THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Dialogue in corporate governance

Beyond the myth of Anglo-American corporate governance

Findings

Emerging issues

How differences between US and UK securities markets create pressures and point to opportunities for international policy, investment, business and accounting

Dialogue in corporate governance

The globalisation of capital markets and capital flows, corporate scandals and newly developing economies are encouraging demands for consistency in corporate governance practices so as to reduce complexity and confusion. Dialogue can help facilitate a better understanding of different approaches to corporate governance and foster an appreciation of equivalent systems.

Difficulties arise in striving to achieve a single, global approach to corporate governance. There are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries and for all companies regardless of their stage of development and business. The ICAEW has launched the *Dialogue in corporate governance* initiative to challenge commonly held assumptions, identify fundamental questions, set challenges for future research and generate practical proposals. This will include:

- **Beyond the myth of Anglo-American corporate governance** – Contrasting US and UK securities markets and how they impact national and international policy, investment, business and accounting.

- **EU approaches to corporate governance** – Contrasting models of corporate governance in EU Member States, drawing out potential implications for future convergence.

- **Matching corporate governance to investor needs** – Exploring the different sources of finance as businesses evolve and the implications for corporate governance.

About the ICAEW

The ICAEW is the largest professional accountancy body in Europe and has over 128,000 members in 140 countries worldwide. Since the establishment of the Cadbury committee in 1991, the ICAEW has played a significant role in the development of corporate governance in the UK.

If you would like to know more about *Beyond the myth of Anglo-American corporate governance* and relevant events and publications visit www.icaew.com/dialogueincorpgov

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Introduction

Background

In June 2005, the Institute of Chartered Accountants in England and Wales (ICAEW) began its *Beyond the myth of Anglo-American corporate governance* initiative and in December 2005 launched the *Pressure Points* consultation at a roundtable in Washington DC. Since then, Mayors Bloomberg and Livingstone of New York and London respectively have endorsed further research into the attractiveness of US and UK capital markets. In the US, two high level groups – the Commission on the Regulation of US Capital Markets in the 21st Century and the Committee on Capital Markets Regulation – have been established to consider US legal and regulatory frameworks and capital market competitiveness. In the UK, the City of London has recently published a report, *Cost of Capital: An International Comparison*.[1]

This initiative aims to generate discussion and broaden debate on the differences between US and UK corporate governance systems. *Emerging Issues* reflects the views of many interested parties on both sides of the Atlantic. It highlights areas of consensus and disagreement about the successes and failures of the US and UK systems. In doing so, the purpose of the initiative is not to make specific policy recommendations but to promote understanding of pressures and opportunities that arise in increasingly international capital markets.

It is widely believed that the US and the UK share an Anglo-American approach to corporate governance. Indeed common language, similar ownership structures, high levels of transparency and unitary board models would seem to justify such an assumption. This is significant because the success of US and UK capital markets encourages the desire to emulate them. However, their historical origins and underlying principles are distinct and lead to different corporate governance practices.

All countries develop corporate governance systems that reflect their economic, political and cultural environment and have different approaches to oversight and enforcement. For example, the US relies largely on regulation under federal securities legislation whereas the UK authorities expect shareholders to uphold a principle-based regime of comply-or-explain. Whilst structure and process can promote conformity, what often matters most is the behaviours and attitudes of market participants themselves. This view was reflected in the words of Jonathan Charkham, former member of the Cadbury Committee and Advisor to the Governors of the Bank of England:

'Beyond SOX and all the governance reforms, most of which were arguably overdue, there lurks the danger of believing we can use structural solutions to solve behavioural problems. Total conformity to all the new requirements will not of itself produce results. It is how people behave that matters most – displaying the ancient virtues of candour, trust, and integrity. Without these, plus sheer competence, "people", and leadership skills, we are doomed to disappointment. We have to see structure and process – even ethics statements – for what they are, road markings and signposts. Someone still has to pick the route and drive the car.' [2]

Scope and activity

Through reporting and auditing, chartered accountants support transparency and the flow of reliable information between management, boards, shareholders, regulators and other stakeholders. It is therefore appropriate for the ICAEW to convene those responsible for the direction, control and oversight of companies. By bringing together counterparts from the US and UK we aim to encourage dialogue on issues relevant to the policy, investment, business and accounting communities.

Equity markets are an important part of a much wider economic system and this initiative is concerned with the governance of publicly quoted companies and with institutional investors. The latter include pension funds, insurance companies, mutual funds and investment trusts.

Public company boards and institutional investors are each agents for the same principal – the beneficial owner, or more broadly, the investing public. Boards and institutional investors are therefore mutually responsible for acting in the best interests of a common beneficiary. However, despite this mutual purpose there are conflicting perspectives between market participants in the US and the UK about their roles and the level of control that each agent should maintain. These conflicting views were referred to by Ira Millstein, Senior Partner at Weil Gotshal & Manges LLP, in his paper for the ICAEW's December 2005 roundtable in Washington DC:

'Each governance system has a distinct "balance of power" and set of tradeoffs among shareholders, boards and managers. In some jurisdictions, the power tilts to the managers, but in other jurisdictions, it tilts to the shareholders. It may not be a dramatic imbalance, but even a tipping of the scales makes a difference. Where the balance of power lies impacts how specific laws and regulations deal with the agency problems arising from the corporate form.'[3]

The problems associated with the separation of ownership and control of companies are well recognised in agency theory. Agency conflicts can lead to misaligned accountability, inefficiencies and even business failure. The *Beyond the myth of Anglo-American corporate governance* initiative explores the different ways in which US and UK corporate governance models approach agency conflicts. As a basis for dialogue, the ICAEW published the *Pressure Points* consultation paper which identifies key differences between the US and the UK and a series of four supporting discussion papers that provide important background material.

Structure and content

Emerging Issues summarises findings for each of the 21 questions in the *Pressure Points* consultation and has been developed after face-to-face engagement with corporate governance practitioners and commentators. The issues addressed are complex and it would be naïve to believe that we can provide simple answers. Instead, we summarise conventional thinking on each of the 21 pressure points and put forward additional ideas to generate discussion. Background historical information and evidence are provided in the four supporting discussion papers which should be read in conjunction with these findings.

This paper looks at corporate governance from four perspectives and is structured in the following sections:

- Policy dialogue: *Effective corporate governance frameworks – encouraging enterprise and market confidence*

- Investment dialogue: *Shareholder responsibilities and the investing public – exercising ownership rights through engagement*

- Business dialogue: *Board responsibilities and creating value – demonstrating leadership and accountability*

- Accounting dialogue: *Disclosure responsibilities and building trust – promoting transparent and reliable information*

A number of areas for research have also been outlined in the final section of this paper. We recognise that corporate governance continues to evolve in response to a host of economic, organisational and regulatory influences. We therefore encourage interdisciplinary research on an international basis into corporate governance to inform policy, investment, business and accounting developments.

We also welcome dialogue and opportunities for interaction between US and UK counterparts to share experiences and broaden understanding. Starting with a January 2007 transatlantic roundtable in London, we intend to convene interested parties to think beyond the myth of Anglo-American corporate governance and consider the wider international capital market environment within which the US and the UK have much to contribute and much to learn.

Policy dialogue

Effective corporate governance frameworks – encouraging enterprise and market confidence

‘There are two main sets of forces which will continue to bring about change in the field of corporate governance worldwide. They are first market forces, primarily driven by investors and the providers of corporate funds, but also by the ever-rising expectations of society. Then there are regulatory forces of one kind or another pursued by international authorities. It is these whose impact is easiest to discern, because their form is precise and they are a product of a predictable procedure… Although proposed reforms may appear to be a domestic matter of interest to UK companies their significance is wider.’[4]

Sir Adrian Cadbury

1. Regulatory conflicts

How can the exchange of information and co-operation between policy makers be encouraged to mitigate regulatory conflict and overload?

It is now widely accepted that international dialogue between regulators helps to mitigate regulatory conflict and overload. National regulators have traditionally worked in isolation but the extraterritorial effects of the Sarbanes-Oxley Act have emphasised the important need for such dialogue. Moreover, international flows of capital, the potential consolidation of trading platforms and regulatory arbitrage are increasing the need for information sharing. The points that follow are intended to highlight some challenges for effective regulatory dialogue and to stimulate discussion:

1.1 There needs to be real trust between regulators. Effective international regulatory co-operation is likely to require a degree of mutual recognition amongst policy makers and an acceptance of the ability of national regulation to maintain market confidence. Suspicions about the effectiveness of any corporate governance system and its applicability beyond national markets may cause hesitancy about regulatory co-operation. Concerns may arise over the degree to which national regulators feel they can rely on foreign supervisory authorities, particularly where accepted practice in one market may not transfer appropriately into another. There is also confusion around the terminology of what is considered good practice in corporate governance given the variety of interpretations emanating from different legal, political and cultural backgrounds.

