CORPORATE GOVERNANCE

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Corporate Governance:

A Boost or a Bane?

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Two years after Enron, all listed US or European companies are subject to new regulations which will compel them to make far-reaching changes in the way in which their corporate governance systems are organised. And yet the markets will only regain confidence as a result of more deep-seated changes that cannot really be brought about by the lawmaker, i.e., as regards the praxis of corporate governance.

For two years now, an unprecedented debate has been raging in the business world concerning corporate governance practices. Indeed, we may legitimately ask ourselves why companies that were held up as models several months before their collapse went bankrupt so suddenly. It certainly appears that destructive mechanisms were at work. Compensation policies, for one, and also the more general greed aroused across the spectrum by the extraordinary growth of the financial markets.

For several years, the issue of shareholder value has figured prominently in the debate. The needs of shareholders, which were very largely satisfied, were subsequently thrown by the wayside to focus on the best ways of creating wealth for senior management executives.

However, this description of the situation is largely inadequate. In this collective agitation, all financial market stakeholders should be contrite: the shareholders who would not or could not have their proper say in shareholders' meetings; fund managers who neglected their fiduciary duties; or external auditors whose vigilance gradually declined over time only to be replaced by a collusive complacency in certain cases. There were also blind, incompetent or conspiring directors who betrayed the trust of those they were supposed to defend; corporate officers who implemented autocratic systems of authority and who were more interested in the way they could fatten their wallets than in how to secure the long-term future of the company under their responsibility. Nor are external observers or players, such as analysts and economic journal-

ists, free from blame insofar as they helped to spread the prevailing ideology of the times. It is therefore the system of governance as a whole that should be criticised, and hence rethought. Public authorities also have a part to play in this debate. The collapse of self-regulation has prompted the lawmaker to intervene, often clumsily, in order to provide assurance to bemused investors who no longer know what to believe.

AMERICAN FORMALISM

US companies were the first to face new regulations requiring an overhaul of the organisation of their corporate governance practices. The Sarbanes-Oxley Act was introduced very hastily in 2002. This Act, which more especially deals with criminal liability law, increases general management's obligations and responsibilities in terms of financial reporting. It redefines the independence of external auditors and the oversight of their work by an external body, as well as introducing more stringent penalties in the event that a number of rules are breached. The Securities and Exchange Commission (SEC) has had to provide clarifications regarding a large number of provisions contained in the Act, in particular in relation to information reported to the financial markets and the functioning of corporate governance systems. Finally, the New York Stock Exchange (NYSE) and the Nasdaq have published corporate governance standards with which all listed companies are required to comply.

The approach adopted by the US is extremely intricate and formal. The strengthening of the Board of Directors by the introduction of a majority of independent directors is one of the key measures of the new system. The independence criteria set forth are extremely rigorous and specific. The role of such independent directors is instrumental in certain committees which the law requires to be set up: the Audit Committee, Compensation Committee and Nominations Committee. The composition and functions of each committee are also subject to specific regulations.

Conceived as a real force of opposition, the audit committee has a vital role to play in corporate governance. Comprised solely of independent directors, its role is defined in regulations published by the company. The scope of the audit committee's work is broad, and consists of ensuring the integrity of the financial statements, the due and proper application by the company of laws and regulations, and the appointment, compensation and oversight of the work of external auditors whose independence it

ensures. The committee is also required to put in place a system whereby anyone in the company can denounce fraudulent practices without having to worry about the implications of his or her action. The committee is also required to oversee audit and internal control procedures.

The second main focus of the legislation is transparency. The law provides that general management must personally attest to the fairness of the published financial statements and the effectiveness of internal control. The quality of the internal control function is in fact a guarantee of the accuracy of the representations made in respect of the company's main accounting items. The SEC has provided specific guidance on the ways in which these provisions, and the provisions pertaining to the disclosure of off-balance sheet information, should be applied. Lastly, listed US companies are required to adopt a code of ethics and to publish detailed information on the organisation of corporate governance within the company.

The steps taken by the European Union obviously stem from a desire to address the crisis of confidence on the financial markets, but also to ensure the successful integration of countries within the EU whose economic or legal traditions are different from those of the EU-15.

