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Session 1: Disclosure and transparency: what is at stake?

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**The Role of Financial Transparency in a Market Economy
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I have some old friends at the OECD, and I am delighted to have been invited. I did wonder if the reason for the invitation might be that, being an American, I might know something about how to create transparency and, after Enron, even more about how to destroy it. Well, there are some good lessons in Enron, but it's not the first order of business.

American professors are not known for their brevity, but while I will cover five areas, I will do so only in enough detail to set a framework for our discussion. Some of this will be familiar, but I want to be sure that we are starting from common ground.

1. Markets matter.

Winston Churchill was fond of saying that democracy doesn't work very well, it just works better than anything else. Likewise, a market economy. The issue is whether the presidents – of the nation or of the company – govern in accordance with the wishes of voters or investors. If the latter, then in government we call it a democracy, in corporate life, we say shareholder rights and market discipline. True, the shareholder votes rarely matter; instead, investors vote with their feet, as we say, by buying or selling the shares. I will return to this issue of political democracy in a few minutes.

Every system is subject to failure; the test is whether it responds promptly or whether the problems simply compound over time. What happens, for example, to a failing company? In a strong market system, it is allowed to fail, so that the losses are kept to a minimum. Think of countries -- and Russia and Indonesia come to mind – where long after any reasonable hope has vanished, governments continue to prop up banks and others, and in the end the mounting losses burden the entire society.

In short, a well functioning market system provides a healthy dose of discipline. Enron tested that in the fall of 2001, when it contacted the Secretary of the Treasury and others in government, arguing that it was, in effect, too big to fail. And Enron was big, though it was not to stay that way. Happily, they were turned down.

We all know about the discipline, but financial markets also do other things well. Let me merely list a few, as I suspect they are familiar:

a. they provide low-cost, long-term capital for industry. Potentially lots of it, which is why companies seek to list their shares in London and New York.

b. they provide liquidity for investors. The combination of permanent equity capital for industry, together with short-term liquidity for investors, is a unique strength of a market system.

c. markets provide an efficient allocation of capital. In recent years, in Europe and the U.S., we saw huge sums mistakenly invested in telecommunications companies, but after a year or two the market turned away, the flow stopped. In short, the market did err, but then a process of correction set in. Compare that with the persistent flow of politically influenced capital to the real estate, retail and other poorly performing industries in Japan, and the lesson is clear.

d. market prices are a useful measure of management performance **over time**, though admittedly some managers have been able to manipulate the process for longer than we would like. The old adage is, give me the power to see myself as others see me. Financial markets hold up to corporate managers a mirror, telling them, in stark terms, what the world thinks of their stewardship. Long speeches by senior officials – and I see several here – rarely catch the same attention.

2. Transparency Matters.

Start with two simple facts: (1) The modern business corporation is often a hugely complex enterprise, with operations spread over many parts of the globe. Investors have no direct way to observe how well a company is doing, whether the inventory count is honest, whether the accounts receivable are collectible. (2) No one, but no one, likes to get undressed in public. Whether in government or in a business, it is simple human nature to speak loudly of our successes and softly, if at all, of our failures.

Market transparency is a simple concept that brings huge private and public rewards. In the first instance, we adopt good disclosure policies in order to make our financial markets fair and thus to encourage people to invest their savings and pension accounts. How to tempt more Germans or Czechs to do the same? Transparency not just of markets but of companies. It is also a sure way for companies in one country, say, Slovenia, to attract capital from abroad, capital which otherwise would be available not at all or only at high cost. The recurrent theme of good securities laws is "disclosure, again disclosure, and still more disclosure." [Loss, *Fundam.* @ 8] It has been critical in helping the U.S. to attract from abroad roughly \$2 trillion (two thousand billion), or 15% of all the publicly traded shares. One of the concerns arising out of the Enron scandals is that foreign investors might withdraw those funds, thus aggravating our already large trade deficit.