1.2 Regulation plays a limited role in corporate governance. The creation of new regulation is often a symptom of market failure. However, a reliance on regulatory solutions in corporate governance may not be appropriate given the rate of change and complexity of capital markets. In extremis, imperfect rules may lead to unintended consequences. The market also often has the capacity to recognise good practice where regulators cannot. Therefore, whilst regulatory dialogue is valuable, there should be an appreciation that dialogue need not lead to more regulation; it provides an opportunity to learn from market experience.

1.3 Intermediaries can help regulators in dealing with international complexity. National fiscal policies, company law frameworks, stock exchange listing rules and securities regulation are subject to arbitrage whereby companies mix and match elements of different systems for competitive advantage. As a result, a company can be incorporated in one jurisdiction, listed in another, subject to financial services regulation in a third and taxed across a variety of countries. International regulatory dialogue may be of limited benefit in addressing these complexities. Market intermediaries such as credit rating agencies, auditors, investment banks and international institutional investors have standards for vetting companies that may complement regulatory oversight and help to mitigate weaknesses in compliance and enforcement. For example, the co-operation between foreign shareholders from the UK, Continental Europe, Australia and Canada influenced the outcome of a vote on the use of a poison pill in the US-based News Corporation.

2. Impact of regulatory burden

Is there a danger of regulation affecting the long-term attractiveness of US securities markets to non-US companies?

There is a widespread view that the attractiveness of the US securities markets has been damaged by excessive regulation and, in particular, Section 404 of the Sarbanes-Oxley Act. This is supported by statistics relating to the declining volume and value of recent initial public offerings (IPOs) in the US in contrast to the increasing numbers of IPOs in markets such as London and Hong Kong. The creation of high level committees to consider the impact of such regulation on the competitiveness of the US capital markets has received much media attention, together with the respective interest from the NYSE and Nasdaq in Euronext and the London Stock Exchange (LSE). In light of these developments the following observations are offered to stimulate further discussion:

2.1 Reports of the death of US capital markets have been exaggerated. Evidence suggests that there are now fewer foreign and domestic companies listing on US markets and some companies are seeking to deregister from the Securities and Exchange Commission (SEC). Moreover, the LSE, and in particular AIM, has benefited from a dramatic rise in numbers of IPOs in comparison with the NYSE and Nasdaq. To the extent that the trends are more apparent on Nasdaq than on the NYSE, the size of a company and its ability to absorb costs are important in decisions about going private. However, the overall value of IPOs is small relative to the market capitalisation of the world's stock exchanges and the capitalisation of the NYSE remains more than four times that of London's Main Market and AIM. In addition, whilst a sustained market in new equity issues is considered a lead indicator of capital market strength, its volume is significantly smaller than the debt market. It also remains to be seen how the impact of potential reform to Section 404 and more general support for applying principles of better regulation in the US may improve the attractiveness of its markets in the future.

2.2 Regulation is not the only driver of market attractiveness. It is very difficult to disentangle the impact of regulation on the attractiveness of US capital markets from other contributing factors. US capital markets have for decades imposed high regulatory barriers to entry and meeting such strict criteria can be seen to raise a company's profile and status. Also, the competitiveness of markets outside the US provides companies with a much wider choice of where to list. These markets are now far better regulated, deeper and more liquid than in the past. As a consequence, many companies that might once have accessed the US markets to raise capital can now satisfy their requirements in their own domestic markets or in foreign markets that are closer to home. Importantly, the perception of over-zealous litigation and prosecution may create a fear of doing business in the US and deter otherwise willing companies from entering the markets.

2.3 Foreign listings are of limited significance. Foreign companies that need to access US capital are still doing so. Whilst IPOs appear to be in decline, capital-raising in the US is still buoyant through alternative investment vehicles such as S144A registrations and global depository receipts. S144A registrations exempt companies from compliance with the 1933 and 1934 securities legislation and permit the sale of unregistered securities in private placements to qualified institutional buyers. Also, the attractiveness of foreign markets may be irrelevant to the majority of investment portfolios which are primarily domestic. Many funds under management are governed by domestic mandates where a large proportion of investment is in national index tracker funds.

3. Shareholder-led versus regulator-led corporate governance

What are the benefits and disadvantages of both a shareholder-led and a regulator-led approach to corporate governance?

It is commonly accepted that there is no single optimal model of corporate governance. National corporate governance frameworks are shaped by each country's history, culture, political environment, legal systems and corporate ownership structures. Market confidence is maintained through a spectrum of measures including voluntary codes and legislative requirements. The extent to which each country relies on securities regulation is affected by the capacity of institutional investors to play a significant oversight role in corporate governance by responsibly exercising shareholder rights. The points set out below are designed to explore these issues and to stimulate discussion:

3.1 A regulator-led approach can be effective in establishing overall market confidence. A regulator-led approach is appropriate where there is an inability, or a failure, of shareholders to regulate companies. Shareholders will always need to judge whether the benefits of engagement with any company are worth the cost, particularly in the case of smaller entities. However, regulators can more readily apply their efforts to companies of all sizes and thereby build overall market confidence. The US system relies heavily on public rules of securities regulation. Consequently, one of the main roles of the SEC is to protect all shareholders by implementing and enforcing requirements to maintain good corporate governance. In the UK, shareholders have powers to protect their interests directly and support the role of the Financial Reporting Council in upholding the Combined Code on Corporate Governance.

3.2 A shareholder-led approach promotes corporate governance that is proportionate. A key advantage of shareholder-led governance is that it operates on a company-by-company basis. It is responsive to particular problems and can produce tailored solutions which are preventative and not simply reactions to scandals of the past. However, it is dependent on the existence of a body of responsible shareholders willing and able to engage with boards, the power of shareholders to influence change, and a real obligation on companies to make corporate governance disclosures work on a comply-or-explain basis. Regulator-led governance is more likely to be 'one-size fits all' and geared towards enforcement rather than prevention. As public bodies effectively acting as agents for shareholders, regulators are also likely to be affected by political considerations and pressures.

3.3 There are important differences between disclosure-based and merit-based approaches to governance oversight. References to a US regulator-led approach to corporate governance should acknowledge that the US model is primarily one of regulated disclosure. The SEC has historically been prepared to allow entities of differing governance quality to have access to US capital markets provided that disclosure requirements are satisfied to ensure that investors can make informed choices. By contrast, UK regulators have generally delegated regulatory powers to sponsors and, in the case of AIM, nominated advisors (NOMADs) to judge the merits of potential market entrants and their suitability for listing. Under this merit-based approach, companies can be denied access to UK markets for a variety of reasons including governance arrangements that are judged to be inadequate.

4. Markets for corporate control

In a takeover, should the law enable directors as fiduciaries to pursue a corporate interest that differs from that of the current shareholders?

In the UK it is broadly accepted that, when subject to a takeover bid, directors should only act in the interests of current shareholders. There is also a widespread belief that in US takeovers directors can pursue the interests of the company at the expense of shareholders. Whilst this belief might be based on a misapprehension, the degree to which directors and shareholders can influence a takeover differs significantly between the US and the UK. These conflicting approaches to takeover regulation give rise to fundamental questions about how a company's interests are to be judged and for whose benefit. The following points are designed to provide insight into how the two systems differ and to raise issues for discussion:

4.1 In the UK ultimate authority rests with shareholders. The UK approach to takeovers is based on the premise that shareholders have definitive authority on whether or not to accept a bid. They have the right to sell their shares at a price that is acceptable to them and can accept a contested offer regardless of what the board recommends. Takeovers are seen as the ultimate sanction available to the market where there are agency issues between shareholders and directors which cannot be resolved by other means, including engagement. Of course, it is recognised that takeover situations will not just arise where there are seen to be ineffective boards. Even where there are effective boards, bid premiums may appeal to shareholders and result in a takeover and the replacement of the incumbent board. Nevertheless, in the UK shareholders judge whether it will be more beneficial in the long run to reject a bid in such circumstances. By contrast, US shareholders have a limited role to play in a takeover although some shareholders may seek to dismantle takeover defences in advance of a bid in the belief that they are indicative of an agency problem because they entrench management.

4.2 In the US ultimate authority rests with directors. US directors may protect the corporation from opportunistic takeovers by installing defences, such as a poison pill, which can dilute the shares held by the potential bidder. However, a poison pill is rarely exercised and is mainly used as a delaying tactic to allow the directors to negotiate a better price from the bidder. Ultimately, US directors are able to reject a bid without referring it to shareholders for a decision. By contrast, under the UK Takeover Code, directors are explicitly restricted from taking any action to frustrate a bid where there is a bona fide offer. Instead, their role is to provide recommendations and ensure shareholders are given all relevant information.

4.3 There is some recognition of non-shareholder interests in both the US and the UK. In the US, directors owe their duties to the corporation which potentially involves accountability not just to shareholders but also to other constituents. For political reasons, many states have enacted constituency clauses which can protect directors in taking decisions which may not be aligned with shareholders' interests. For example, it could be argued that a bid should be resisted as it may harm state employment. The outcome of a takeover bid is therefore not necessarily just intended to maximise shareholder value. Similarly in the UK, the Takeover Panel must defer to other authorities regarding the interests of other stakeholders in a takeover, for example in relation to competition and creditor protection issues. The implementation of the EU Takeover Directive will also require UK companies to consider the interests of employees and face the threat of criminal penalties for employee-related misrepresentation.