The third main area of the Act relates to the enhanced role of shareholders. Shareholders must be able to have a say in any issuance of securities in favour of the company's directors or major shareholders, or on any financial transactions which would have a significant impact on the company's ownership structure. Similarly, they must be able to express their views on any shares allocated to management.

The SEC's project to change the rules for appointing directors in order to allow candidates proposed by minority shareholders to be put to the vote at the shareholders' meeting further emphasises this marked overall tendency to give back a certain degree of power to shareholders.

European flexibility

The approach adopted by Europe has been more cautious. In May 2003, following a series of discussions including those of the working group chaired by Jaap Winter in 2002, the Commission set out an action plan which supplements and provides a framework for a number of initiatives in the field of European business law. This action plan aims to strengthen shareholder rights and third party protection, and to foster efficiency and the competitiveness of enterprises. The steps taken by the European Union obviously stem from a desire to address the crisis of confidence on the financial markets, but also to ensure the successful integration of countries within the EU whose economic or legal traditions are different from those of the EU-15.

The main provisions to be adopted by each country now appear to have been relatively clearly outlined. These provisions mostly concern transparency. First and foremost, there is the requirement to adopt international accounting standards as from 1 January 2005. A Directive on abusive market behaviour deals with insider trading and fraudulent practices. This Directive is to be transposed into the law of each Member State by October 2004. A Directive on prospectuses was also approved by the European Parliament at the end of last year. This Directive ensures that European companies issuing securities on the market are all subject to the same requirements.

The Commission is also working on a proposal for a Directive on transparency requirements for listed companies. The proposal is set to be reviewed by the European Parliament in 2004 and implemented by each country in 2005. The aim of this proposal is to protect investors by requiring a minimum level of transparency, facilitating the access of European issuers to countries other than their country of origin and lastly, to foster a more effective distribution of capital in the long term by offering the market a more effective means of comparing European companies.

One of the provisions, which has provoked a certain amount of agitation in European business circles, is the requirement for listed companies to publish quarterly financial information such as turnover and earnings, as well as half-yearly abridged financial statements with an update on the last management report. The Board of Directors is liable in the event of any misrepresentations. However, information requirements are less stringent than those imposed on US companies.

Compensation policies for senior management executives are also under scrutiny. Following along the lines of the Winter report, the Commission could require listed companies to disclose their compensation policy for senior management executives and directors. Shareholders should be informed, and maybe even consulted, on certain points, such as the link between performance and compensation. Finally, the Commission is to provide guidance on the ways in which this compensation, and in particular, compensation in the form of stock options, should be recognised in the accounts.

