

The 2nd Asian Roundtable on Corporate Governance

The Role of Disclosure and Strengthening Corporate Governance and Accountability

“The External Audit — What Kind of Assurance Does the Market Need?”

Peter Dey, Chairman, Morgan Stanley Canada Limited

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Introduction

Good morning.

I too am delighted to have this opportunity to participate in this 2nd Asian Roundtable on Corporate Governance.

The timing for this Roundtable is excellent — at least from a market perspective. With what has happened to the technology sector in recent months, high growth investors have returned to emerging markets in search of opportunities. This means renewed attention by international investors to all aspects of emerging markets including, corporate governance.

Like many of you, I have had the opportunity over the last several years to look at corporate governance from a variety of perspectives.

When I first became directly involved in corporate governance with the publication of “Where Were the Directors?”, as you can tell from the title, I looked at the topic from the perspective of the board of directors.

In 1998/1999 I was Canada’s representative to the OECD Task Force which developed the OECD Principles of Corporate Governance. That exercise was particularly constructive because it forced my thinking beyond the limited perspective of internal corporate governance systems of corporations. The Task Force studied and developed principles which embrace the broader corporate governance framework.

Today, I have the opportunity to explore, with you, the topic of corporate governance from the “buy-side” of the market, that is, from the perspective of the investor, by considering the question — what assurance does the market need?

General Market Observations

What I’d like to do is open with a couple of general observations about markets and then make some specific observations about the role of corporate governance in supplying the assurances required by investors.

Each market is different. We talk about the international capital market, but in doing so we are really talking about a number of markets based in different regions offering differing degrees of access to issuers and investors. What is common to all markets is the objectives they pursue.

The principal objective is market efficiency and we know that the most efficient markets are characterized by a high degree of transparency in the conduct of the market participants — principally the issuers — and by a high degree of accountability of these participants to shareholders and other stakeholders.

While these objectives may be common to all markets, not every market will achieve the highest degree of liquidity and efficiency, arguably now established by the U.S. capital markets.

But, not surprisingly, investors are grateful that not every market is the U.S. market. Investors thrive on risk. Investors are not just looking for large cap, liquid, investment grade investments. Investors seek opportunities where they can understand and can measure the underlying economics, the intrinsic value, of the enterprise to which they are committing capital. Investors will shun markets or extract an excessive risk premium if the quality of governance in the market does not allow them to make these measurements.

Investors seek to uncover hidden value in the corporations in which they invest; investors do not want to uncover hidden risks and hidden values in the governance framework governing the market.

Important to Ask What Assurances the Market Needs

The question — what assurances does the market need? — is logically asked by the public sector which has the principal responsibility for developing the corporate governance framework. It is important for the question to be asked both by the public sector and the private sector because of the relationship between corporate governance, capital market efficiency and ultimately corporate competitiveness.

While the public sector will provide assurances to the market concerning the governance framework, the private sector in responding to the governance framework will establish the level of integrity in the market.

The efficiency of the capital formation process in a market can provide domestic corporations with an important competitive edge.

If the domestic market does not succeed in providing these assurances, domestic corporations will finance in other markets and the local market will lose liquidity and the other commitments from market participants necessary to sustain an efficient capital market.

The Character of Investor Capital

In order to understand what assurance the market needs, I want to spend a minute talking about the character of investor capital — I want to, in effect, define the so-called “market”.

I think it is fair to characterize investor capital as impatient. Why is it impatient? Those committing capital are driven by performance. Performance may be over various time horizons, but whatever the time horizon, there is immense competition to achieve superior returns. Capital is super-sensitive with a tendency to over-react in the process of analyzing and digesting developments in the market. Capital is also incredibly mobile. Which means it has an almost infinite choice of opportunities. Many investors are challenged by the concept of loyalty. Loyalty can mean missed opportunities and poor performance. Consumers of capital should also presume that capital is a scarce commodity.

Given these characteristics, those markets and those corporations which rate highest on the governance quality scale will generally be in the best position to meet the demands of impatient capital.

Globalization compounds the importance of market assurances. The competitive environment for domestic corporations is changing. Host jurisdictions must recognize that domestic corporations are competing with corporations from other jurisdictions financed in different markets and subject to the discipline of different markets.

The Market's Look at Corporate Governance: Two Perspectives

Now I want to turn to the practicalities: what is the process for getting a market on the radar screens of international investors?

The selection of markets for international attention is effectively determined by the financial intermediaries who manage the capital formation process. These intermediaries are very commercial in their outlook and have analysts who monitor the world's markets and if they see attractive investment opportunities in a marketplace, they will commit the corporate finance, the m and a and the analyst resources to take advantage of these opportunities. These decisions are not made lightly and are based upon a long term perspective on the commercial opportunities in the market — long term because once the resources are committed, the successful intermediaries will start building relationships and these relationships are not constructed overnight.