Investment dialogue

Shareholder responsibilities and the investing public – exercising ownership rights through engagement

'Despite the implicit importance of their role shareholders have too often played a bit part in corporate governance debates. They crop up in the academic text amidst the theory and new jargon of corporate governance: in discussions of "principals" and "agents", tensions with "stakeholders", as players in the "nexus of contracts". Shareholders may appear in the somewhat bewildering charts that now seem to be a requirement in academic tracts on the subject, with two-way arrows and Venn diagrams describing their relationships with auditors, government, directors, management and even employees.'[5]

Anne Simpson

5. Shareholder engagement and improved corporate performance

How does shareholder oversight and engagement actually improve the corporate governance and performance of companies in both markets?

Debate on corporate governance is moving on from internal matters and the responsibilities of boards to external engagement and the responsibilities of ownership. It is believed that shareholder oversight and engagement can help to mitigate agency conflicts and encourage more alignment between company objectives and shareholder interests. It is against this backdrop that the following challenges for improved engagement are considered for discussion:

5.1 Links between good shareholder engagement and returns to shareholders are complex.
It is difficult to quantify objectively any link between good corporate governance and underlying business performance as reflected in the quality of corporate strategy and its implementation. However, it is clear that the market will often react adversely to perceptions of poor corporate governance which impact on share price performance through higher equity risk premiums. Evidence that the investment community values good corporate governance, as opposed to mere box-ticking compliance, is provided by opinion-based research and institutions such as CalPERS and Hermes which maintain that working with underperforming companies to improve governance can help increase investor returns over the long term.

5.2 The fact that shareholders are a heterogeneous group complicates engagement.
Shareholders are a diverse group and each may follow different mandates which can vary in terms of investment time horizons and their appetite for engagement. This diversity can cause complexity and confusion for effective board and shareholder engagement. Increased transparency of ownership through the identification of beneficial owners and their custodian shareholders may help facilitate more meaningful two-way communication. However, such identification can be difficult given the sophistication of capital markets and the use of alternative investment instruments such as contracts for difference (CFDs).

5.3 UK shareholders are more collegial in their engagement than their US counterparts.
The majority of shares in the US and the UK are held by institutions. However, a higher concentration of shareholding amongst fewer institutions in the UK has led to unique engagement behaviour. Close geographic proximity of institutions facilitates an organised and generally cohesive approach to engagement. In contrast, the sheer size of the US markets and the greater number of institutions mean that mobilising shareholders to defend collective interests is more difficult. The UK regulatory environment also supports collegiality in three ways: it permits dialogue between boards and investors by not presuming that such dialogue represents privileged disclosure which is restricted by Regulation Fair Disclosure in the US; it allows dialogue amongst investors without triggering concert party issues; and it is free of the divisive threat of class action litigation.

5.4 Both short-term and long-term investors have an interest in good corporate governance.
There is a common view that short-term investors ‘rent’ shares and long-term investors ‘own’ shares and that there should be more emphasis on the latter. Yet, it is the essence of liquid and efficient markets that many investors pursue short-term interests. In doing so, they take into consideration a company’s prospects, its cost of capital and the risk and return associated with a potential investment. Since all these factors are impacted by corporate governance, investors are likely to take an active interest in the stewardship of their investments, even where the buying and selling of shares is inherently short term.

6. Shareholder rights and company law

To what extent should shareholders be empowered to participate directly in fundamental decisions affecting companies and hold directors to account?

The US and the UK corporate governance systems accord different powers to shareholders to participate in fundamental corporate decisions. This is evident, for example, in the greater influence that UK shareholders have in areas such as board appointments and major transactions. Mechanisms to enforce shareholder rights also differ with US shareholders often relying on prosecutors and litigation and UK shareholders directly exercising their voting power. The following factors may help explain differences in the nature and extent of shareholder participation in corporate decisions and are intended to stimulate discussion:

6.1 Institutional investors are responsible for participating in fundamental decisions. Directors ostensibly have the requisite experience and knowledge to pursue the success of a company and to this extent may exercise discretion. However, institutional investors also have a fiduciary responsibility, and should have the necessary expertise, to act in the best interests of their beneficiaries. As such they are obliged to engage with companies where value can be added to their investments. Moreover, in cases where directors' duties are breached and/or there is corporate under-performance, institutional shareholders are expected to intervene to help protect long-term share value and failure to do so may be publicly criticised.

6.2 There is pressure for participation where funds are index-linked. Many shareholders are forced to remain as investors in companies which are poorly governed because exit through the markets is not available to them. Where investment is matched against index portfolios, which limit the ability to sell and there is corporate underperformance, shareholder engagement may be the only way to protect and enhance share value.

6.3 Competing shareholder interests make boards more defensive. Boards are likely to resist engagement where there is a wide divergence of shareholder interests, especially where some investors are perceived to have political or social agendas. When boards are accountable to many competing interests they effectively become answerable to none. In the UK, institutional shareholders tend to work together and this facilitates engagement with boards. Under the US system, shareholders have weaker rights to influence the governance of the companies in which they invest and are more likely to resort to litigation through class actions to bring about change. However, whilst class actions may successfully return losses to shareholders in the 'class', it can be at the expense of other shareholders.

6.4 Shareholder rights are balanced by shareholder responsibilities. Effective engagement in the UK is facilitated by the Combined Code on Corporate Governance which is reliant upon shareholders with genuine legal powers to hold directors to account. The comply-or-explain nature of the Code allows for flexibility in application and relies on institutional investors to take their responsibilities seriously when evaluating governance disclosures. Section 2 of the Code, which applies to institutional investors, makes this explicit with recommendations concerning shareholder dialogue with companies and voting decisions. Such clarity about what is expected of both boards and shareholders helps to facilitate meaningful dialogue between the two parties.

7. Contrasting use of proxy proposals

How effective are shareholder proposals as a means of influencing the governance of companies?

Annual general meetings (AGMs) are a common mechanism for boards to communicate with shareholders and to seek their approval on routine resolutions. They also provide the opportunity for shareholders to raise issues of concern through specific shareholder proposals (resolutions). However, these rights are part of wider US and UK corporate governance systems where the use of shareholder proposals is very different. The principal differences are expanded upon below to promote wider discussion:

7.1 UK shareholders can wield real power through binding votes. In the UK, under the Companies Act, shareholders can choose to put forward resolutions which are binding, rather than advisory. These 'special' resolutions need a qualified majority vote of 75% to pass. If passed, these resolutions cannot be ignored by the board. Consequently, often the mere threat that a shareholder will resort to adding a resolution to the AGM agenda is sufficient to act as a catalyst for change. The voting power bestowed on UK shareholders leads to an environment where disagreements between boards and shareholders are often resolved before the use of such resolutions becomes necessary.

7.2 US shareholder proposals have limited power but can be a catalyst for change. Shareholder proposals in the US have historically been non-binding and, as such, the board can choose to ignore them even if the proposal receives a majority of the votes cast in favour. However, US shareholders are increasingly proposing that companies adopt by-laws to make some shareholder proposals binding to influence corporate governance reform. In particular, this includes shareholder proposals on majority voting in relation to the appointment of directors or poison pill amendments. To this extent it would seem prudent for US boards to take shareholder proposals to adopt binding by-laws seriously. For example, this is already evident in the number of US companies that have proactively adopted majority voting systems for the election of directors to the board.

7.3 Outside parties play a significant role in proxy battles. In the US, the SEC and proxy voting advisors, such as Institutional Shareholder Services (ISS), play powerful roles in shaping board agendas and the proxy process. SEC Rule 14a-8 gives shareholders the right to include a proposal on the management proxy statement but limits the use of such proposals to effect true change. The rule allows a company to exclude all proposals that relate to the 'ordinary business' of the company, i.e. decisions entrusted to boards. Furthermore, studies have shown that ISS have significant influence over the outcome of a shareholder proposal: *'An ISS recommendation can make a 15-20% difference in the support that a shareholder proposal receives. As a result shareholder proponents often tailor their proposals to meet ISS's guidelines…and devote significant effort in convincing ISS to support their proposals.'*[6]

8. Shareholder influence on board composition

To what extent should shareholders be afforded powers to influence or determine the composition of boards?

In the UK, directors are elected to the board on the basis of a simple majority of votes cast. Ultimately, shareholders can remove a director through calling an extraordinary general meeting (EGM) or voting against them at the AGM. It is widely believed that such powers are entirely appropriate and yet shareholders in the US currently have only limited rights to influence board composition and structure. For example, the US plurality system can allow the election of a director to a board on the basis of a single affirmative vote, regardless of the number of votes withheld. The points that follow are put forward to help explain this major difference and promote wider discussion:

8.1 Shareholder democracy works in the UK. Board directors are responsible for directing the affairs of the company and are accountable to shareholders for the stewardship of their investment. The fact that UK shareholders have the authority to appoint or remove a director encourages an environment where the use of such power is rarely needed. The threat alone is sufficient to ensure that boards take shareholders' concerns seriously and are sensitive to shareholder opinion on governance matters.

