corporations' business activities.

The crisis of confidence in corporate America has been created by recent scandals that have generated a sense of uncertainty and vulnerability among investors. These events have put pressure on regulators, corporate directors, and management to address problems of corporate accountability and control. Changes are in the works and appear to be in the right direction. To a large extent, this direction is where banks and bank regulators have gone before.

Many ideas to improve corporate governance are being offered by a variety of parties. Adopting a system of principles-based accounting standards, rather than primarily amending the current rules-based standards, may be useful in ensuring that our accounting rules do not become quickly out of date in the face of rapid financial innovation. But given the wide range of ideas being offered, the challenge will be to move forward and implement those proposals most likely to be effective in yielding benefits at a reasonable cost of compliance and to do so without generating unintended consequences. The challenge is in the implementation, but the challenge is a noble one. We must proceed.

In the end, however, we must bear in mind that the core principles of ethical behavior and sound business practices are the keys to any real success in this arena. This tone is set at the top. Without these values we will never really succeed in conquering the problems and conflicts that arise in corporate governance.