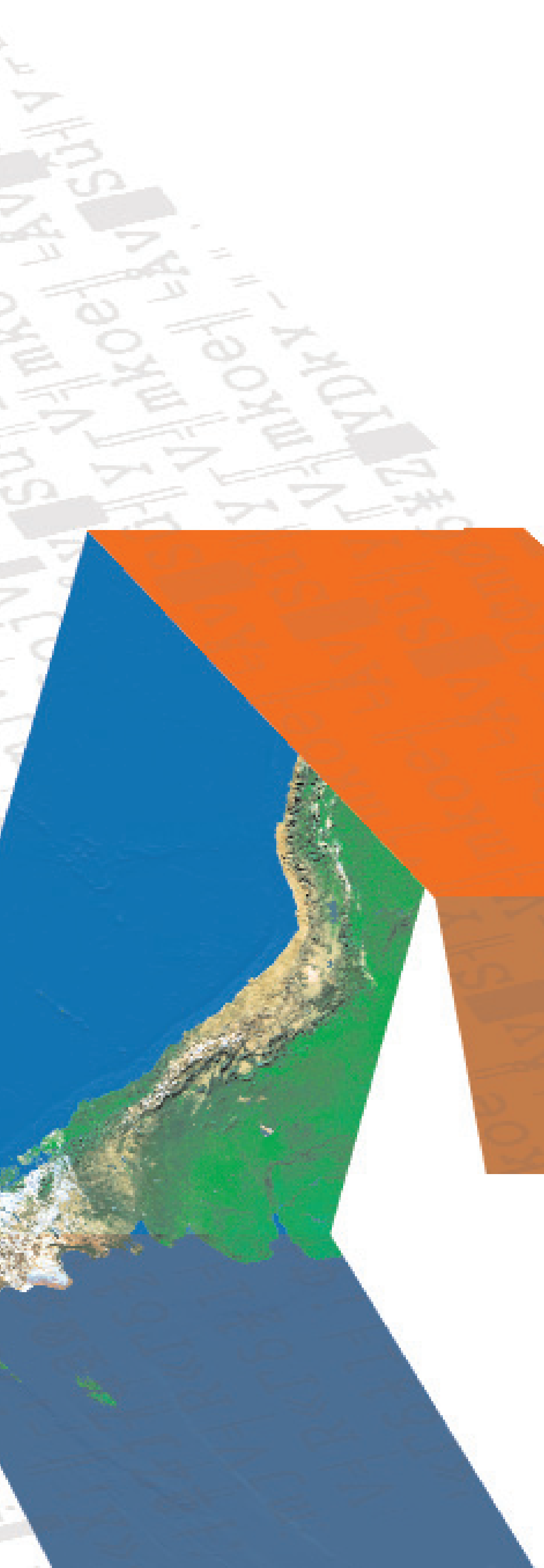
Finally, in the wake of the Parmalat scandal, the Commission has stepped up its work on the proposal for a Directive concerning the audit of the financial statements of European companies. This Directive would make it compulsory for companies to set up an audit committee. Besides strengthening the independence and competence of external auditors, it would also introduce the requirement for each Member State to set up a specific body in charge of overseeing the quality and independence of work carried out by external auditors, similar to the Public Company Accounting Oversight Board (PCAOB) in the US or the Haut Conseil du commissariat aux comptes in France.

NATIONAL INITIATIVES

The Commission leaves other areas of corporate governance subject to the codes of national best practices. Indeed, there are around forty such codes, underpinned by relatively similar principles. Some countries are well ahead of others in this area. The UK, for example, can be held up as a model: following the Smith report on audit committees and the Higgs report on the role of non-executive directors, a new code was drawn up. Companies are encouraged to comply with this code, or to explain why they chose not to act in accordance with a specific provision.

This new code specifically defines independence criteria, and the roles and responsibilities of the Chairman, advisory directors, and non-executive directors. It requires that there be a separation of the duties of the Chairman and CEO, and for the Chairman to be independent at the time of his or her appointment.

In France, the findings of the Viénot and Bouton reports were consolidated in October 2003 by the Medef (Mouvement des entreprises de France–