8.2 US shareholders have limited influence over board composition. US shareholders can do little to influence board composition except to withhold votes to signify their dissatisfaction. Furthermore, proxy contests, where a group of shareholders gather support to oppose the incumbent company boards by putting forward an alternative slate of directors, have a limited role in influencing board composition. Currently, a shareholder proposal to nominate a director is excludable from the proxy under SEC Rule 14a-8. Therefore, shareholders who wish to propose alternative directors for election to the board must enter into a proxy fight and pay for the costs of communicating with other shareholders directly. The expense involved often dampens shareholders' appetite for battle and therefore such action is rare.

8.3 US independent directors have a decisive impact on CEO tenure. A primary responsibility of US independent directors is to oversee the performance of executive management. They are often receptive to external opinion as manifested in analysts' ratings and broker coverage. Such opinion can directly influence a company's share price and cost of capital and recent studies have shown that this is a determinant of CEO turnover. In the UK, whilst external analysis is important, non-executive directors are likely to be particularly sensitive to the views of institutional shareholders if the performance of a CEO becomes an issue.

8.4 Shareholder power and influence over board composition bring responsibilities. Most jurisdictions recognise that shareholders, as equity owners, should have the right to hold boards to account and as such should be able to appoint and remove directors. However, such an approach relies upon responsible shareholders who do not simply nominate board candidates to serve their sole interest. Such appointments would be a divisive influence on the unitary board concept. The increasing use of shareholder proposals to amend company by-laws to allow majority voting provisions in the US may give shareholders a bigger voice on board composition which they should use responsibly for the benefit of the corporation and their beneficiaries.

9. Pre-emption rights

Do pre-emption rights adversely affect competitiveness and are shareholders deterred from investing if a company does not provide such rights?

Pre-emption rights help to ensure that when new shares are issued they must first be offered, as far as is reasonably practicable, to current shareholders in proportion to their existing shareholdings before they are offered to other investors. This system of first refusal to existing shareholders is known as a 'rights issue'. The perceived value and importance of pre-emption rights between market participants in the US and the UK is perhaps one of the most important examples of how the two systems of governance differ. However, the existence or lack of pre-emption rights do not appear to prevent UK investors from investing in US companies or US investors from investing in UK companies. The following points are intended to highlight why there are such differences in the use of pre-emption rights and to stimulate discussion:

9.1 Shareholders are sensible in the application of pre-emption rights. In the US, there is a general view that pre-emption rights can be an impediment to raising finance quickly and pursuing a company's objectives, for example because of the time required to seek approval for disapplication of those rights. In particular, research-based businesses often only have a short window of opportunity to raise capital. However, shareholders in the UK are generally reasonable when there are genuine capital raising needs and also show greater flexibility on the time allowed for rights offer acceptances to help address this concern.

9.2 Pre-emption rights matter in the UK because shares confer voting power and influence. Pre-emption rights provide for the protection of existing owners against the erosion of ownership and influence by allowing existing shareholders the right to subscribe for new shares before new investors. Voting power is a key ownership right in the UK reflecting the importance of shareholder approval in fundamental corporate decisions. In the US, shareholder votes are often non-binding and therefore the principle of pre-emption to safeguard influence is generally not a major issue.

9.3 Placing new shares at the market price is widely accepted in the US. Pre-emption rights protect shareholders from a dilution in value of their existing investments. Shareholders can either subscribe to the shares or sell their rights to other investors and in this way any loss of value through dilution is protected. In the US, rights issues are less common and it is considered generally quicker and easier to issue new equity through placings by investment banks. US markets are also highly liquid and therefore this can generally be done at the current market price without adversely affecting existing members.

Business dialogue

Board responsibilities and creating value – demonstrating leadership and accountability

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'Governance activists and regulators are right to be concerned about structure and processes, and directors must heed their concerns. But all the rules in the world won't govern behavior behind closed doors in the boardroom. It's time to recognise the enormous burden that boards carry and understand that there is no universal "right" answer.'[7]

Colin Carter and Jay Lorsch

10. Duty of care and the Business Judgment Rule

How does the Business Judgment Rule impact upon the ability of US directors to discharge their fiduciary duties and is there any substantive difference from the position in the UK?

Under common law, directors are required to act with a duty of skill and care and in a fiduciary capacity with a duty of loyalty. It is often assumed that these duties, and the defined breaches of such duties, are common to both US and UK company law systems. However, the purpose and application of the Business Judgment Rule in determining whether directors have shown gross negligence in the US is an example of how the two systems differ and the following observations are made to promote discussion:

10.1 In the UK, directors' duties are owed to a company of members, not a corporation. In the UK, company law is rooted in concepts of property rights, trust law, and contract law. A company has historically been defined as a body of members and its purpose, determined by the members, is described in its Memorandum of Association. Primary control of a company is derived from the members who delegate authority to directors to direct the affairs of the company. Directors' duties are therefore owed to the body of members, i.e. the company. In contrast, US corporate law is rooted in legislation and all authority flows from the state, rather than the members, and is embedded in statutes. Consequently, a corporation is viewed as a public construct, rather than a creation of the members who own it and directors' duties are owed to the corporation.

10.2 There is no equivalent of the Business Judgment Rule in the UK. In the US, the duty of skill and care is a standard of desired conduct owed by directors to a corporation. The duty of care is satisfied if directors simply follow procedure and, according to Professor Black of the University of Texas, *'show up, pay attention, and make a decision that is not completely irrational.'*[8] This accepted margin for judgement in the US, where the courts will tend not to interfere or second guess the decisions made by directors, is a creation of judicial precedent known as the Business Judgment Rule. In the absence of bad faith or conflicts of interest, this may be seen as protecting directors by presuming that they have not shown gross negligence. There is no such equivalent in the UK where directors' duties are owed to a company of members, not the public construct of a corporation, and breaches of such duties cannot be prevented largely by following procedure. Furthermore, most US state company law permits indemnification of directors by a corporation for breaches of duty of care and many state statutes permit exclusion of liability for nearly all such failures. In the UK, directors cannot be indemnified for such breaches.

10.3 Codification of directors' duties in UK law may change practice. In the US, the codification of directors' duties in statute is commonplace in many states, excluding Delaware. Traditionally, the UK has been reluctant to set out directors' duties in written law, preferring instead to rely on judicial precedent. The codification of directors' duties in the Companies Act 2006 moves the UK towards a statutory approach. Although the original intention was to provide clarity around directors' duties, rather than to herald a regime in which duties could be discharged through box-ticking, it remains to be seen how boardroom and judicial practice will evolve.

11. Board balance and the role of non-executive directors

How do differences in the relative roles and proportions of non-executive directors and executive directors in the US and the UK impact on company performance?

It is commonly assumed that US and UK boards have comparable structures and perform similar roles. This is understandable given that, under company law in both countries, executive and non-executive directors are treated as equals. All directors are responsible for directing the affairs of the company and are thus equally liable for any breaches of directors' duties. On this basis, differences in the relative roles and proportions of non-executive directors and executives might seem to be a minor influence on company performance. However, the observations set out below challenge the notion that US and UK boards are similar and are designed to set the scene for a wider discussion:

11.1 Common accountability encourages UK boards to be collegial. The ability of shareholders to appoint and remove board members in the UK encourages a sense of collegiality and an appreciation of accountability to shareholders. CEO influence on board appointments in the US creates a perception that, although the board acts in the interests of shareholders, in practice it is accountable to management. In this sense it can be said that boards are perceived as being one-down from management in the US in contrast to being one-down from owners in the UK. In either case, the effectiveness of the board is reliant on mutual respect between executive and non-executive directors in pursuing corporate success.

11.2 References to 'board members' have different meanings in the US and the UK. Reference to board members in the US usually denotes non-executive directors and excludes executive management. In practice, US non-executives can be likened to a supervisory board particularly when meeting in executive session without executive management present. In contrast, a 'board' in the UK denotes a group comprised of both executive and non-executive directors who collectively pursue the success of the company in the interests of shareholders. There is more of a sense of division on US boards where non-executive directors are perceived to represent the interests of shareholders and executives represent the views of management. Therefore, whilst shareholder engagement in the UK is often with both executive and non-executive directors, shareholder communication with a US board is generally a matter reserved for non-executive directors.

