

Corporate Governance and Accounting

Concept: Corporate Governance and Accounting

Author: Sarah Eaton , University of Toronto

Date Entered: 2005-03-01

Description In its broadest sense, corporate governance refers to the various means of holding the modern corporation to account. The contemporary study and practice of corporate governance bears the stamp of two American Depression-era scholars, Adolf Berle Jr. and Gardiner Means, who first identified the great potential for rapacious management practices in joint-stock companies. In *The Modern Corporation and Private Property* (1932), they pointed out that separation between a concentrated management and dispersed shareholders provided managers with both the incentive and the opportunity to exploit their privileged position in the corporation for personal gain. In economics, this phenomenon has since become known as a principal-agent problem where the "problem" is how to align the incentives of agents (managers) and principals (shareholders).

The modern corporate governance movement is borne of the belief that it is possible to mitigate the principal-agent problem through a combination of carrot and stick inducements. Ballooning executive compensation packages reflect one (very controversial) attempt to mitigate the principal-agent problem. In the 1980s and 90s many corporate boards opted to make CEO pay performance-based on the grounds that a manager with a direct financial stake in the company's performance will strive to maximize shareholder value. The exposure of fraudulent management practices among extremely well-paid Enron executives has called into question the wisdom of this carrot-based approach. Indeed, it has been argued that performance-based compensation in fact encourages management to mislead shareholders about the financial health of the company (e.g., Burns and Kedia 2006). Economists argue that failing effective intra-company incentives an active takeover market in North America and, increasingly, in Europe should encourage responsible management since non-performing CEOs face job loss via takeover.

In addition to market-based solutions, corporate governance also refers to different means of trying to enhance the direct control of shareholders over management. Due to information asymmetries and minimal voting power, lone shareholders encounter considerable difficulty in acting as a check on management. In recent years, however, institutional investors or powerful organizations that invest large sums on behalf of a dispersed membership (e.g., the California Public Employees' Retirement System) have begun using their considerable proxy voting power to try and exert more control over management decisions. Elsewhere in the world, the audience of company practices is often defined more widely than shareholders and creditors. In Germany for instance, trade unions are seen as legitimate

stakeholders in company affairs and have traditionally been influential participants on company boards.

Accounting is an important tool of corporate governance because it helps principals hold agents to account. Financial accounting is especially crucial since the financial statements which corporations are required by law to publish at regular intervals are the most important sources of information about the company to which company shareholders and financial analysts have access. It is for this reason that professional accountants who prepare company accounts and, even more importantly, auditors who are employed by outside firms to evaluate the accuracy of these financial statements are seen as having such an important role to play in minimizing the principal-agent problem. Thus, when it came to light that one of the "Big Five" audit firms, Arthur Andersen, had been complicit in Enron management's efforts to conceal massive losses from investors it was widely seen as a massive failure of corporate governance. Since the US corporate scandals of 2001-2002, a major batch of securities regulation, the Sarbanes-Oxley Act, has been enacted in an effort to improve American corporate governance practices. To try to prevent the kinds of alliances that developed between Enron management and auditors in the now-defunct Arthur Andersen, Sarbanes-Oxley requires the periodic rotation of audit firms. As well, CEOs are now required to personally attest to the truth of their company's financial statements.

Following the Asian Financial Crisis of 1997-98, corporate governance became something of a global buzzword largely because the major international financial institutions (IFIs), such as the International Monetary Fund and World Bank, interpreted the crisis in terms of a failure of good governance. The argument advanced by the IFIs was that the financial panic would not have taken place if foreign investors had had access to accurate information about their investments from the get go. The IMF's Article IV Consultations have since become the most important vector of corporate governance reform outside of Europe and North America. Under Article IV, the IMF is empowered to assess debtor countries' compliance with loan conditionality imperatives. In 1998, corporate governance was added to the Fund's standards of assessment as a component of the newly-minted Reports on the Observance of Standards and Codes (ROSCs). The IMF's corporate governance standard is a controversial one because it holds debtor countries up to an Anglo-American standard which emphasizes the twin disciplining effects of shareholder "voice" and the external takeover mechanism. In the East Asian economies that were first subject to the IMF's ROSC consultations, these mechanisms are largely absent because corporate finance is largely bank-based and takeovers are rare. Some observers see a profit motive at work behind the IFI's efforts to globalize Anglo-American style corporate governance. Soederberg (2003) argues that the IMF's promotion of shareholder-referent corporate governance is a thinly-veiled effort to protect the rights of American institutional investors operating in foreign markets.

Finally, the burgeoning corporate social responsibility (CSR) movement suggests that the business world is increasingly policing itself. CSR covers a range of activities from socially and environmentally responsible production to ethical investment to social accounting. What unites the CSR movement is a belief that business should be hemmed in by ethical standards not unlike those that circumscribe the activities of human beings. Global civil society has played a key role in pressuring multinational corporations to adopt socially and environmentally responsible practices. For instance, it was Jeff Ballinger's 1992 *Harper's* magazine exposé of Nike's deplorable factories in Indonesia that first brought Nike's bottom-line production to the world's attention. There is considerable debate about how best to ensure that corporations act in accord with accepted CSR principles. Some suggest that getting corporations to sign on to voluntary codes of conduct is a market-friendly and realistic means of promoting CSR. The UN's Global Compact (GC) reflects this view. The GC, an initiative of Secretary-General Kofi Annan, challenges corporations to incorporate ten core CSR principles into their business practices on a purely voluntary basis. A notable achievement of the GC is the agreement by Norwegian oil company Statoil to hold developing world plants to the same labour standards as Norwegian operations. Some observers are less sanguine about voluntary means of promoting CSR, however. Vogel (2005) argues that because the market incentives for corporations to abide by CSR are limited, what is needed is much more government regulation around the globe.

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