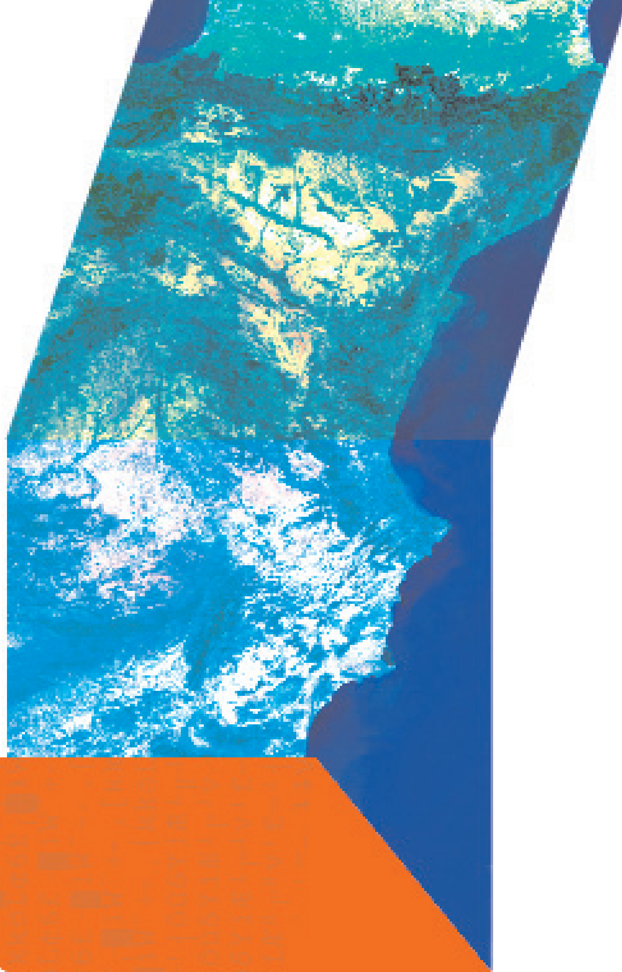


French Employers' Organisation for the Promotion of French Businesses) and the Afep (Association française des entreprises privées–French Association of Private Businesses).

The COB (Commission des opérations de Bourse-French stock exchange authority) whose role has now been assumed by the AMF (Autorité des marchés financiers–French Financial Markets Authority) require listed companies to devote a chapter of their "document de référence" (shelf-registration document) to corporate governance practices in light of these recommendations. This requirement is currently reinforced by the French law on financial security, which specifies that the Chairman of the Board of Directors (or Supervisory Board) must describe, in a report accompanying the annual management report of the company and Group, on the "conditions for preparing and organising work by the Board of Directors as well as the internal control procedures put in place by the company".

Costly, but effective, measures

Obviously, compliance with this more or less mandatory set of requirements or recommendations has a cost for the company: more rigorous external audit procedures, use of external legal counsel or organisational consultants, upgrading of internal control systems and the corresponding IT tools. Compliance with such rules also involves strengthening the internal audit system, creating new functions, stepping up the work of the various boards and committees, increased insurance costs, etc. In



total, the estimated costs of implementing these new measures for a Fortune-500 company with revenues of USD 3 billion are between USD 3.5 million and USD 9.5 million for the first year and between USD 2.8 million and USD 8 million per year thereafter [1]!

These figures may look exorbitant. Yet they should be seen at in comparison with the impact of better corporate governance on the value of the company. Based on a corporate governance index including over 20 provisions, many of which relate to shareholder protection, researchers in the US have demonstrated that in terms of market performance, companies with effective corporate governance practices consistently outperform (+ 8.5% over the 1990s) those without an efficient corporate governance system [2].

Many studies confirm that in general, the independence, competencies, organisational abilities and motivation of directors are key factors in value creation. The alignment of managers' interests with stakeholders' interests through a system of compensation linked to company performance can also increase shareholder value, even though the recently witnessed spate of abuses has led to a

1 *New Regulations: Preparing for the Unplanned Costs*, Financial Executive, January-February 2003

2 *Corporate Governance and Equity Prices, Gompers*, Paul A.-Ishii, Joy L.-Metrick, Andrew, 2001.

reconsideration of the conditions in which such compensation should be granted.

ESCAPING THE CONFORMITY TRAP

These analyses of the impact of certain components of good corporate governance practices are supported by a smaller number of global studies. In this regard, a survey of institutional investors conducted by McKinsey in 2002 confirmed that the issue of corporate governance was at the very heart of investment decisions. Most of the investors surveyed were willing to pay a very substantial premium for companies that had adopted strict governance practices: between 12% and 14% in Western Europe and the US, between 20% and 25% in Asia and Latin America, and around 30% in Eastern Europe and Africa.

However, better corporate governance practices will not automatically drive up company value, as some companies could easily get caught in the conformity trap. Indeed, too many companies in fact consider that they have fulfilled their corporate governance "obligations" once they have set up one or two committees, appointed a few high-profile independent directors or provided more information on the frequency of Board meetings. Instead, these companies should realise that all companies will soon be in compliance with these regulations. The market will no longer make any distinction between issuers on this basis alone.

There is no ideal model of corporate governance. From this point of view, the measured approach adopted by the European Union offers a real opportunity for our companies to put in place systems specifically tailored to a given situation.

Going beyond governance obligations

There will no longer be any premium associated with good corporate governance… except for those companies which look to adopt measures that go above and beyond their governance obligations. Corporate governance is not an end in itself, but a tool offering companies the means to reassure their shareholders as to the way in which decisions are taken and monitored in three key areas: investment policy, risk management and value distribution. Losing sight of this fact can only lead to disembodied corporate governance practices.