11.3 US securities legislation confuses the concept of collective board responsibility. US securities legislation, particularly some Sarbanes-Oxley Act provisions, dilutes the concept of a unitary board and encourages segregated responsibility. This is notable in the standalone powers of audit committees in the US and the requirements for CEOs and CFOs to certify SEC required financial statements. By contrast, in the UK the laying and delivery of annual accounts is a collective board responsibility. The consequences in terms of control responsibilities are quite dramatic. For example, in the UK, the internal control system and the implementation of the Turnbull Guidance are a board responsibility and the audit committee is part of that system. In the US, the internal control system is the responsibility of management and the board and the audit committee sit above it.

12. Separating or combining the roles of the Chairman and CEO

What are the key benefits and/or disadvantages of either separating or combining the positions of the Chairman and the CEO?

There are benefits and disadvantages of separating or combining the roles of the chairman and CEO. However, they are considered with differing degrees of scepticism and enthusiasm by proponents and opponents of each approach. Moreover, there is no conclusive evidence that either structure can claim a decisive benefit of leading to improved company performance. It is against this backdrop that the following points generate issues for discussion:

12.1 There is broad consensus around the advantages of both systems. Separation of the roles supports the decentralisation of leadership power, a clear delineation between the responsibilities of running the board and running the company, and the impartial facilitation of board meetings. Combining the roles promotes speed of decision-making and the provision of a single point of accountability helps to create effective board leadership.

12.2 Management is different from direction. Board membership imposes a different set of responsibilities than those required for the day-to-day running of the business. The position of a director is therefore different to that of executive management. Combining the roles of chairman and CEO, in effect, marries the two functions and blurs their distinct responsibilities. Even where the roles are separated, it can be the case that a retiring CEO will succeed as chairman thereby blurring responsibilities. Appointment to the role of chairman can be seen more as a matter of top management succession and not necessarily as a responsibility for ensuring the independent leadership of the board.

12.3 Power should not be centralised in the hands of a single individual. To address the potential problems that arise from a concentration of power, the separation of the CEO and chairman roles is the prevailing leadership structure in the UK. In the US, it is also recognised that the leader of the board should be sufficiently independent from executive management and the appointment of a lead independent director (LID) can offset a potential power imbalance. Indeed, widespread endorsement of the role of the LID has led to a dilution of the power traditionally held in the hands of a single, imperial board leader and today there are more US companies following the UK model and splitting the roles of chairman and CEO.

12.4 There is no leadership model that guarantees success. With the wrong leadership any board can be dysfunctional. Moreover, with the right people, any board structure can be effective. The key issues of importance are the personalities of board leaders and their interaction with other board members. In this sense the matter is less about labels and more about leadership styles, individual integrity and character. However, because shareholders rarely, if ever, have the opportunity to see a board in action, they are most likely to favour a board leadership structure that incorporates externally devised safeguards to ensure that the board is properly run.

13. Strengthening independence

Are independence criteria for directors different in substance between the US and the UK?

It is commonly accepted that ensuring a degree of non-executive director independence is important in safeguarding shareholders' interests. Independence criteria are outlined in Sarbanes-Oxley Act related regulations and stock exchange listing rules in the US. In the UK, broadly similar independence criteria are recommended as voluntary principles in the Combined Code on Corporate Governance. However, it can be argued that such criteria deal primarily with 'independence in appearance'. This is important in building public confidence but is of little relevance if non-executives do not have 'independence in fact'. In this context, the following ideas highlight issues for discussion:

13.1 Too much independence can have a perverse impact on board effectiveness. It is often assumed that a majority of independent non-executive directors on a board means better corporate governance. However, having a high proportion of individuals, who by virtue of their independence must be less familiar with the company, can lead to boards lacking understanding of the business that is essential for directing the affairs of the company. The irony therefore is that the greater the proportion of independent non-executive directors on a board, the greater the reliance on executive management to supply them with information. Where non-executive directors are largely dependent on management for their knowledge about the company this can have an adverse impact on the objectivity of board decision-making. The emphasis therefore should not be solely on making up 'independence quotas' but on ensuring a balanced board comprised of individuals knowledgeable about the company with access to information to direct it effectively.

13.2 Independence criteria should not be followed uncritically. Often independence criteria can miss the point by imposing externally set solutions which may not translate into practical benefits. For example, many non-executive directors have built networks of contacts after years of service in business which may include relationships with a company's customers or suppliers. Banning all such relationships, where potential conflicts are adequately disclosed, may reduce board effectiveness. It is also questionable whether an individual director, highly regarded for his or her objectivity, should automatically lose 'independent status' by virtue of length of board tenure. It follows that real independence is not achieved simply by following rigid rules.

13.3 Real independence can only be judged from within the boardroom. Relying on externally devised rules imposed by those outside of the board may not address real issues of behaviour and attitudes. Non-executive directors can demonstrate that they are independent in practice by being objective in their judgements. This in turn is determined by the character and integrity of the director in question. Ultimately, board members are best placed to reach their own judgements about the independence of fellow board members. They are capable of recognising issues of most relevance to shareholders' concerns that potentially threaten objectivity in areas such as financial self-interest, over-familiarity, and over-dependence on executive management. Improving the dynamics of the boardroom and maintaining independent leadership and objective decision-making processes may prove to be more effective than the application of strict criteria.

14. Level and make-up of executive compensation

To what extent is it seen as feasible or desirable in the US and the UK for levels of compensation to be influenced by investors or regulated by governments?

It is commonly accepted that levels of executive pay are driven by economic factors external to the company and are often influenced by cultural and social norms. There is also recognition that attracting high calibre executives requires competitive salaries particularly when competing for talent in international markets or with domestic private equity markets. Increasing pay levels may also simply be a symptom of increased time commitments expected of directors and the higher personal risks involved in business. Although these comments may indicate that there is little scope for investor or government action to mitigate perceived excesses in executive pay, the following ideas raise issues for discussion:

14.1 Regulation is restricted in its ability to rein in excessive pay. Direct regulation of pay levels is considered politically impossible and is therefore limited to influencing behaviour through disclosure. In fact, UK experience suggests that disclosure may have unforeseen consequences in creating an upward spiral in pay levels. Whilst regulation may help to enhance transparency around rewards it does little to curb individual excess. Even disclosure is problematic because a single regulatory template to guide a multitude of individual companies can result in meaningless boilerplate information. The range and complexity of pay packages makes it difficult to codify all information, to recognise what is important to individual shareholders, and to deal with issues of concern such as the linkage of company strategy, individual performance and rewards.

14.2 Ratcheting pay can be a product of a self-perpetuating system. Remuneration specialists continue to develop innovative reward packages and recruitment consultants help to negotiate packages for their clients which often translate into upper quartile rewards. Another significant influence on executive pay may be benchmarking with peers in investment institutions or in larger organisations in professions such as accountancy and law. These mechanisms can create a perception of a market value for executive rewards which is not in line with the views of society at large. Where regulation and shareholder action are limited in their effect, intervention by the media may provide a more effective constraint.

14.3 It is difficult to differentiate between good performance and excellent performance. A good CEO leading a large company with a sound track record does not necessarily require the same energy and attributes as an entrepreneur leading a smaller, growing enterprise. In large companies the level of executive pay is likely to be insignificant in relation to overall market capitalisation and therefore subject to fewer shareholder constraints and sensitivities. Moreover, it is difficult to determine to what extent performance is influenced by systemic factors which are not reliant on a particular individual. More variety in terms of key performance indicators would be useful to match exceptional performance with perceived high rewards.

15. Non-executive director incentivisation

Is company performance enhanced if non-executive directors are compensated with stock options or other performance-related incentives?

The level of non-executive director pay in both the US and the UK is rising so possibly reflecting perceived increased personal liability risks associated with the role and overall increased time commitments. Non-executive directors are typically remunerated for their services with a retainer and basic fees. In the US it is also common for non-executive directors to receive stock (share) options whereas in the UK restricted shares are more common. This difference in practice between the US and the UK prompts the following observations which merit further discussion:

15.1 Different rewards for US and UK non-executives appear anomalous. Non-executive directors are expected to perform both a monitoring role and oversee company strategy. US non-executive directors are generally perceived to be more active in their monitoring role whilst their UK counterparts are involved in both monitoring and strategy. Despite this involvement in strategy, UK non-executive directors' remuneration is less closely linked to overall corporate success. In contrast, US non-executive directors are often rewarded in share options to reflect their contribution to corporate strategy. In this sense, UK non-executive directors can be seen to act more like executives but are paid more like compliance officers, whilst conversely US non-executive directors act more like compliance officers and are paid more like executives. An explanation for this is that share-based incentives are generally seen as creating a self-interest threat to a UK non-executive director's independence and objectivity. This contrasts with the US where share options are considered to align the interests of non-executive directors with those of the company.

15.2 Share options should not be ruled out as a reward for non-executive directors. A common complaint about share options is that they encourage the manipulation of financial results to meet short-term market expectations. Also, the popularity of share options is declining possibly reflecting lower market returns in comparison to previous years, changes in accounting rules to require options to be expensed, and negative publicity associated with the US back-dating scandal. In contrast to the decline in options there is more prevalent use of restricted shares. Such rewards motivate directors because, without actually owning the shares, they still have the right to vote and receive dividends. Nevertheless, share options can be a good way of attracting top talent and, by offering a stake in the future of a company, they foster a sense of ownership.

