

Corporate governance pays dividends

Corporate governance and control systems geared to enhancing value are becoming a crucial competitive factor for companies of all sizes.

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If there is one issue which, perhaps more than any other, reflects the deep-seated economic unease that characterizes the beginning of the new century, it is that of corporate governance. The equity bubble has burst and the illusions inspired by many corporate success stories have been shattered, while the use of accounting ploys that tread a narrow line between legality and illegality has combined with scandals involving prominent individuals to fire public debate on the subject. The number of articles on the topic published in the Swiss financial press has increased almost tenfold since 1999. Uncharacteristically, even Switzerland – normally considered a bastion of probity – has been rocked by a series of high-profile cases involving inadequate corporate governance and control.

Recent events have certainly brought to light weaknesses in the management and supervision of private companies that need to be rectified. Opinions remain divided,

however, on the best approach to tackling them. Although public discussion has tended to focus on listed companies, corporate governance is also of key relevance to entrepreneurial success and risk management in the small business sector. While there is no consensus on the best form for such measures to take, there is no disagreement on the link between causes and effects.

What exactly is “corporate governance”?

The term “corporate governance” (CG) may sound simple enough, but pinning down what it actually means is far from easy. Essentially it refers to the conduct, interaction and responsibility of various parties in business activity. Depending on which definition is preferred, the parties concerned are either primarily shareholders, managers and the board of directors, or a broader constituency encompassing employees, clients, suppliers, creditors and the general public.

The OECD defines corporate governance as “the system by which companies are directed and controlled.” Consequently, it is argued that the incentives available to management and the board of directors must be designed to ensure that they pursue only those objectives which are in the interests of the company and its shareholders. Yet even the OECD is forced to concede that there is no standard model for good CG. Whatever the definition, CG is not an end in itself. Rather, its

aim is to promote the long-term success of a company. This is a far from simple task, and the reason lies in the separation of ownership and management of a company which has accompanied the creation of modern forms of corporate structure.

The corporation: a model for success ...

The “public corporation”, or publicly owned limited company, is a relatively recent institution, but an extremely successful one. At varying points between the 17th and 19th centuries, business undertakings in different regions of the world reached a size that began to exceed the financial resources and risk capacity of even the most powerful corporate magnates. The first institution to be granted the right to issue share capital of unlimited validity, in 1602, was the Dutch “United East India Company (VOC)”, which needed capital to finance voyages of exploration to the new colonies.

This legal form (which in French is aptly termed the “Société Anonyme”) offers a number of advantages, including the pooling of resources, the fact that property rights can be freely transferred and the limitation of shareholders’ liability to the amount of capital they have invested. While lenders expect no more than a fixed rate of interest and repayment of the capital lent, shareholders bear part of a company’s risk and therefore want

Success requires effective interaction



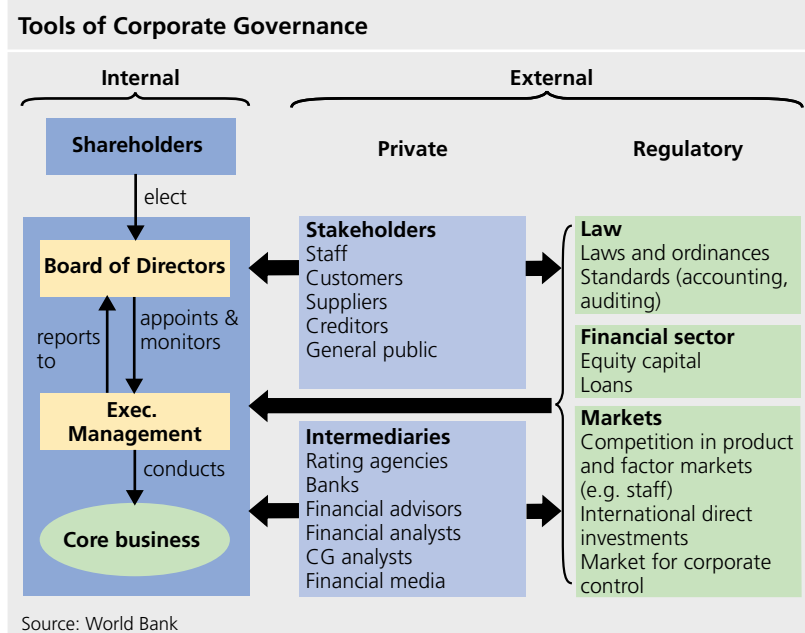
to participate in its success. Equity financing therefore incorporates rights of control and dividend rights, though the latter are residual claims which come into play only when the claims of all other interested parties, such as lenders, staff, clients, suppliers and the state – also termed the stakeholders – have been satisfied.