A sound investment policy is a vital condition for ensuring a high level of return on the companies' intangible or tangible assets. A company's investment policy covers both recurring and major investments, but also the portfolio of real options that it should seek to build up and maintain. The company's growth in the future depends on the quality of this portfolio and the way in which it is managed. This strategic and organisational issue, key to ensuring the company's competitive advantage going forward, should figure prominently in the Board's deliberations and in information provided to shareholders.

Secondly, investors will also have to be reassured that the company has a sound risk management policy. The volatility of the markets only serves to mirror the fragility of competitive positions. Nowadays, risks are more pernicious and multi-faceted than ever, and companies are finding themselves to be increasingly vulnerable. Obviously, not all risks to which organisations are exposed can be avoided, but current techniques do allow risks to be managed more systematically.

Finally, the company must look to rebuild shareholder confidence regarding the way in which the value created by the company is distributed. This means convincing investors that the company is not generating private profits in favour of a specific group of people, whether it be senior management executives, majority shareholders, privileged partners, etc. The policy adopted by the company in respect of financing, its executive compensation policy, agreements with influential shareholders, and its transfer pricing policy may all signal a transfer of value that can be harmful to shareholders' interests.

EFFICIENCY, ACCOUNTABILITY AND EQUITY

Creating and maintaining shareholder confidence means reassuring shareholders that a corporate governance system exists to ensure that any decisions regarding these key areas are taken with the following three fundamental principles in mind: efficiency, accountability and equity.

Efficiency, because the aim of corporate governance is to optimise decision-making. From this perspective, recent scandals have revealed the limits of the visionary, but autocratic, boss. Studies conducted show that results of collective decisions are more successful than those of decisions taken individually, provided that directors do not fall into the "groupthink" traps described by Janis[3]. The contribution of an active, independently minded and competent Board of Directors is a critical component in ensuring the company takes high-quality strategic decisions.

The corporate governance system should also endeavour to create the conditions for genuine accountability of decision-making and oversight bodies. Shareholders cannot trust organisations which in fact fail to hold decision-makers or those overseeing their actions accountable. The principle of accountability entails a clear separation of duties between executive management and oversight bodies, clear and transparent objectives for each person, the implementation of a professional evaluation process and a system of performance-related compensation. Finally, penalties in the event of shortcomings should be able to be applied in a fully transparent manner.

Equity is the final core principle that any corporate governance system should aim for. Above all, equity should apply with respect to shareholders. Trust stems from the conviction that major decisions will be taken in compliance with express or implied commitments. Equity should be ensured with respect to management, which helps to enhance value for shareholders. Equity should also be ensured with respect to majority shareholders, who have a major stake in the company. Lastly, equity should be ensured with respect to the company's partners.

The Board of Directors acts as the guarantor of this principle of equity, one of the keys for securing market confidence.

Tailored strategies

Companies who want to stand out and benefit from a valuation premium must therefore lay down a genuine corporate governance strategy. While the objectives are clear, the way in which companies choose to implement such a strategy is left to their own discretion. There is no ideal model of corporate governance. From this point of view, the measured

3 "Crucial decisions: leadership in policy-making and crisis management", Irving Janis, Free Press, 1989.

approach adopted by the European Union offers a real opportunity for our companies to put in place systems specifically tailored to a given situation. It is another matter entirely for the governance strategy to reach beyond organisational and procedural issues and have a direct effect on behaviour.
Best corporate governance practices are all well-known. However, companies need to focus on the extent to which such practices are adapted to their particular situation, and in particular, their size, maturity and industry, the market on which they trade, their legal structure, the geographical distribution of their capital, and the size of their floating capital, etc. Naturally, a group listed on the New York and Paris stock markets, whose stock ownership is widely dispersed across the international spectrum, cannot have the same corporate governance system as a family-controlled company listed on the Paris "second marché".

Gradually, institutional investors will spur companies to go beyond regulatory requirements and official codes of ethics. Some investors have already issued their own recommendations.

