

CORPORATE GOVERNANCE: AN INDIVIDUAL RESPONSIBILITY

With the scandals that so often occupy newspaper headlines, it is easy to fall prey to the idea that corporate fraud is the norm and honesty the exception. Yet, the entire capitalist system is based upon trust and voluntary exchange. These headlines eschew the majority of businesses and individuals who have made fortunes in an honest and upstanding way. Federal Reserve Chairman Alan Greenspan observed, “Of necessity, therefore, in virtually all our transactions... we rely on the word of those with whom we do business. ... Indeed, we could not have achieved our current level of national productivity if ethical behavior had not been the norm or if corporate governance had been deeply flawed.”¹

With analysis confined to publicly traded companies in the United States and with a free market ethos, this essay will attempt to define corporate governance and propose solutions that may mitigate the frequency of corporate fraud.²

Good Corporate Governance Is No Small Task

There are two essential components to corporate governance: **strategy** and **details**. Strategy is based largely on corporate philosophy—a vision for the business. Details involve the metrics of achieving the vision. In an ideal situation, the board of directors provides the business strategy, or rather guides and advises executives on the strategy. Employees go about achieving the objectives, which the board will in turn disclose as financial results to the shareholders and the public. A necessary part of this process, of course, is the directors’ evaluation and compensation the chief executive.

A word that describes the duties of a board member is “fiduciary,” or “one that stands in special relation of trust, confidence, or responsibility in certain obligations to others”. It is no coincidence that the word “fiduciary” comes from the Latin “fiducia,” meaning trust. Members of the board of directors and the chief executive bear ultimate responsibility for the firm, with the key responsibility being to increase profits³.

Conflicts involving strategy and details provide a necessary tension in business. Inherently, these two business components are indefinite and amoral; they are realized by either honesty, fraud, or both, depending on human input. Board members and the chief executive, should they be forthright and take their responsibility seriously, can provide tremendous value to the corporation. However, at the other extreme, exist situations like Hollinger International.

¹ Greenspan, Alan. Commencement Address. Wharton Business School. 15 May 2005.

² In presenting my inquiry, I am indebted to the scholarship and assistance of Chairman William A. Niskanen and Paul G. Mahoney of the Cato Institute’s Project on Corporate Governance, Audit, and Tax Reform; Alex J. Pollock of the American Enterprise Institute; accounting professor Elizabeth Capener, CPA, Dominican University of California; and James Wall, CPA, Chief Financial Officer, Core-Mark. Any mistakes or misstatements are my responsibility.

³ Friedman, Milton. “The Social Responsibility of Business is to Increase Profits”. *New York Times Magazine*. 13 September 1970.

The *Wall Street Journal* illuminated the debacle of the publishing concern and the subsequent Securities and Exchange Commission (SEC) investigation of Chairman/CEO Conrad Black and certain directors and executives for the charge of siphoning \$400 million from the company, for which half of the transactions were approved by the board⁴.

Insolent and smug, Hollinger board member and Audit Committee head James Thompson glibly stated, “The board doesn't run the company,” making a mockery of board service. Board service for Hollinger in the high-flying years of 1995-2003 was just a ruse for “rubber-stamping” CEO actions and gaining entry into an elite social club with annual two-day star-studded galas costing the company millions. In a purely literal sense, the board does not run the company—making sales calls and the like—but at the levels of vision, strategy, and fiduciary duty, the board does, in fact, run the company.

As for his reference to accounting⁵, the other half of the twin role of board responsibility, Thompson acquiesced to an egregious example of a board's willing failure to increase the firm's profits. While Hollinger's board was approving transactions for Conrad Black—\$52 million for special one-time fees, \$38 million to Black's holding company for outsourced executive management, a corporate jet, four lavish houses, servants, parties, and even \$8 million to purchase Franklin D. Roosevelt memorabilia—it allowed the financial position of the company to deteriorate rapidly. During 2000–2003 we see that Hollinger experienced three successive years of operating losses and declining earnings. During those years, an average of six percent of revenue funded “non-operating expenses”, presumably part of the charge for the high life.⁶ Thompson's aloofness and disregard do not pass muster for the requirements of board service for the chair of the audit committee of a multi-billion dollar concern. It is precisely the responsibility of members of the board to ask questions and find out what is going on.