Transparency, which applies to self-dealing and share trading by managements as well as to company revenues and profits, also gives substance to shareholder rights by providing the information essential to their exercise. One of the shocking aspects of Enron is that executives of the company had, even while concealing the heavy losses, used a little noticed provision of the rules to sell off secretly huge amounts of their personal Enron shares. We will soon close that loophole, but the obvious lesson is not to allow people – even those who wear tailored suits and give generously to charity -- to operate in the dark.

But wait, I have held my favorite benefit of transparency for last. Quite apart from the benefits just discussed, good disclosure forces managers to manage better, thus benefitting workers, investors, and the country as a whole. Speak of corporate governance, and in the U.S. at least scholars tend to focus on legal remedies and board structures, all of which do matter. A culture that supports the rule of law matters, too, of course. Almost unnoticed in the usual discourse, however, our financial reporting system has had immediate, day-to-day and very positive effects on corporate management itself. A good financial disclosure system, while initially intended to keep markets fair, has had the quite independent effect of forcing managers to confront disagreeable realities in detail and **early on**. A few years ago, McDonald's, that icon of American business, had been blaming the press for its troubles. Not so said *Business Week*; the problems were real. While the company looked strong, in fact its per store profits had dropped sharply, and there were many problems.

The U.S. succeeded early on in requiring public companies to disclose operating results not just for the company as a whole but for each significant segment, and by geographic area, too. The vast amount of data thus made public puts enormous pressure on managements who would rather bask in the sunlight of their triumphs than to confront their failures. If nothing else, managers become reluctant to invest additional money in those mediocre segments which have earned them nothing but criticism in the world at large.

Particularly in the U.S. and the U.K., good disclosure compensates for the lack of a body of large, long-term stakeholders – think of the main bank system that dominated German industry or the keiretsu in Japan.

3. Transparency seems simple but is highly complex.

Transparency is easy to define but the reality is complex and difficult to maintain. It is of enduring value, but inherently fragile. It is the cornerstone of good governance, public or corporate, but has many dependent parts.

First off, financial markets depend on good disclosure, they do not by themselves create it. Securities are mere pieces of paper, intangibles. They can be printed with large or small numbers on them, because they are nothing in and of themselves, representing only an interest in something else. The entire history of financial markets documents the need for governmental laws, rules, oversight and, yes, the discipline – the threat of suit – to ensure that investors receive the information they need.

Remember, financial reporting rests on a host of difficult judgments, about pension liabilities, revenue recognition, and other factors. The regulatory goal is to make financial reporting consistent from year to year, and comparable across companies -- \$1 of earnings here should be comparable to \$1 there. It is not an easy assignment. Even with governmental regulation, market abuse and excesses are possible; without it, they are inevitable.

But popular capitalism, with its widely dispersed investing public, depends also on a series of private sector players. The task has gotten immensely more difficult in recent years, notably in the U.S., because of the pressures on senior corporate managements – and the incentives, too – to report good earnings, even if the reality is bad. There is almost no substitute for an honest, forthcoming management. Having said that, however, transparency depends on a great many other gatekeepers as well. Here is a short list:

a. accounting standard setting groups, which are privately run in the U.S., though they do operate under SEC oversight.

b. security analysts, who work the company-specific reports into a varied mix of economic and industry analyses for investors.

c. credit rating agencies, which do much the same for banks and other lenders and often have preferred access to company data.

d. investment banks, which market new issues to investors and who by law carry a heavy burden of public trust.

e. major law firms, which structure the often complex transactions that can be used to enhance or defeat disclosure.

f. If disclosure begins with corporate managements, it surely ends with accountants. Think of them as the two bookends. Auditing has grown immensely more complicated in recent

years, largely because of the pressures on managements to keep up appearances. The public's primary line of defense has always been the audit firm whom we expect to be not just skilled and diligent, but above all, independent. Independent of whom? Management, of course. The auditor's real client is not management, but the board of directors and the investing public. Only an audit can assure the board and the public that the company's sales were made to a bona fide buyer, that the buyer can be expected to pay, that the goods were shipped in December, not in January.