The quality of governance in a marketplace is critical to market selection. Financial intermediaries look at governance in two ways: First, the market looks at the terms of the corporate governance framework and the systems of the corporations trading in the market; second, the market looks at the quality of the information generated by the corporations in response to the governance framework.

The OECD Principles

In judging the quality of governance, the market increasingly uses the OECD Principles which establish international norms for an effective governance framework and for effective governance systems and, therefore, serve as benchmarks against which the adequacy of governance in developing markets is being measured.

I want to highlight three characteristics of the Principles which are important to investors.

Disclosure and Transparency

The Principle dealing with disclosure and transparency requires the corporate governance framework to ensure that timely and accurate disclosure is made of all material matters regarding the corporation. This is the most important Principle because it defines the integrity of the marketplace. It embraces both the standards legislated by the public sector and the behaviour of the private sector in responding to the framework.

Why is transparency so important? Transparency is the key factor to establishing investor confidence and investor confidence is the key contributor to efficient capital formation. Markets are known for varying degrees of transparency and the greater the transparency, the greater the sense of equity or fairness which investors will believe exists in those markets. Investors are more willing to contribute capital and to trade in secondary markets if they believe the markets are fair to all investors. This, of course, translates into efficient capital formation and a lower cost of capital for issuers — a major competitive advantage.

Disclosure is the principal mechanism for achieving transparency. But disclosure has its limitations. Disclosure does not equal transparency. Transparency depends upon the existence of a rigorous and comprehensive disclosure framework and upon a committed response by the private sector to these requirements.

The market has a “show me” attitude toward disclosure — particularly in developing markets. Increasingly the market demands more than disclosure and looks for some form of independent verification of the disclosed information.

A good example is the commitment of a corporation to good governance. A corporation can disclose an elegant and comprehensive system of governance. But the market won't really know if the corporation is well governed without some form of independent verification. Independent verification could be provided if the corporation implements a board evaluation and an individual director evaluation requirement in its system of governance. An evaluation system will help convince the market that the corporation is committed to good governance.

Stakeholders and Corporate Governance

Another Principle I want to highlight is the principle relating to the role of stakeholders in corporate governance. This was perhaps the most hotly debated of the Principles because the 29 members of the OECD reflected the full spectrum of approaches to this sensitive issue; from total shareholder value jurisdictions where boards must act only to create shareholder value, to "stakeholder jurisdictions" where boards must act in the best interests of all stakeholders and where shareholders simply constitute one class of stakeholder.

The members of the Task Force decided, after an inconclusive discussion, that there was no single right approach to this issue and that the language of the Principle should simply require the corporate governance framework to recognize the rights of stakeholders as established by law. However, as one participant noted "Adopt whatever approach you want; the approach chosen will simply be reflected in the cost of capital".

The resolution of this issue emphasizes the importance of the shareholder in any scheme of governance. If the board of directors regards the shareholder as just another stakeholder, investors will extract a higher return to compensate them for the ambiguous position of the shareholder in the stakeholder hierarchy.

The Board of Directors

The fifth OECD Principle addresses the constitution and responsibilities of the board. The most important element of an effective corporate governance system is the relationship between the board and management. Is the board independent of management?

“Where Were the Directors?” focussed on this issue and carefully identified the characteristics of an independent director and spelled out a number of structures to constitute a board independent of management.

What we have found, however, is that Canadian corporations have gone to great lengths to establish these structures, but there is still a concern that the Canadian business community has not yet fully endorsed a “corporate governance culture”. By this I mean, Canadian corporations have structured independent boards but the boards do not function independently of management.

In Canada, we are in the process of reviving the exercise which was conducted in the mid-90s to try to recapture the initial energy the private sector invested in corporate governance and to re-establish the momentum necessary to ensure that governance systems continue to be effective. The corporate sector must recognize that corporate governance is organic and must be monitored and nurtured on an ongoing basis.

Macro Issues – A Limitation

Before leaving the issue of what assurances the markets look for in the way of governance, I want to note a limitation. Investors recognize that markets develop within the context of other macro issues relating to political stability, economic development and currency risk, amongst others. These issues can overwhelm issues of governance and, in effect, prevent international investors from seriously considering, what may be, noble efforts of those developing the governance framework for the market. It is important to keep a balanced perspective on the limitations of governance and on the role of governance in the broader scheme.

Assurances as to Information

I now want to turn to the second way financial intermediaries look at governance, that is the quality of information generated by the governance framework.

By judging the quality of governance in a marketplace, investors are implicitly judging the quality of information generated in the marketplace. The analysts and the investors, who depend upon the analysts, must be satisfied that a particular market satisfies a minimum standard of governance. The standard is not quantified but there must be a general sense of commitment to governance in the marketplace for information to have an acceptable level of credibility.