Temptation is a feature of board service in a publicly traded corporation. In a world where “corporate officers can make tens of millions of dollars instantaneously through the exercise of incentive stock options...[to unethical individuals] the benefits of a brief one-time increase in price may really outweigh the discounted value of future compensation and reputation”, notes Cato Fellow Paul G. Mahoney.⁷ That being said, board service is a tall order, and not everyone is fit to be a board member.

We would like to think that justice will be done. Indeed, Hollinger faces a barrage of lawsuits; those implicated have been ousted; and a new management team and board have taken the helm. Greenspan does not fail to mention that “After the revelations of recent

⁴ Cherney, Elena and Robert Frank. “Paper Tigers--Lord Black's Board: A-List Cast Played Acquiescent Role”. *Wall Street Journal*. 27 September 2004.

⁵ “...I think that the directors are entitled to presume that they are not being lied to or than information is not being withheld....”

⁶ www.Hoovers.com and Hollinger Inc. Press Release “Release of Alternative Financial Information”. 4 March 2005. 2000-2003 are the years for which the most recent Hollinger financial data is available—presently, the Canadian and American securities commissions have halted trade of Hollinger International and its holding company Hollinger Inc., because the companies are delinquent in disclosures for 2004.

⁷ Mahoney, Paul G. “Public and Private Rule Making in Securities Markets”. *Policy Analysis*. Cato Institute. 13 November 2003. p. 7

malfeasance, the market punished the stock and bond prices of those corporations whose behaviors cast doubt on the reliability of their reputations”. It is too bad that only the perpetrators would suffer the scourge of their misdeeds. For in this system, externality is present, and many have been harmed.

Rules and Regulations as a Response to Fraud (the Way to Hell Is Paved With Good Intentions)

While Congress may have had good intentions in mind with the various pieces of legislation it has proposed, the outcome on many counts has been undesirable. As a result of legislation made under political pressure, Congress’ actions tend to be knee-jerk and punitive rather than considered and incentive. Because it is impossible to legislate such things as corporate strategy, Congress has focused instead on what can, ostensibly, be controlled and measured: the numbers. However, the greatest assets of a corporation will never appear on its financial statement, namely, its corporate philosophy and management effectiveness⁸. Those things will only be shown on the financial statements indirectly.

Congress and President Bush, wanting to grandstand their so-called care for the investor, unwisely ratified the Public Company Accounting Reform and Investor Protection Act of 2002, or Sarbanes-Oxley (SOX). This legislation has proven to be a draconian response to accounting fraud, especially the infamous section 404. Not unlike the situation in elementary school, where one student misbehaves and the whole class gets punished, SOX has unfairly burdened companies and has created a fetish for their numbers.

With the new SOX guidelines, it is not an exaggeration to say that companies have faced a *doubling* of their audit and regulatory compliance costs. Business leaders are reluctant to take risks and develop new products. Previously, board members could be advisors, however they are now de facto bean counters, and their main concerns are not building the business but avoiding lawsuits. The remaining major public accounting firms now constitute an oligopoly, and with increasing fear of liability, they shy away from making judgment calls⁹.

The most troubling concern is for small and medium-sized businesses—the very foundation of American capitalism—that now face new and perhaps insurmountable barriers. It is relatively less difficult for a Fortune 500 company to absorb the doubling of an audit fee, but not for a smaller corporation. Unless this overzealous legislation is redressed, fewer firms will be able to go public, as the disclosure costs are too high, and instead will take the path of lesser resistance, being purchased¹⁰.

After a 30-year period marked by increasing regulatory budgets and the SEC’s ever-expanding power, thousands of pages of accounting rules from the Financial Accounting Standards Board (FASB) have failed to prevent the scandals of Hollinger, Tyco, Adelphia,

⁸ Pollock, Alex J. “From Making Judgements to Following Rules”. American Enterprise Institute. 19 July 2005, p. 6

⁹ Pollock, Alex J. “Economic Consequences of Sarbanes-Oxley”. American Enterprise Institute. 7 June 2005.