... but one that has its downside

While managers today are no longer necessarily recruited from amongst the company owners, thereby encouraging the professionalization of management, this trend also increases the complexity of processes and the division of responsibilities. In an ideal situation, management and the board of directors would behave in the same way as a sole owner. That this is not always the case is something Adam Smith, the father of economics, had already observed in overseas trading companies. Yet it was not until 1932 that the so-called “principal-agent” concept was systematically investigated.

The basic idea behind this concept is that in the modern corporation, the true owners (principals) are now absent from the company, and it is the managers (agents) who conduct the actual business. These “agents” normally have little or nothing by way of residual claims. However, as decision-makers within the company, they can influence other criteria such as compensation and prestige factors, from which they can draw direct benefit. As a result, short-term opportunities often conflict with the long-term well-being of the company.

For example, selling products that are not market-ready can lead to immediate positive results, but at the cost of damaging the longer-term relationship with customers.



More common are problems associated with the growth of the company or diversification into too many different areas of business. Often the problem is not clearly identifiable errors of judgment, but rather a failure to maintain a sense of proportion. When it comes to assessing such matters, however, the company’s managers are inevitably a step ahead of the other interest groups, given their inside knowledge of what drives the company’s earnings.

Tools of corporate governance

There is no completely reliable method of avoiding this fundamental conflict of interest within management, but it is important to take appropriate steps at a variety of levels to keep the potential risks firmly under control. There are essentially three models of corporate governance: the market, control and supervisor concepts. The latter takes as its starting point the role of the board of directors as the link between the company and its shareholders, and supports it through effective external auditing. Swiss company law, however, only lays

down duties of fiduciary care and diligence, in other words an obligation to comply with standards specific to a given profession or function. Boards of directors can be obliged to take decisions with due care and attention, but cannot be made liable for ensuring successful financial management.

Yet, with the exception of Germany, no state has so far enacted stricter legal standards. The imposition of additional rules seldom leads to increased security, since the basic assumption is that everything which is not explicitly forbidden is allowed. Associations of interested parties in most states have chosen the alternative route of stepping up self-regulation in accordance with the OECD guidelines. In Switzerland too, a broadly-based panel of experts commissioned by the business federation *economiesuisse* and the SWX Swiss Exchange have drawn up guidelines which operate within the existing legal framework. In general, there is a strong and welcome tendency towards harmonization of international norms.

The aim is to evaluate conduct not simply on the basis of minimum standards but also against the yardstick of firm rules and practices. This means not just protecting the interests of shareholders, but also extends to the allocation of responsibilities within various functions and the structuring of the supreme governing bodies of the company. Consequently, corporate governance covers organizational principles that include advocating the separation of executive management from the chairmanship of the board of directors, the need to set up special audit, compensation and nominations committees, the disclosure of information relating to CG and procedures for dealing with conflicts of interest.

Incentives and transparency

The control model takes a far more direct and financial approach to the issue than the pure supervisor concept, by creating appropriate systems of incentives for management. Granting managers increased allocations of shares in their own company and performance-related compensation have long been part of the measures used. It needs to be ensured, however, that prices for option plans, in particular, are beyond the influence of those at whom they are directed, while the entire compensation and nomination processes are coordinated and set by an independent body, normally a special committee of the board of directors.

It is also important to establish internal processes and functional procedures that are transparent, predictable and coherent. It is entirely in companies' own interest to do so, especially if the result is that they

are perceived by the outside world as responsible and fair. A reputation is a tangible asset that influences potential members of staff, customers and providers of capital. Some aspects of this pattern of conduct can also be observed from outside. Those who frequently come into contact with a given company, such as analysts working for banks and investment companies, also look at the longer-term consistency of management's situation assessments, strategy and communication. Recent stock market history has demonstrated all too clearly that high

earnings forecasts which are neither transparent nor predictable often depress share prices more than weaker but more visible earnings trends.

Does corporate governance pay off?