15.3 Remuneration isn't the only motivating factor for joining a board. Pay is not necessarily the only motivating factor for non-executive directors when considering a board appointment. Other factors can include keeping abreast of current issues; expanding and maintaining networks with peers; personal development and knowledge sharing; maintaining self-esteem; and satisfaction from contributing to the success of the company.

Accounting dialogue

Disclosure responsibilities and building trust – promoting transparent and reliable information

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'What are we trying to accomplish? We want companies to present their business and financial condition based on current knowledge and expectations for the future. We want accurate reports of companies' operating results and cash flows. We also want financial statements to reflect economic and business reality because, ultimately, this helps investors formulate their investment decisions.'[9]

Cynthia Glassman

16. Disclosure controls

To what extent will new US requirements on disclosure controls increase the demands placed on non-SEC registrants?

US requirements on disclosure controls were introduced as a result of Section 302 of the Sarbanes-Oxley Act of 2002 along with the Section 404 requirements related to internal control over financial reporting. It was originally believed that many of the requirements of the Sarbanes-Oxley Act would be explicitly copied and adopted by regulators in other jurisdictions. Although the Act's bad press makes this increasingly unlikely, the following ideas are set out as a basis for discussion of emerging issues:

16.1 The Sarbanes-Oxley Act is not just Section 404. The Sarbanes-Oxley Act is now widely dismissed by media commentators as burdensome and unnecessary regulation. This is because most discussion of the Act focuses on the internal control provisions contained within Section 404. By contrast, the requirements of Section 302, which reflect activities already undertaken by well-controlled global companies, have generally been implemented without significant upset by large companies. Within companies, Section 302 is generally seen as encouraging sensible and proportionate procedures which can be applied by many different sorts of entity to enhance the quality of external disclosure.

16.2 The spreading of good practice does not depend on regulators. Introducing regulations to harmonise with other jurisdictions may be counter-productive if they fail to take account of the particular circumstances in those jurisdictions. Favourable experiences of dual-listed UK companies in respect of the disclosure control provisions of Section 302 are likely to raise the benchmark for UK companies without a US listing. Good practice tends to spread of its own accord as auditors, finance providers, credit rating agencies and other market intermediaries exert their influence to go beyond compliance and promote the global adoption of good practice. It would therefore be expected that good practice will develop to respond to some of the drivers of Section 302, without the need for intervention by non-US regulators.

16.3 Slimming down the implementation of Section 404 is much needed. Ongoing projects to review the implementation of Section 404 need to ensure that the review of internal control over financial reporting is top down, risk based, and focused on what truly matters to the integrity of a company's financial statements. If this can be achieved successfully, it may increase acceptance of Section 404 in the US and its influence on other jurisdictions.

17. International Financial Reporting Standards convergence

Is complete convergence between US GAAP and IFRS possible or will US standards always need to be different to reflect the US legal environment?

In recent years the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) have been coordinating their work programmes. Their aim is to eliminate differences between International Financial Reporting Standards (IFRS) and US GAAP to such an extent that the SEC would no longer require foreign registrants to prepare a reconciliation from IFRS to US GAAP. Whilst there has been broad support for this convergence programme, many people see mutual recognition of two systems with shared principles but different amounts of detail as a more practical outcome than full convergence. This is in large part due to the view that US standards will always need to be different to reflect the US legal environment. However, there must be some doubt about the sustainability of such a practical outcome and the following reasons for this are set out as issues for discussion:

17.1 It may not be possible to establish common principles for IFRS and US GAAP. The recent publication of the first two draft chapters of a common IASB and FASB conceptual framework has highlighted major differences of opinion between US and UK standard setters and commentators about the objectives of financial reporting which are rooted in differences in corporate governance systems. Whilst in a US context, financial statements are required by securities legislation purely to enable market participants to make buy, sell or hold decisions, UK company law also requires directors to prepare accounts for shareholders because they are accountable to shareholders for their stewardship of company assets. It remains to be seen whether this disagreement will have any practical impact on convergence between IFRS and US GAAP.

17.2 The quest for consistent application of IFRS could become a Trojan Horse for more rules. The intention of work to encourage consistent application is sensible. However, securities regulators and other users of financial information must recognise that absolute consistency is not compatible with principle-based standards. If efforts focus on financial reporting outputs, such as whether companies have applied a particular standard in a uniform manner, then they risk creating more rules. To maintain the principle-based nature of IFRS, regulators should focus on 'inputs' to financial reporting such as the way preparers approach the determination of accounting policies, selecting appropriate accounting bases, staff training and development, and methods of dispute resolution. The initial signs are not encouraging. In enforcing compliance with IFRS as it sees it, the SEC is in danger of adding rules and interpretations to the IFRS literature that companies and auditors will feel compelled to consult when applying IFRS. As a result IFRS could be absorbed into US GAAP.

17.3 Detailed rules might fall out of favour. The development of detailed rules in US GAAP is typically portrayed as a drive toward greater certainty in financial reporting. However, the belief that regulators and standard setters can reduce risk by introducing more rules and that there is ultimately safety for preparers and auditors in a rule-based environment may be an illusion. More rules frequently mean that more judgement is needed, as preparers must determine whether each rule has been applied properly. Even within a supposed rule-based environment there will inevitably be areas of judgement in which inconsistent application may develop, potentially exposing preparers and auditors to the charge that they failed to follow a particular provision. Were the IASB to reject incorporation of SEC guidance into the IFRS literature and ringfence its applicability to the US securities markets, US markets might become less popular as companies opted for an environment where they could report using principle-based standards. The appeal of rules in the US markets might also be challenged if the promise of legal certainty were seen to be an illusion.

18. Timeliness of financial reporting

To what extent does quarterly reporting either improve market efficiency or encourage short-termism and compromise reporting quality?

It is widely believed in the UK that quarterly reporting encourages short-termism and can compromise reporting quality. Accordingly, it is viewed by many as being bad for market efficiency. In particular, the practice of providing quarterly earnings guidance, until recently very common in the US, is considered particularly damaging. However, in the US the SEC continues to endorse the widely-supported principle of quarterly reporting and has recently reduced reporting deadlines for registrants. It is against this background that the following may be useful topics for discussion:

18.1 Market participants will always bet on anticipated announcements. Markets relish information. Where there is a stream of regular statutory information, some market participants will make predictions as to the outcome and then take positions that reflect their views on the likely market response. Whilst the reduction in companies providing explicit quarterly earnings guidance is to be welcomed, it should be recognised that the mere existence of quarterly reports will lead to markets continuing to predict quarterly earnings and responding dramatically to departures from what is expected. Reducing the frequency of such reporting, whilst requiring interim trading updates, as under the UK approach, would arguably lead to reduced pressures from the market to meet short-term targets.

18.2 Reporting earnings too frequently can adversely affect the behaviour of market participants. Increasing the frequency of reported earnings must at some point have an adverse impact on market efficiency. A crowding-out effect may prevent market participants from seeking multiple sources of information on companies, including both financial and non-financial measures, and taking the time to understand their implications for valuation. Too frequent reporting also means that companies do not have time to evaluate judgemental items properly so that the reliability of information becomes more variable.

18.3 There is necessarily a trade-off between speed and quality of reporting. Speeding up regular reporting may lead to a reduction in reporting quality, as businesses move from 'hard-close' to 'soft-close' reporting. As well as giving management less time to prepare and check the figures, it also reduces the time available for external audit or review, with a consequential impact on reporting quality. As in the case of the frequency of reporting, policy makers have to balance the desire to secure the benefits of increased speed against the costs and the adverse effects on quality.

19. Convergence of auditing standards

How are US auditing standards likely to influence the development of principle-based ISAs?

There is concern that US auditing standards are at the heart of an agenda to move global auditing standards from a principle-based framework towards greater prescription and reduced judgement. In particular, critics have commented that the clarity project of the International Auditing and Assurance Standards Board (IAASB) will be used to introduce more prescription into the International Standards on Auditing (ISAs) applied in the UK, at the expense of their principle-based origins. Yet, these fears may be misdirected and it is for that reason that the following ideas are set out for discussion:

19.1 US auditing standards have historically been principle-based. The generally-held view that US auditing standards are overly prescriptive often derives from criticism of Auditing Standard 2 issued by the Public Company Accounting Oversight Board (PCAOB). This addresses the provisions of Section 404 of the Sarbanes-Oxley Act, a US-only requirement, and should not be viewed as representative of the overall body of standards. AS 2 has been heavily criticised for being too detailed and prescriptive and is due to be revised. By contrast the 10 standards at the heart of US Generally Accepted Auditing Standards are clearly principle-based.