The role of the Board of Directors is to design and build a structure in which each party reinforces or compensates the role of the others, and which should be designed in such a way as to allow for changes over time. All aspects of corporate governance should be analysed and specific choices made in each area, e.g., company management and oversight; the selection, appointment, evaluation and compensation of management executives and directors; upward and downward information flows between shareholders, directors and senior management executives; the rights and duties of shareholders; external commitments with regard to other stakeholders, etc.

CORPORATE GOVERNANCE: A COMPLEX AND CROSS-FUNCTIONAL DISCIPLINE

Experience has shown that to design an effective corporate governance system, companies must look at all of aspects of governance in order to identify and resolve the frequent contradictions that will inevitably be brought about by a fragmented approach, and manage the implications of the system in terms of civil and criminal liability. Corporate governance is thus a complex discipline, at the crossroads between law, finance, organisational and behavioural sciences, and communications[4].
Over and above the organisation and the procedures put in place, the company must endeavour to change behaviour and inform the market of its efforts in this respect. Only by doing so will it be able to foreground its corporate governance practices as a genuine plus for investors who themselves join forces in an attempt to ascertain whether or not such practices have any underlying substance.
The issue of independent directors is a good example of the need to tackle the practical difficulties of corporate governance[5]. The number of independent members serving on the Board of Directors is less important than their qualifications, the extent of the information they have on company issues and the possibilities available to them to take an active part in Board discussions. An independent director who receives a 500-page file three days before the Board meeting and who is to attend a discussion that management has structured around completely abstruse technical points is of no use in the decision-making process.
Investors are no fools: studies carried out have underlined that there is no correlation between

4 In order to advance current thinking on corporate governance, Ernst & Young serves on the Benjamin Franklin committee, a multi-disciplinary think tank which aims to establish the bases for a new approach to corporate governance.
5 For a critical description of the functioning of corporate governance in France, see the report drawn up by Bénédicte Bertin-Mourot and Marc Lapôtre, "Gouvernement d'entreprise : fonctionnement des organes de contrôle et rôle des représentants des salariés", Observatoire des dirigeants, LSCI-CNRS.

greater independence of the Board of Directors and company performance. Indeed, a disproportionately high number of independent directors may actually be counter-productive: they are less familiar with the company, show less assurance when it comes to voicing their opinions during Board meetings (due to limited access to information), and finally… they depend more on management! It is the Chairman's role to ensure that independent directors can genuinely take an active part in Board meetings. Gradually, institutional investors will spur companies to go beyond regulatory requirements and official codes of ethics. Some investors have already issued their own recommendations.
These investors are a particularly effective stimulus for companies wishing to avoid confrontations with powerful shareholders, which often damage their reputation. Under pressure from those that mandate them, but also as a result of constraints imposed on them by US legislation, these investors have to vote at shareholders' meetings and explain their particular voting rationale. Shareholder revolts, such as those recently witnessed by groups such as Disney or Newscorp, are proof that this threat no longer exists only in theory.

ANTICIPATING MARKET REQUIREMENTS

Another factor to be taken into consideration by companies is that methods for analysing corporate governance practices are gradually being developed by both institutional investors and specialised rating agencies (GMI, ISS, etc.). The approaches remain at a very formal stage, but with time, and thanks to information provided to the market by companies with better corporate governance practices, and the consequences of corporate officers and directors being held liable for questionable practices, it would appear that analyses of corporate governance practices will be made in greater depth, and hence become more pertinent. The interest shown by rating agencies in corporate governance [6] should help to bring about this change more quickly.
Companies that are keen to amortise the costs of compliance should therefore anticipate market requirements: paying lip service to corporate governance is not enough. The corporate governance ethic must be lived out by companies on a day-to-day basis and thereby prove its worth in order to convince and restore market confidence. Regulators are useful for establishing principles, but of no use when it comes to putting them into practice. Ultimately, it is for companies to decide whether corporate governance is a boost or a bane.

6 "Ne tirez pas sur les agences de rating!", Jean-Florent Rérolle, Banque Stratégie, April 2003.

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