Corporate Governance - convergence?

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As the 21st. century dawned corporate governance seemed to be developing well around the world. Codes of principle or best practices in corporate governance were in place for listed companies in many countries. The importance of good corporate governance was well recognised. Markets offered a premium for shares in well-governed companies, because risks were lower. This was particularly the case in the United States. Indeed, there was a widespread expectation in the States that the rest of the world would gradually converge with the American approach to corporate governance and US generally accepted accounting principles (*GAAP*), not least because the world, it was felt, needed access to American funds.

But the new century had scarcely begun when disaster struck. Enron, one of the largest companies in America, collapsed on the back of heavy unreported indebtedness and dubious corporate governance attitudes among the executive directors. Governance problems appeared in other companies around the world – Waste Management, Worldcom and Tyco in the United States; Marconi, British Rail, Independent Insurance and Tomkins in the UK; HIH Insurance in Australia; Parmalat in Italy and Vodaphone Mannesmann in Germany, not least. Arthur Andersen, one of the big five global accounting firms, who had been the auditors of Enron, Worldcom and Waste Management, collapsed as clients changed auditors and partners changed firms.

American accounting standards (GAAP) were now pilloried as being based on rules that could be manipulated, rather than on the principles of overall fairness required in international accounting standards. The financial transparency, the governance processes and, most significantly, the corporate governance attitudes in other companies were questioned**.** Confidence in the financial markets was shaken. Suddenly, from being the leaders of economic success, entrepreneurial risk-taking and sound corporate governance, directors were depicted as greedy, short-sighted and more interested in their personal share options than creating sustainable wealth for the benefit of the shareholders.

The response in the United States was more legislation. The Sarbanes Oxley Act, which was rushed through in 2002, placed stringent new demands on the governance of all companies listed in the United States. This act, nicknamed 'SOX', significantly raised the costs of corporate governance. Only independent directors could now serve on audit and remuneration committees, shareholders must approve plans for directors' stock options, subsidised loans to directors were forbidden, and directors had to certify that their systems recognised risk, or risk going to jail themselves. A new institution was created to oversee audit firms, which must rotate their audit partners to prevent over familiarity between auditor and the client's finance staff. Auditors were forbidden to sell some non-audit services to their clients, and audit staff must serve a cooling off period before joining the staff of a client - all of which had happened in Enron. Then came the global collapse of the financial markets in 2007/8. Had corporate governance failed again?

- Where were the directors of the failed financial institutions, particularly the independent outside directors who were supposed to provide a check on over-enthusiastic executive directors? Did they really understand the strategic business models and sophisticated securitised instruments involved? In other words, did they appreciate the risk inherent in their companies' strategic profile?
- Where were the auditors? In approving the accounts of client financial institutions did they fully appreciate and ensure the reporting of exposure to risk? Expect some major legal actions as client companies fail.
- Did the credit agencies contribute to the problem by awarding high credit ratings to companies exposed to significant risk?
- Government bailouts also raised the question of so-called moral hazard - by protecting bankers from their past reckless decisions, would others be encouraged to take excessive risks in the future?
- Will the experts who designed the sophisticated loan securitisation vehicles and other financial engineering systems be held to account? Are their ideas and enthusiasms now under control?
- Where were the banking regulators? Although the extent of the crisis was unprecedented, the regulators seem to have been beguiled into complacency, perhaps taken-over by the industry they were there to regulate. New rules seem inevitable.
- Were any of the financial institutions' activities illegal? Compare the situation with ENRON, where some top executives continued to believe that nothing they had done was wrong, even when they were in jail.
- Finally, did excessive bonuses and share options encourage short-term and unrealistic risk-taking with shareholders funds? In the future, controls are likely on performance related remuneration. The news that some bankers had lost their fortunes as share prices collapsed was cold comfort to mortgagees who lost their homes, shareholders who lost their savings, and employees who lost their livelihoods.

The world no longer needed access to American capital: the reverse had become true. Western nations urgently sought support from the sovereign funds of oil rich and other successful trading countries. Corporate governance had reached another cross-road.

In the past many commentators on corporate governance contrasted what they called the Anglo-American (or Anglo-Saxon) approach to corporate governance with the continental European approach. They pointed out the fundamental differences between:

- case-law based, company law in the US and UK/Commonwealth countries such as Australia, Canada, India, Singapore, South Africa, and other places (including Hong Kong) on the one hand and the rule-based European company law on the other
- the unitary boards of the Anglo-American companies and the two-tier supervisory boards of continental European companies, and

- The liquid markets of the Anglo/American model and the bank-dominated finance of the others.

However, when the US responded to the Enron saga with stringent new corporate governance law (the SOX Act), it became apparent that American and British/Commonwealth corporate governance no longer shared the same foundations. Indeed, it seemed that they were based on fundamentally different philosophies. The US model of corporate governance relied on a prescriptive rule-based, regulatory legal approach, whereas the UK/Commonwealth model was rooted in a non-prescriptive, principles-based, self-regulatory approach.

Essentially, in the United States, corporate governance is now regulated through the law. Boards and their directors must follow the regulations and obey the law or face penalties, including in some cases unlimited fines and jail.

By contrast in Hong Kong, the United Kingdom and all those other countries, influenced over the years by UK law, corporate governance regulation is still based on compliance with codes of principle and good practices, with directors still expected to conform to the relevant code or explain the circumstances which have led them to choose not to conform.

This frontier has become a fundamental philosophical debate of massive significance for the future of the subject.

Moreover, another dimension has been added to the debate. It is no longer just a matter of Anglo/American versus European, or rule-based versus principles-based. Cultural aspects are now seen to be significant to the evolution of corporate governance: the way business is done, the extent to which legal contracts or inter-personal trust form the basis for business decisions, the complex structure of corporate groups, the sources of capital, the legal traditions, the state of company law, the reliability of the courts, the existence of relevant institutions, the standing of the accountancy, audit, and legal professions, the powers of the regulatory authorities, overall the traditions of the country and the expectations of its people are now seen to influence the way that corporate governance develops.

So, overall, corporate governance continues to evolve. Present practice is still rooted in a nineteenth century legal concept of the corporation that has become totally inadequate in the emerging global business environment. The metamorphous that will determine the bounds and the structure of the subject has yet to occur. Present theory is even less capable of explaining coherently the way that modern organisations are governed. What is needed is a vibrant alternative way to ensure that power is exercised, over every type and form of corporate entity and strategic alliance around the world, in a way that ensures both effective performance and appropriate social accountability and responsibility. It would be good for such concepts to be rooted in rigorous and replicable research. Unfortunately, the driver of further changes in corporate governance is most likely to be the exposure of further board level excesses, corporate collapses and economic malaise.

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