19.2 Audit regulation is leading the charge to a rule-based approach. The increase in audit monitoring by external regulators is not confined to the US and will tend to lead to calls for more rule-based standards as regulators enforce auditing standards and seek certainty over whether standards were followed in particular circumstances. Auditors also look for greater understanding over whether procedures followed will be sufficient to eliminate the risk of their judgement being questioned. This is particularly likely to be the case in a litigious environment. The PCAOB's AS 3 on documentation is symptomatic of the resulting trend. According to this standard, if an auditor cannot point to documentary evidence of testing or other work, it is reasonable to conclude that the work was not carried out. Even if regulators do not drive UK and international auditing standards in the direction of rules, there remains the risk that regulators will undermine principle-based standards more directly. The drive towards mutual recognition of oversight systems as an alternative to direct supervision may improve cooperation and reduce inefficiency but it may also lead to an alignment of regulatory approach and a rigid interpretation of standards.

19.3 A global consensus on auditing standards needs to be developed. There are encouraging signs that the PCAOB is not seeking to establish fundamentally different auditing standards from the IAASB. The principal risk to the development of principle-based ISAs therefore seems to be concern over the enforcement of such standards and their impact on auditors' litigation risk. However, the view that enforcement is made more straightforward and litigation risk is reduced by more detailed rules needs to be challenged. The benefits may be illusory if detailed rules just lead to more numerous and arcane grounds for enforcement action and litigation.

20. Non-financial disclosure

Is it realistic to expect non-financial disclosure to evolve beyond current US practice?

It is generally believed that the information contained in a US Management Discussion and Analysis (MD&A) is too boilerplate, despite existing 'safe harbor' provisions, and that it is therefore of limited value to investors. By contrast, the UK approach and the Operating and Financial Review (OFR) with its emphasis on principles and judgement are widely believed to result in higher quality, more meaningful disclosures and to represent the way forward internationally. However, in practice, the issues may be less clear-cut, with advantages and disadvantages to both the US and UK approaches. It is in this context that the following ideas are put forward for discussion:

20.1 Investors may find the mandatory US MD&A more useful than the voluntary OFR. Initial research conducted by Vivien Beattie and Bill McInnes found that the disclosures in US MD&As were potentially more useful to investors. *'Overall, the findings indicate that… mandatory rules in relation to narratives can produce disclosures of higher quality than a voluntary, principles-based system. The close monitoring regime of the SEC may also be a contributing factor, as may the more litigious environment.'*[10]

20.2 There is growing support for the US MD&A amongst preparers. There is also anecdotal evidence of support for the US approach from preparers. A voluntary disclosure regime can make it difficult to justify the collection of information or to validate that it is being prepared on a consistent basis from year to year. The statutory backing of MD&A disclosures provides an incentive within an organisation to prepare and present information on a consistent basis over time.

20.3 The UK approach to non-financial disclosure will only be successful with active shareholder engagement. Although many large UK-listed companies already produce quality narrative disclosures, it is unclear what preparers will do following the abandonment of plans for a mandatory OFR and the implementation of the enhanced business review which is required under European law but which is not backed up by standards. Safe harbour provisions within UK company law are welcomed, but it should be recognised, in the light of recent experience in the US, that this does not automatically lead to better disclosures. The UK's light touch enforcement regime may need to be supplemented by shareholder engagement to emphasise the importance of useful disclosures.

20.4 Shareholders need to be realistic about the limits of voluntary disclosure. There is also a need for realism from shareholders. Not all information is withheld for bad reasons: management may perceive the cost of preparation to be too high, or disclosure might be commercially damaging. Under a framework of mandatory disclosures, such as that required by US securities law, the need for disclosures is agreed and their costs are common across all companies. Voluntary reporting, whether in the US or the UK, will always be subject to individual calculations of costs and benefits.

21. External audit and the role of audit committees

What are the practical implications of differing external auditor reporting lines and how do the roles of audit committees in the US and UK differ?

Whilst there is some unease in the UK over the introduction of the US auditor reporting line to audit committees and some investor support in the US for the UK auditor reporting line to shareholders, there is a lack of real understanding of what the implications of such changes might be in practice. There is also no consensus on how the roles of audit committees in the US and UK differ. Against this background the following ideas are set down as issues for discussion:

21.1 Different routes are all leading to the same model of audit relationships. It is clear that there are significant historical differences between a UK shareholder-stewardship audit and a US regulatory audit, with auditors appointed by and reporting to shareholders in the UK and boards in the US. However, the differences have become blurred in practice. For example, both systems have recognised the need for audit committees of board members with specific responsibilities relating to the audit, auditor responsibilities towards audit committees, and affirmations that auditors should ultimately serve shareholders. The role of statute, case law, auditing standards and practice in underpinning these responsibilities varies between systems but how much this matters is a moot point.

21.2 Developing better structures for auditor-shareholder relationships is a real challenge. It is tempting to over-romanticise the UK model of the external auditor-shareholder relationship. However, in a practical sense, the US Sarbanes-Oxley model, whereby the auditor reports to the audit committee as a proxy for shareholders, has improved accountability. Investors, auditors, business people, standard setters and regulators need to continue working together, as in the UK's *Audit Quality Forum*, to see if they can develop forms of auditor reporting and engagement that give substance to the principle that auditors are there to serve shareholders.

21.3 The biggest difference between US and UK audit reports lies in their content rather than their addressee. The most important difference between US and UK auditing may find expression in the auditors' opinion itself. In the UK it covers the 'true and fair view', not simply compliance with accounting standards. Research by Professor Stephen Zeff indicates that the US has historically flirted with a two-part opinion which includes an opinion over 'presents fairly', separate from the opinion over 'presented in accordance with GAAP'. The implementation of Section 302 of the Sarbanes-Oxley Act introduced a requirement for management to certify that their reporting *'does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading'*.[11] This has been seen by some commentators as in effect affirming legislative support for the introduction of a two-part audit opinion.

Future research needs

Beyond the myth of Anglo-American corporate governance

'This won't be the last time that corporate governance breaks and cracks in a key way. Different stress points will develop in the public firm and one or other of the persisting fissures will threaten to open, crack and need to be fixed. If we're lucky someone will anticipate the problem and fix it up beforehand. If not, we'll muddle through once again. It's worked so far.'[12]

Professor Mark Roe

Future research needs

Corporate governance is a means to an end and not an end in itself. Good corporate governance promotes economic activity and prosperity by inspiring trust in companies so that people have confidence to do business and invest.

Historically, corporate governance systems have evolved on a country-by-country basis, shaped by national politics, legal traditions and market practice. Generally corporate governance develops and improves incrementally but this pattern is broken where major failures occur in a system.

Research into corporate governance can help to support rational thinking about how to improve corporate governance practice and underpin both market-led and policy-led initiatives. Objective academic evidence can also stimulate dialogue and lead to debate and consensus. Research can help both to prevent crises of confidence and to ensure that, if and when scandals occur, the public policy response is well-judged, effective and proportionate and does not result in unintended consequences.

The ICAEW is therefore committed to encouraging and promoting research in corporate governance but recognises the challenges that researchers face in terms of academic breadth and rigour in order to make useful contributions in the field of corporate governance. In this respect, there are three particular challenges:

- Corporate governance research is by its nature interdisciplinary and may need to draw on knowledge of law, finance, accounting, organisational behaviour, economics, politics, psychology and other disciplines.

- There is a need for an international approach because today, more than ever, globalisation means that national systems of corporate governance can be affected by evolving practice as well as scandals and reactions to them occurring anywhere in the world.

- It is very difficult to conduct research into corporate governance that reflects actual practice because it is so difficult to probe beneath the surface.

This third challenge was summarised by Professor Laura Spira in her inaugural professional lecture on audit committees, 'Black boxes, red herrings and white powder', in May 2006 when she said:

'Black boxes remind us that we need to question the taken-for-granted assumptions about corporate governance and that we need to find out more about what goes on behind the boardroom door. Red herrings prompt us to be alert to the political dimension of proposed solutions to corporate governance problems and to the activities of policy entrepreneurs, waiting in the wings with ready-made responses which favour their own interests. A story is told of a man walking along a road scattering white power. Passers-by asked what the powder was for. "It's to keep elephants away" the man explained. "But there are no elephants round here!" they pointed out. "Yes it works well, doesn't it?" he replied. White powder warns us that in the continuing search for the characteristics of good corporate governance, we need to be cautious about attributing causation.'[13]

Suggestions for possible future areas of research have been identified and are set out below for each of the questions covered in this paper. These suggestions are not meant to be exhaustive but are intended to help researchers in developing projects which would be interdisciplinary in nature, international in outlook and probing in their approach.

Policy dialogue

1. Regulatory conflicts: How effective have transatlantic meetings of regulators been in mitigating regulatory conflict and overload in the period since the Sarbanes-Oxley Act was passed? What evidence is there of the client acceptance procedures of global accounting firms and investment banks and the expectations of credit rating agencies setting de facto international standards of corporate governance?

2. Impact of regulatory burden: Is it possible to perform a post-implementation regulatory impact assessment on the Sarbanes-Oxley Act, or on Section 404 in particular? How can perceived over-zealous litigation and prosecution be measured along with their effects on the attractiveness of US capital markets?