The market model offers another approach to solving the conflict of interest. Here, inefficient management teams are eliminated through takeovers if the market for control of the company works. Yet this concept is largely theory. One

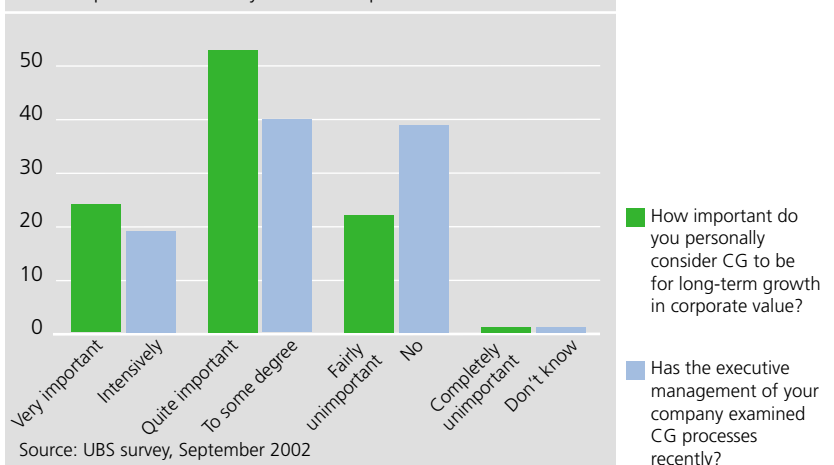
argument against it is that hostile takeovers have seldom been successful in either the US or the UK, and are almost unheard of in Europe and Japan. In addition, top managers naturally anticipate such patterns of thinking and take preemptive steps to avert the danger. Accordingly, they push through measures designed to make takeovers more difficult or at least unattractive. Tactics range from the more traditional imposition of restrictions on registered shares or "poison pills", through sale of the most attractive parts of the business, to the notorious "golden parachutes" offered to management.

More recently, too, the increased concentration of voting rights with institutional investors has given birth to a strong new shareholder constituency made up principally of public and private pension funds and investment funds, who already hold more than 50% of shares in the US. Even in the light of legal restrictions on the concentration of investments and a reluctance to exercise an active influence, such large investors have both the means and the incentive to control companies. When making investment decisions,

Responsibility goes beyond rules

Corporate governance seen as an important issue

% of responses to a survey of 400 companies



they increasingly look not just at expected returns, but also at good CG. In a study conducted by McKinsey, 56% of institutional investors claimed that when it comes to North America and Western Europe, CG is at least as important as pure financial performance; in the emerging markets the percentage is considerably higher. 80% of investors are even prepared to pay a premium for good CG in the form of a share price which can be anything between 11% (Canada) and 41% (Morocco) higher. For Switzerland, the figure is at a satisfying 15%.

CG is also an issue for SMEs

Our own survey of some 400 companies of all sizes confirms that decision-makers in Switzerland too attach great importance to CG. Over 70% consider the subject to be quite important or very important, while not one views it as irrelevant. It also transpires that companies have reacted accordingly: at an impressive 60% of firms, the executive management has examined the issue of CG, while around a third actually claims to have conducted an intense debate on the subject. 90% of those polled consider that a well organized corporate governance system is also a valuable factor for SMEs. A large proportion of these, however, favour a solution for smaller companies that takes account of their particular requirements and their limited resources. It is seen as vital to implement systems that allow the company to take and control calculated risks but which at the same time can be used to communicate with both shareholders and lenders.

When it comes to the measures necessary in Switzerland, the verdict is equally clear: 60% view the status quo as adequate, around a third

favour additional private standards, while only an isolated few argue for statutory regulation. Almost all the businesspeople surveyed believe that transparency of structures and business activities is the primary aim of good CG. Issues such as the responsibility of the board of directors and the rights of all stakeholder groups lag some way behind, while the interests of shareholders are accorded far less weight. This assessment is presumably a reflection of the

existing need for action, underscored by the international comparison already mentioned. Switzerland's below-average performance is chiefly the consequence of insufficient transparency – particularly in the area of CG systems – and the lack of board activism. However, the study also confirms that differences between firms are especially great in Switzerland, and that a few pioneering companies are actually world leaders when it comes to CG standards.



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Corporate governance – the key to prosperity

The basic dilemma posed by the principal-agent problem will always be with us. None of the individual tools can by itself guarantee effective CG. Rather, systems need to incorporate an appropriate balance of all of them. Discussion of the issue, however, raises awareness of the crucial aspects and contributes to the process of finding the best possible solutions in what is inevitably an imperfect world. Yet overregulation can be as damaging to the economy as loopholes in the monitoring apparatus. Voluntary standards complemented by correctly formulated systems of incentives and underpinned by the requirement for transparency are the cornerstones of good CG. Yet for companies, the added value is generated not just by literal compliance with a code, but ultimately by a more sustained earnings trend combined with lower equity financing costs. For all their imperfections, corporations have proved to be a viable structure, and will continue to play an important role in increasing prosperity. Responsible and successful private business initiative is and will remain the driving force behind a country's overall development. ■

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