Of all these groups, it is only the auditors who enjoy a government mandated, privileged and total access to a company's records and staff, worldwide. No matter what research others may do, they all depend on the audit. There is no substitute. It is essential that accountants be as independent as possible.

That is easier said than done.

4. Transparency is a never-ending battle.

The Achilles heel, the weak point, of a market system is that the investing public, even the professional money managers, take too little interest in corporate governance and in ensuring adequate financial reporting. They are widely dispersed, typically own less than one percent of the shares, and trade so often that the so-called Wall Street Rule – if you don't like what you see, just sell – is what everyone believes.

Transparency depends, therefore, on the auditors and the other groups described in Section 3. And alas, everyone of them, every single one, is either hired by, or paid by, the very managements whom it is their duty to monitor. We speak sometimes of the "golden rule," meaning that it is the gold, the money, that rules. That is the problem here.

The accounting standards board? In the U.S. it is funded by the very companies for whom they should be setting strong rules. The board studied off-balance sheet liabilities for 15 years, and in the end did nothing. Had it acted, Enron's huge fraud would have been revealed.

Credit-rating firms? They provide, for a fee of course, debt ratings for issuers of new securities. At Enron, as in other bankruptcies as well, they waited until the company was at death's door before taking away their investment grade ratings.

Security analysts? In the U.S. only about 1% of their ratings have been to "sell." They personally get paid for helping their firms attract new investment banking business, not for advising investors. Trading commissions are so low that the public investor has become almost irrelevant as a source of income.

Predictably, however, the worst culprits were the corporate executives themselves and the accountants. The total pay of large company CEOs last year was 411 times that of the average factory worker. Stock options and stock grants, originally intended to align the interests of management and the shareholders, had the opposite effect. Executives soon began to manipulate earnings, manipulate the price of their stocks, then sell out before the public could know. It is what economists like to call a moral hazard, what others of us would simply call fraud. True, some of the ways were at least legal, say, by deferring advertising or investments. Some were plainly not. In the last four years alone, over 700 U.S.-traded companies were forced to restate their earnings, even under the existing standards.

Auditors had lost their independence. Audit fees now comprise only about 25% of audit firm revenues in the U.S., and at some clients far less. More money, more interesting work,

more growth, all lay in the consulting work that an accounting firm could harvest once it was on the job. Auditing alone pays poorly. Like security analysts, the rewards lay elsewhere. But their ability to say "no" to a client had dried up. That is why they have become an industry, no longer a profession.

Oh, and add one more group, the political leaders who, having received generous campaign funding from various sources, used their power to repress the very disclosures that might have saved the day.

In short, every link in the chain of public oversight broke, . A distinguished American once said that "sunshine is the best disinfectant." Conversely, it is under the cover of darkness that moral fungus flourishes.

5. Can a market system ever hope to maintain transparency?

I have focused on the U.S. because it is the most notable market system and also a recent and visible failure. We Americans write everything large. But it helps to remember that no system is safe from failure, surely not the German main bank system, the Japanese keiretsu, the Korean chaebol. The issue is the ability to cure one's failures. And like the democracy that is my working model, a market system contains within it the seeds of its renewal, because power has by the very nature of the system been decentralized, broken into many parts. In the final analysis, there is no meaningful inner circle or network, everyone looks to protect himself. Enron, which once upon a time had friends all over Washington, soon had none. Audit firms, security analysts, and the rest found themselves beset by hearings, and hopefully, hopefully, changes in the rules. Congress at long last passed a meaningful campaign finance bill, which was a splendid place to begin.

Happily for me, this is only a keynote speech. I don't have to be wise, only provocative. But it does seem to me that democracy, in all its aspects, is a necessary component. The U.S. press, for example, has worked hard to keep the public aware of the unfolding Enron story. Private civil litigation has helped to frighten wrongdoers. And so on. I do not mean to suggest that vigorous democratic institutions are a complete answer, but as I look around the world it does seem that without them, the task is impossible.

Hopefully, I have stirred the pot of discussion. Thank you.