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Corporate Governance

Financial Responsibility, Controls and Ethics

Erik Banks

CORPORATE GOVERNANCE

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Erik Banks has held senior risk management positions at several global financial institutions, including Partner and Chief Risk Officer of Bermuda reinsurer XL Capital's derivatives subsidiary, and Managing Director of Corporate Risk Management at Merrill Lynch, where he spent 13 years managing credit risk, market risk and risk analytics/technology teams in Tokyo, Hong Kong, London and, latterly, New York. He received early bank training at Citibank and Manufacturers Hanover. Erik Banks is the author of a dozen books on risk management, emerging markets, derivatives, alternative risk transfer, merchant banking, and electronic finance.

PART I

The Function of Corporate Governance

CHAPTER 1

Governance Defined

The re-emergence of governance

Corporate governance has re-emerged as one of the most significant business topics of the early twenty-first century. ***Governance*** – which we define as the structure and function of a corporation in relation to its stakeholders generally, and its shareholders specifically – is not, of course, new.[1] It has been widely discussed, debated, and analyzed for many decades, ever since joint stock companies moved into the mainstream of the global economy.[2] It has also been the focus of reform proposals over the past three decades, as successive waves of corporate problems – some appearing in isolation, others made obvious by difficult economic times – have yielded a variety of recommendations.[3] With recovery in economic growth and corporate profits, however, reform proposals have often been pushed aside. While certain modest improvements might occur, the commitment to sweeping and sustained reform within the global corporate system has not yet appeared.

Privatizations, pension deregulation, free capital movement, and market integration are creating a greater equity investment culture around the world.[4] This phenomenon, together with an increase in the frequency and severity of corporate problems, has moved governance back into the limelight. Public focus is strong because governance failures can now impact a very large number of stakeholders: institutional and retail shareholders (the original and primary focus of most governance initiatives), retirees and pensioners, employees, bank creditors, clients, suppliers, regulators and broad communities. There is heightened realization that good governance is effective in protecting stakeholders, while poor governance puts all parties at risk. Governance failures can lead to a broad range of problems, from temporary reputational damage to insolvency. Events of recent years have demonstrated that even small governance problems can turn into much larger ones if left unchecked. They must therefore be resolved forcefully: any delay can damage a firm's reputation, market share and shareholder value.

Governance issues have an impact on companies and countries throughout the world. The subject is relevant in the United States (with spectacular governance failures such as Enron, Tyco, Andersen, and WorldCom), Switzerland (Swissair), Germany (Kirch Media), Japan (Daiwa Bank, Sumitomo Corporation), and every other national system where shareholder rights have to be protected and stakeholder interests require representation. [5] To illustrate the global nature of governance and governance failures, Table 1.1 highlights a small sampling of difficulties that have appeared since the turn of the millennium (we consider some of these in greater depth in Chapter 7 as they are rich with lessons on failed process and control). It is, unfortunately, just a sample as the actual incidence of problems is much greater.

Table 1.1 A sampling of governance problems

AOL Time Warner (USA): The media giant was forced to restate its revenues by US$190 million after improper recognition of advertising revenues in 2000–2.

Asea Brown Boveri (Sweden/Switzerland): A deeply flawed expansion strategy created by the CEO and sanctioned by the board put the industrial engineering company in financial jeopardy; problems were compounded by the granting of US$170 million of pension benefits to the CEO and his successor without full and proper board approval.

Adephia Communications (USA): The US communications company filed for bankruptcy in 2001 under the weight of financial reporting improprieties and fraud perpetrated by the CEO and his top management team over a period of several years.

Ahold (Netherlands): The board dismissed the CEO, CFO, and several other senior executives of the Dutch food retailer after it was forced to restate revenues by US$1 billion as a result of financial improprieties.

Akai (China): The diversified conglomerate became Hong Kong's largest corporate failure when it collapsed in 2000; executive management looted the company by redirecting assets and defrauding investors and creditors.

Allfirst/Allied Irish (US/Ireland): The US subsidiary of the largest Irish bank reported losses of US$691 million in 2001 as a result of the fraudulent activities of a foreign exchange trader; inadequate controls allowed the activity to proceed unchecked for several years.

Arthur Andersen (USA): The accounting firm filed for bankruptcy under the weight of many flawed auditing/consulting assignments (including Enron, for which it was charged with criminal obstruction of justice).