3. Shareholder-led versus regulator-led corporate governance: To what extent are shareholders, sponsors and NOMADs effective in acting as quasi-regulators enforcing good corporate governance in the UK markets and how is their effectiveness perceived in the market?

4. Markets for corporate control: Does US and UK experience of post-takeover performance indicate that either country's public policy on takeovers is effective in promoting the interests of shareholders or the wider economy?

Investment dialogue

5. Shareholder engagement and improved corporate performance: How difficult is it in practice for US and UK directors to identify beneficial owners of shares given hedge fund investments and the more prevalent use of CFDs and to what extent does this frustrate effective engagement?

6. Shareholder rights and company law: Is there any evidence that shareholder participation in fundamental decision-making has any beneficial or adverse impact on company or director performance? To what extend are comply-or-explain disclosures considered and acted upon by UK shareholders?

7. Contrasting use of proxy proposals: Why do many shareholders not exercise their power to vote on proposals and resolutions? How can independent judgement be maintained and exercised even where there are apparent conflicts of interests, for example between private fund managers and their corporate clients or public fund managers and political leaders?

8. Shareholder influence on board composition: How effective have nominating committees been in ensuring that board composition better reflects shareholder wishes and interests in both the US and the UK?

9. Pre-emption rights: Does the lack of pre-emption rights in the US raise or lower the cost of capital compared to the UK?

Business dialogue

10. Duty of care and the Business Judgment Rule: Is the codification of directors' duties in the Companies Act 2006 affecting directors' behaviour? How, if at all, does legal advice given to directors in the US and the UK differ in tone and substance?

11. Board balance and the role of non-executive directors: Does the Sarbanes-Oxley Act amount to a first step in developing federal corporate legislation in the way that it allots responsibilities to individuals rather than the board?

12. Separating or combining the roles of the Chairman and CEO: What evidence is there of the lead independent director role in the US being an effective safeguard against concentration of power? What challenges have faced US companies adopting the UK model of separating the roles of Chairman and CEO?

13. Strengthening independence: What are the views of board members, investors and regulators on the effectiveness of board independence criteria in the US and the UK and is there any belief that a more principle-based approach might be feasible?

14. Level and make-up of executive compensation: What has been the impact of increased disclosure requirements in the UK on executive remuneration and what are the implications for policy makers? What do we know about what motivates CEO and executive performance and how might reward packages better reflect this knowledge?

15. Non-executive director incentivisation: Do the different approaches to non-executive remuneration in the US and the UK reflect differences of opinion amongst US and UK shareowners and, if not, is harmonisation possible? What evidence is there of effects on non-executive director effectiveness of different types of remuneration?

Accounting dialogue

16. Disclosure controls: How have SEC registrants responded to the requirements of Section 302 of the Sarbanes-Oxley Act in the absence of authoritative rule-making or guidance on the subject? What evidence is there of companies outside the scope of Section 302 making similar changes in practice to those made by SEC registrants and why were such changes made?

17. IFRS convergence: What are the practical implications, if any, for standard setting of adopting a stewardship objective rather than relying exclusively on the objective of decision-usefulness? From the perspectives of management, boards, auditors, investors, regulators and litigators, how successful have specific examples of detailed rule-making in accounting been in increasing the certainty, consistency and quality of financial reporting?

18. Timeliness of financial reporting: As the accelerated filing requirements in the US become effective, what have been the implications for reporting quality? How do analysts following US companies and analysts following UK companies differ in terms of their information sources and methods of analysis and to what extent are differences attributable to the reporting of quarterly earnings in the US?

19. Convergence of auditing standards: How do regulators with responsibility for enforcement of auditing standards seek to influence the setting of those standards by the IAASB and other bodies and how successful are they?

20. Non-financial disclosure: What steps do companies and shareholders take to enhance the credibility of voluntary non-financial disclosures and how successful are they?

21. External audit and the role of audit committees: To what extent are formal differences in US and UK audit relationships and audit committee roles reflected in substantive differences in the perceptions and behaviour of management, auditors, audit committee members, other board members and shareholders in relation to the audit process?

Further reading

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[1] *The Cost of Capital: An International Comparison*, Leonie Bell, L. Correia da Silva and A. Premimanis, City of London, 2006.

[2] *Keeping Better Company*, Jonathan Charkham, Oxford University Press, 2005, p. 287. Quoted material by permission of Oxford University Press.

[3] 'Future steps', I. Millstein, paper for the ICAEW Corporate Governance Roundtable, Washington DC, 2005.

[4] *Corporate Governance and Chairmanship*, A. Cadbury, Oxford University Press, 2002, p. 199. Quoted material by permission of Oxford University Press.

[5] *Fair Shares: The Future of Shareholder Power and Responsibility*, A. Simpson and J. Charkham, Oxford University Press, 1999. Quoted material by permission of Oxford University Press.

[6] 'Shareholder activism and corporate governance in the United States', Professor Bernard Black, *The New Palgrave Dictionary of Economics and Law*, vol 3, pp. 459-465, Palgrave Macmillan, 1998. Quoted material by permission of Palgrave Macmillan.

[7] *Back to the Drawing Board: Designing Corporate Boards for a complex world*, C. Carter and J. Lorsch, Harvard Business School Press, 2004, p. 200. Quoted material by permission Harvard Business School Press.

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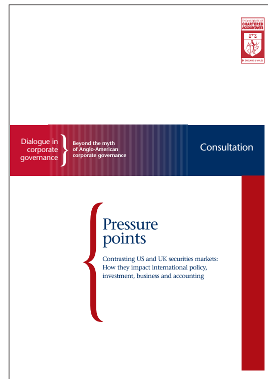
Beyond the myth of Anglo-American corporate governance

Divided by common language – Where economies meet the law: US versus non-US financial reporting models

An independent viewpoint, ***Divided by common language****, written by Tim Bush of Hermes UK Focus Fund, highlights major differences between US and non-US financial reporting models. It provides an historical analysis of differences in the purpose, authority and enforcement of financial reporting.*

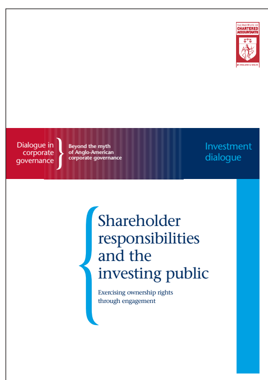


Pressure Points: Contrasting US and UK securities markets: How they impact international policy, investment, business and accounting

Discussion around the similarities and differences between US and UK systems of corporate governance challenges the commonly held presumption of an Anglo-American model. This consultation paper summarises key questions around how policy makers encourage business and investor confidence; how companies are directed and controlled; and how disclosure and reporting requirements are framed and enforced.

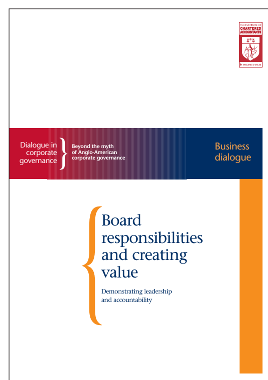
Policy dialogue: Effective corporate governance frameworks – encouraging enterprise and market confidence

Effective corporate governance frameworks promote prosperity, market confidence and public trust. The US and the UK are among the world's most successful economies each with a strong tradition of corporate governance. This paper explores how policy makers are challenged with striking the right balance between market forces and regulation in supporting internationally recognised corporate governance principles of responsibility, accountability, transparency and fairness.



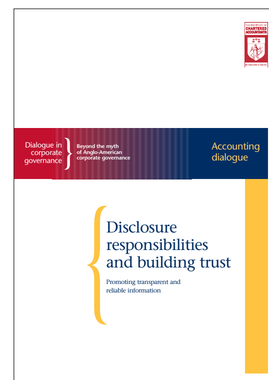
Investment dialogue: Shareholder responsibilities and the investing public – exercising ownership right through engagement

Institutional investors play a significant role in the governance of companies in the US and the UK. They are the guardians of other people's money through the management of pensions, insurance and savings products and are expected to act responsibly in exercising their ownership rights. This paper explores the role of shareholders in corporate governance and their rights and responsibilities.



Business dialogue: Board responsibilities and creating value – demonstrating leadership and accountability

Boards of directors are responsible for acting in the long-term best interests of the company for the benefit of shareholders. Effective boards require skilled leadership, balanced decision-making, informed risk-taking, good judgement and integrity. This paper explores how US and UK boards operate differently and the role, responsibilities and powers of directors in each jurisdiction.



Accounting dialogue: Disclosure responsibilities and building trust – promoting transparent and reliable information

The disclosure of meaningful, reliable and timely information to shareholders is of fundamental importance for informed investment decision-making and market confidence. High levels of financial disclosure are characteristic of both US and UK corporate governance models. This paper explores the role of the accountancy profession in helping to facilitate the flow of capital through transparent, efficient and trusted information.

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