There is no shortage of information available to research analysts. Indeed, one of the challenges for analysts in this information technology era is the overload which IT creates. The IT revolution is transforming the research process. The ability of analysts to sort through this information overload is increasingly difficult. However, screening information is one of the principal responsibilities of an effective financial intermediary.

The Role of Financial Intermediaries

As I said a few minutes ago, large financial intermediaries are ultimately driven by commercial opportunity. Commercial opportunity will drive these intermediaries to commit resources to markets where the risk reward ratio is attractive. From the investor perspective, the important resources committed by the intermediaries are the equity analysts who take the information generated in these jurisdictions and provide guidance to investors.

Focus on Sectors

One of the most interesting recent developments in market analysis is the emergence of business sectors as the principal criterion for identifying a market for international investment. Country specific issues, of course, continue to be important but are not on the same plane as the identification of the business sector. Intermediaries will identify a sector where they believe there is an opportunity for investors and then identify the principal participants in the sector, regardless of the home jurisdiction of the participant; the analysts will organize themselves to track global trends in the sector. Country specific factors will be blended with the sector analysis.

The push to look at sectors on a global basis and the discounting of country specific issues has forced these intermediaries to neutralize the accounting and auditing idiosyncrasies of different jurisdictions so that analysts can focus strictly on the sector.

The analysts develop mechanisms which enable the market to compare an issuer publishing financial information under one set of national accounting principles with financial information published under another set of principles in another jurisdiction.

Apples to Apples

For example, my own firm has identified at least ten sectors for its “apples to apples” analysis. This has involved looking at accounting principles in the jurisdictions which are active participants in the specified sector and extracting from the financial information generated by these accounting principles the information which is necessary to determine the value drivers for the sector.

What the research teams then do is identify those corporations within the sector which have a so-called “competitive edge” which means identifying the corporations which the analysts believe can sustain a global advantage over well-financed competitors.

Given the determination of the modern corporation to dominate or achieve significant scale in its sector, the major players within a sector will all be competitors looking for every possible competitive advantage. One of the competitive advantages will be access to capital which means these corporations will generally try to produce financial information which facilitates comparison of one competitor to another.

Intermediary Activism

This activist role of financial intermediaries raises some important questions for governance reform in various markets. Does this activity in some respects relieve the pressure on the initiative to establish international accounting principles which will facilitate comparison of companies in different jurisdictions.

The answer is a resounding “NO” — for two reasons. First, even though the “apples to apples” exercise eliminates the “apples to oranges” problem in comparing financial information, the exercise is not complete, and as one of my colleagues said, it probably takes us to a “green apples” to “red apples” standard and the accountants should complete the job. The accounting initiatives will also enable analysts to concentrate on underlying fundamentals rather than accounting principles.

Second, there is a vast array of corporations which would like to attract global research coverage but which don’t have a chance because of the cost of producing financial information reconciled to international standards. These corporations will continue to push for reform of accounting principles in their domestic jurisdictions to conform to standards which are acceptable internationally — thereby putting all competing corporations on the same footing.

Auditing Standards

I have only talked about accounting standards. How do financial intermediaries providing global research satisfy themselves as to the auditing standards in the jurisdictions which host domestic corporations subject to global research. This is where the culture of the jurisdiction is important. Does the private sector of the jurisdiction aggressively endorse a corporate governance culture?

The culture of the jurisdiction will be reflected in accounting and auditing standards. Does the culture, for example, support the application of “accepted accounting principles” or does it support the best accounting principle for the particular circumstances, that is to say, the best principle being the one which best reflects the underlying economics of the enterprise.

Likewise, in assessing the strength of auditing practices, investors (through their analysts) will analyze the governance infrastructure surrounding the audit. For example, is there an audit committee? What are the rules for constituting the audit committee? What is the role of the audit committee? This information is very relevant to handicapping the quality of information generated by the governance system.

Closing

In closing, I want to re-emphasize the opportunistic and commercial nature of investor capital. Those jurisdictions which are not willing to commit to the adoption of a corporate governance culture will seriously compromise the ability of domestic corporations to compete in a globalized world and will ultimately compromise the quality of life in the community in which these corporations play such a vital role.

Reform of governance must be lead by the domestic private sector. Reform won't come from outside investors. Although outside investors will not lead reform, they can drive reform by their actions. By their acceptance or rejection of a marketplace, investors send an eloquent message to the public and private sectors as to the quality of governance in the marketplace — just as investors send a strong message to boards and management when they buy or sell a security.

It is virtually impossible to completely satisfy investor expectations. But market sponsors must continually work to close the gap if the market is to thrive.