Corporate governance and responsibility

Foundations of market integrity

Bill Witherell, Head, OECD Directorate for Financial, Fiscal and Enterprise Affairs

© Getty Images

Good governance goes beyond common sense. It is a key part of the contract that underpins economic growth in a market economy and public faith in that system. The OECD Principles of Corporate Governance and Guidelines for Multinational Enterprises are two essential instruments for ensuring that this contract is honoured.

The recent spate of US corporate failures and breakdowns in truthful accounting has undermined people's faith in financial reporting, corporate leadership, and the integrity of markets the world over. The fact that the wave of scandals has come hot on the heels of a collapse in the high-tech bubble has a sharp ironic flavour. Both events have their roots in the heady days of stock market exuberance, when anything was possible, from creating multibillion dollar companies with little more than an idea, an investment angel and a lot of faith, to believing that markets would buy any yarn a group of fast-talking executives could spin, even if to cover up serious losses and illegal practices. The corporate scandals and the bursting bubble have different causes though: on the one hand, illicit management decisions and cover-ups, and on the other, over-bloated investment assessments followed by a sharp market correction that spelt the end for thousands of high-tech wannabes. Still, it is difficult to disentangle the negative effects these two parallel developments have had on the confidence of investors.

With the bursting of the high-tech bubble, share values were written down and venture capitalists took a bruising, as did many shareholders. That is the downside of committing resources to investments with a high risk/high reward profile. But in the cases of corporate misbehaviour, the public, employees and pensioners were deliberately misled. They have now lost many billions of dollars, and in some cases their life savings, while some insiders benefited. The truly unfortunate part is that both events might in their own way have been avoided (or at least anticipated) if effective corporate governance and high levels of corporate responsibility had been respected.

The role of good governance and corporate responsibility in helping to assure the well-functioning markets needed for economic growth and development cannot be taken for granted. This idea has been repeated by government and business leaders the world over, and most recently reaffirmed at summits from Doha to Johannesburg. But we are falling short: the systems may be there – the US had, on paper, one of the best – but evidently they have not worked. Fixing them will require both private initiatives and strong government action.

Good corporate governance – the rules and practices that govern the relationship between the managers and shareholders of corporations, as well as stakeholders like employees, pensioners and local communities – ensures transparency, fairness and accountability. It is a prerequisite for the integrity and credibility of market institutions. By building confidence and trust, good governance allows the corporation to have access to external finance and to make reliable commitments to creditors, employees and shareholders. It is this contract that underpins economic growth in a market economy.

When this trust is undermined, lenders and investors lose their appetite for risk, and shareholders offload their equity, resulting in lost value and reduced availability of capital. This goes for every stage of the investment process, affecting issues from property protection and ownership registration, to disclosure and the distribution of authority and responsibility among company organs.

Clearly, the importance of good corporate governance goes far beyond the interests of shareholders in an individual company. Indeed, the central corporate governance principles of transparency and accountability are crucial to the integrity and legal credibility of our market system. We already trust corporations to create jobs, generate tax revenues and provide markets with goods and services. Increasingly we make use of private sector institutions to manage our savings and secure our retirement income.

Private participation in delivering these services has been proven to work, but it is constantly under scrutiny and must remain so. Some private pension funds, for instance, have recently been informing their pensioners of the prospect of reduced payments, due to falling stocks. If market risk and cycles were the only cause behind these announcements, that would be fine. The stakeholder public would probably live with that, and anyway, the market provides other instruments for customers to invest in, like property or long-term bonds. But to the extent that the market's fall can be traced to scandals and breaches of trust, public support wanes and the market becomes unworkable. The state's reputation is also at stake.

This underscores a widespread public – and hence political – interest in reinforcing corporate governance practices. Such concerns become even more important in an international context where the full benefits of free capital flows will only be realised if there is a mutual understanding on the basic elements of good corporate governance. These are the core concerns that triggered and nurtured the discussions on corporate governance in OECD countries, leading to the development of the **OECD Principles of Corporate Governance**. These principles, that have received OECD ministerial backing, form the basis of a true global standard in corporate governance.

We need to develop governance tools and incentive structures that are more robust in the face of rapid financial innovation, and procedures that leave no doubt as to the stakes involved. Accounting standards need to become principle-based, rather than being based on rules that invite evasion.

In the light of recent developments, OECD ministers have called for an assessment of these principles. The basic ideas enshrined in the principles are not being questioned, but there evidently is a need to provide further guidance, particularly with respect to achieving effective implementation in the dynamic markets of the 21st century.

Corporate structures change fast, while financial innovation and globalisation all present new challenges to maintaining good corporate governance. The recent high-profile cases of governance failure and corporate misconduct have shown that corporate governance mechanisms sometimes have not kept up with these developments.

The OECD principles already highlight that an annual audit of accounts be conducted by "an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented". The principle is there, but as we have seen recently, it was not always heeded. Governments, security market regulators and the private sector itself are all taking steps to strengthen the implementation of this principle.

Nor have company boards lived up to their responsibilities. For instance, the OECD principles recommend that the board "monitors and manages potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions". There is obviously a gap between risk management practices by corporations and investors and the existing tools for disclosing, accounting for and controlling risk. And monitoring is not easy, since the conflicts of interest that have been identified extend beyond the corporations themselves to financial analysts, rating agencies and financial institutions. In other words, who can we trust? We need to develop governance tools and incentive structures that are more robust in the face of rapid financial innovation, and procedures that leave no doubt as to the stakes involved. Accounting standards need to become principle-based, rather than being based on rules that invite evasion.

