Gatekeepers: The Professions and Corporate Governance

Professor John C. Coffee's visit to Australia produced an unexpected endorsement of the ASX–Finsia Equity Research Scheme designed to increase research coverage of mid-cap listed companies. **MARK LEY F FIN** reports.

Professor John C. Coffee, the esteemed United States expert on corporate governance, travelled to Australia in mid-March to promote his book, *Gatekeepers: The Professions and Corporate Governance*. He has a distinguished academic and government advisory career and was recently nominated as one of the '100 most influential lawyers in the United States'.

The lecture and book, like most recent studies on governance, focused on the Enron failings with particular attention on the gatekeepers — the auditors, lawyers, equity analysts, credit-rating agencies and investment bankers — who advised the board and its shareholders.

Much has been written on the shareholder–director relationship and Coffee contends that, over recent decades, the board of directors has been extensively reformed and is now an independent, harder working and more proactive body.

Logically, he asserts, the outburst of financial irregularities and governance failures that surfaced in the United States from 2001 to 2003 cannot be purely attributed to the board. One needs to identify the other actors whose performance deteriorated.

Coffee does not accept the widely held view that Enron, and the other corporate failures, were the result of fraudsters who were cynical, deliberate and intended to deceive investors. Alternatively, he considers, all participants, managers, directors, advisers and professionals needed to believe they were following a lawful course of operations within boundaries established by regulation and professional standards. From this mindset, it was permissible to bend the rules, push the envelope, and manipulate accounting and legal practice to pressure the auditors and other gatekeepers.

From this perspective, he asks: Why did the gatekeepers acquiesce?

Coffee does not accept the widely held view that Enron, and the other corporate failures, were the result of fraudsters who were cynical, deliberate and intended to deceive investors.

Why were they so passive? And how can we get the gatekeepers to truly act as watchdogs?

The increase in stock- and option-based compensation for executives and managers explains their desire to adopt more aggressive, risk-taking approaches. Perhaps more importantly, Coffee illustrates the impact of other industry changes in reducing the independence of the other gatekeepers.

Firstly the traditional auditing role of the accounting firm, particularly at Arthur Andersen, was superseded by the consulting business. Arguably its demise could be attributed to the fact that their own internal watchdog, the Professional Standards Group, was overruled in its objections to Enron's accounting treatment on four occasions. No other Big Five firm permitted audit partners to overrule their own watchdog.

Of all these gatekeepers, Coffee notes that it is only the auditing profession that has been impacted by the contentious Sarbanes-Oxley legislation.

However, lack of independence was not purely a problem faced by the auditors. In terms of the equity analysts, even after Enron's major downward restatement of earnings in October 2001, 16 out of 17 analysts covering the stock had a 'buy' or 'strong buy' rating. Merrill Lynch's analyst John Olson had earlier downgraded Enron but was fired after his employer was removed as underwriter in the subsequent Enron public offering.

Coffee cites academic studies showing that, for an equity analyst's career advancement, being optimistic is more important than being accurate. In October 2001, 60% of Enron's stock was held by major mutual funds implying that the 'buy-side' has also missed the signs of distress.

Even credit agencies had missed the Enron warning signs, with the debt being rated as 'investment grade' by the major ratings agencies four days before bankruptcy.

Coffee argues that Enron's accounting

manipulation was detectable. Back in November 2000, some organisations started short-selling Enron stock and there is considerable research proving that the unconflicted short-sellers are a strong predictor of negative accounting restatements and corporate failure. Similarly a potential partner, Dynergy, withdrew from a merger proposal due to accounting irregularities.

The conclusion is that the gatekeepers must be restored to their status to ensure that boards of directors are their ‘prisoners’. The four basic factors that constrain and contain the gatekeepers are liability, regulation, reputational capital and supervision by a principal. Sarbanes-Oxley took the obvious route in finding a stronger principal by transferring all responsibility over the selection, compensation and termination of the auditor to the audit committee.

Coffee explores options to improve these constraints and introduce a ‘stronger principal’ to monitor the other gatekeepers. He considers shareholder voting to be a ‘facile but shallow’ answer. The retail shareholders’ informational impediments and dispersed ownership could potentially aggravate the problems.

Coffee cites academic studies showing that, for an equity analyst’s career advancement, being optimistic is more important than being accurate.

His proposal is that the stock exchanges perform the role as Principal. The exchange could appoint the lead analyst for every listed firm not publicly covered. The exchange would pass on these costs in the form of higher charges and listing fees but would make a strong principal that could hire in volume and negotiate fees as well as using objective criterion (accuracy) in selecting the appropriate analyst.

This suggestion replicates the voluntary scheme initiated by the ASX and Finsia that allows companies to ‘purchase’ two years of research for $50,000. Finsia’s allocation of the research provider to the company ensures the independence of the advice and the integrity of the scheme. J

***Mark Ley F Fin** is a former Senior Policy adviser of Finsia.*

Gatekeepers: The Professions and Corporate Governance
By John C. Coffee (Oxford University Press, UK, 2006)