¹⁰ Wall, James. Personal Interview. 8 July 2005

WorldCom, Enron, and others. Indeed, the Enron disaster was actually facilitated by rules-based accounting¹¹.

Not only is increasing the budget of the SEC and FASB failing to prevent corporate fraud, it is costing American taxpayers a bundle. Taxpayers, who may not even own shares of publicly traded corporations in question, realize only a miniscule portion of the benefits of regulatory enforcement, yet they bear a disproportionate amount of the cost. Additionally injurious are the findings of various studies that show the vast majority of the damages awarded from suits brought by the SEC go back to government coffers, not to the “mom and pop” investors that Congress and the law are purported to protect.

Aligning Incentives: Whoever Wants to Play Should Pay

Indeed, some kind of regulation is required, however it need not cost so much. There is still a role for the SEC for its unique powers of subpoena and search and seizure¹².

What is wrong with limiting the costs of compliance and enforcement of a company to the buyers and sellers of that company? While it is sure to be controversial, the Cato Institute’s proposal should certainly be explored: let the securities exchanges (the NYSE, NASDAQ, AMEX, etc.) set the disclosure rules for the listing of public companies and let the exchanges to hire and compensate accountancies to conduct the audits.

The benefits of this arrangement include the efficient pricing and fair allocation of the costs of compliance, monitoring, and enforcement of listed companies; the alignment of incentives for the securities exchanges; and the elimination of conflicts of interest between listed company and auditor. Unlike political actors who “are motivated to seek approval in the form of votes and campaign contributions”¹³, the exchanges are beholden to their customers—both the companies they list and the investors who trade the companies. Also, the exchanges have a vested interest in providing good financial information so that trading volumes can increase. As such, a securities exchange is in a better position to supervise a company’s audit. Freed from the concerns of complying with SOX, board members can return to advising their companies. At the same time, public accounting firms need not worry about losing a client for reporting bad news.

To address concerns that an exchange will not enforce its rules for fear that a company will leave and go to another exchange, an exchange can issue a public reprimand letter. It can also require that the company to deposit a sum as a deterrent to future infractions. Graduated penalties from fines to halted trading to delisting can be applied for the varying degrees of compliance¹⁴.

¹¹ Bassett, Richard and Mark Storrie, “Accounting at Energy Firms after Enron: Is the “Cure” Worse Than the “Disease?””. *Policy Analysis*. Cato Institute. 12 February 2003. p. 1

¹² Mahoney p. 11

¹³ Mahoney, p. 2

¹⁴ Mahoney, p. 11

To improve the operations of corporate governance, Congress should also pursue the flat tax to eliminate the double taxation on corporate earnings as well as the accounting of stock options when exercised, not granted (thereby providing a true market test). Congressman Jeff Flake of Arizona is to be commended for his proposal of H.R. 1641, a move to make section 404 of SOX voluntary¹⁵.

Of course, rules are not a substitute for character. With the passage of SOX, many companies adopted stringent codes of corporate governance. Indeed, Hollinger, now in the “purification process,” has adopted a new set of ethics that exceeds all proposed regulatory standards¹⁶. However, any board can adopt a code of ethics, but if board members do not practice the code, the code is meaningless. The problem is not in the stars or in the organization chart; it is in the people. If each board member does not commit to his or her responsibility, then the organization will rise no higher¹⁷.

Finally, we come back to individuals, each of us—investors. Let us not be fooled into pursuing corporate governance to ensure the loss of capital. Even the best corporate governance system cannot protect against a business model that is flawed. If we want a flourishing economic system, we have to live with the discomfort of risk. The market is inherently risky.

Just as we expect corporate directors to act responsibly, we must act responsibly in our investing. Diversification is the best hedge against the loss of capital. If we demand good corporate governance, we do so for its own sake and because it is the right thing to do.

¹⁵ Pollock

¹⁶ Hollinger Inc. Press Release “Hollinger Inc Adopts Rigorous Governance Policies; Meets or Exceeds Canadian Public Company Requirements”. 27 January 2005.

¹⁷ Robinson, Daniel, PhD, Professor of Philosophy and Psychology, Oxford University. Discussion of Aristotle’s “Eudaimonia” emailed to Roslyn Layton. 9 August 2005.