But while details and principles may be strengthened on paper, they will serve little purpose without the political commitment to abide by them. The aim is to reinforce the contracts of trust that drive our market democracies; governments as custodians must take a lead in ensuring these contracts are not only understood, but honoured too.

Responsibility

Corporate managers' responsibilities, of course, are not limited to producing truthful financial reporting, carrying out the core functions of conducting business and obeying the various applicable laws. Businesses also have to respond to the expectations of the democratic societies in which they operate – expectations that often are not written down as formal law. The term "corporate responsibility" refers to the actions taken by businesses in response to such expectations in order to enhance the mutually dependent relationship between business and societies. Shareholders, in fact, expect their corporations to meet society's demands, consistent with maximising the value of the firm. Indeed, experience has shown that companies that do so are generally the best performers in the long run.

The challenge of meeting these expectations has become more complex in today's global economy, with firms typically operating in a number of legal, regulatory, cultural and business environments. Globalisation's benefits are well documented, but it has raised legitimate public concerns, several of which have been directed at multinational enterprises as agents of the globalisation process. Multinational enterprises sometimes are perceived as taking the money and running, not doing enough to build up local economies, and so on. They are accused of being party – in many cases, inadvertently – to serious problems such as corruption of public officials, human rights and labour rights abuses and environmental damage. Companies have to address such concerns when they arise. In fact, apart from ethical considerations and the law, their host-country market valuations would suffer if they ignored them.

In recent years, businesses have engaged in voluntary initiatives to improve their performance in various areas of business ethics as well as legal compliance. They have developed codes of conduct and management systems designed to help them comply with these commitments. They have developed them with the help of labour unions, non-governmental organisations and governments.

The recently updated OECD **Guidelines for Multinational Enterprises** complement and support these private initiatives for corporate responsibility. These guidelines are recommendations addressed by governments to multinational enterprises operating in or from adhering countries. Being from the OECD is somehow appropriate, given that nearly all FDI that takes place in the world originates and is financed in the OECD area. In fact, the MNE guidelines are the only multilaterally endorsed instrument for corporate responsibility and reflect extensive consultation with countries outside the OECD, as well as business and civil society. They cover the full range of areas relevant to standards of responsible business conduct and so provide to corporations a most valuable international benchmark of society's expectations (see article, p.10).

Further improving the "fit" between corporations and the societies in which they operate is a key goal of the OECD. That means strengthening the governance structures and practices within corporations, and their relationships with shareholders and other stakeholders. Good corporate governance and corporate responsibility are no longer add-ons to markets; they are integral to them. They are the basis on which public-private partnerships can grow. The OECD is determined to lead the way. ■

End of an affair?

An opinion poll in *BusinessWeek* magazine shows half of the US believing that what is good for business is not necessarily good for their country. Hardly surprising, you might think – except that the poll was carried out over two years ago, before the high-tech bubble burst and well before the recent corporate scandals. And the fact that the opinion poll was in one of the US's main pro-business magazines meant that the results simply had to be taken seriously.

They were also quite unexpected. The *BusinessWeek* poll was wide-ranging, with respondents asked to agree or disagree with several given statements. The one that made the headlines was simple: in general, what is good for business is good for most Americans. Some 47% of respondents agreed with that statement, but 49% disagreed. This was much more negative than the previous poll conducted in 1996, when just 28% felt their interests and those of business were not necessarily the same. Another finding to ruffle corporate plumes in the 2000 survey was that 72% of respondents agreed that business had gained too much power over too many aspects of American life.

It was not all bad news for corporate America. Indeed, 68% of respondents agreed that American business should be given most of the credit for the prosperity that prevailed during most of the 1990s. However, one question might make worse reading if the poll was conducted today: when asked how much confidence they had in those running big business, only 19% had a lot of confidence, though as many as 58% had at least some.

Opinion polls have their limits, though the *BusinessWeek* survey at least suggests that, probably because of a backlash against globalisation as demonstrated at Seattle in 1999, the public image of corporate America was looking tarnished well before the scandals that erupted at Andersen, Enron and elsewhere. These scandals appear to have transformed that disillusion into a crisis of confidence.

Is it the end of the affair between America's public and its business world? Probably not, though a more demanding public will mean the relationship may never be quite the same again. There is a coincidental footnote to add to this story: the issue of *BusinessWeek* in which this rather astonishing opinion poll appeared was dated 11 September, 2000.

- "Business Week/Harris Poll: How Business Rates: By the Numbers" in *BusinessWeek*, 11 September, 2000. See the full poll at: http://www.businessweek.com/2000/00_37/b3698004.htm

References

- The OECD Principles of Corporate Governance and the MNE Guidelines can be consulted online at www.oecd.org, click corporate governance.
- Fliess, B. and Gordon, K., "Better Business Behaviour", in *OECD Observer* No. 229, November 2000. Article focuses on corporate codes of conduct. See www.oecdobserver.org, search Fliess.
- Witherell, W. and Maher, M., "Responsible corporate behaviour for sustainable development", in *OECD Observer* No. 226-227, Summer 2001. See www.oecdobserver.org, search Maher.