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INTERNATIONAL SCIENTIFIC JOURNAL
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# CORPORATE OWNERSHIP & CONTROL

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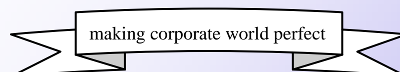


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## CORPORATE OWNERSHIP & CONTROL

## КОРПОРАТИВНАЯ СОБСТВЕННОСТЬ И КОНТРОЛЬ

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# EDITORIAL

*Dear readers!*

Boards of directors are a crucial part of the corporate structure. They are link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers). The board's primary role is to monitor management on behalf of the shareholders. As Tricker says, in the common definition corporate governance "addresses the issues facing boards of directors". In this view, corporate governance in the task of the directors and therefore attention must be paid to their roles and responsibilities. In the broader view, boards of directors are the part of the governance system. The bankruptcy scandals, happened in the USA and Europe at the beginning of the third millennium accentuated our attention to the need of the corporate governance system reform.

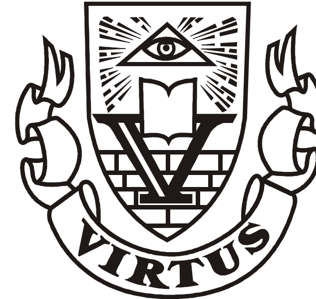
UK and the US corporate governance reforms have been already initiated to reconsider the role of Board of directors. As soon as Derek Higgs had recommended strengthening a board of directors' mechanism through increasing the level of directors' independence, following the reports by Turnbull, Tyson and others, very active dispute has been initiated not only in UK and worldwide. Many countries in the world, and this concerns not only developed countries, decided to join that dispute. The Directors' forums both at the national and international levels were supported worldwide by academics and practitioners..

It seems to us, members of Editorial board of the journal of Corporate Ownership & Control, that the critical steps in corporate governance reform are to ignite an engine of investor shareholder activism and develop the best practices of corporate governance, i.e. accountability, transparency and social responsibility. The only thing we, scientists of the world, need to do know is to keep on supporting the movement with our investigations in the field of board of directors and delivering these to practitioners.

From this perspective, we decided to accentuate attention of reading audience of the journal to corporate board practices once again, as it was in a few previous issues of our journal. We provided contributors with an opportunity to reconsider the role of committees on the boards, status of non-executive directors on the boards, stock option plans. We hope the US and UK experience, delivered to you by authors, would be an excellent explanation of recent trends in corporate governance.

If you care about further development of shareholder activism and take yourself for an integral part of the board best practices movement, you can make your contribution through submitting results of your investigations to the journal of Corporate Ownership & Control. We promise to do our utmost to deliver your ideas to all sites of corporate world to make directors more accountable, transparent, responsible and committed.

# CORPORATE OWNERSHIP & CONTROL

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Topics discussed include the adoption and implementation of International Financial Reporting Standards (IFRS), education for accounting practitioners, recent changes in accounting education in Ukrainian universities, accounting certification and taxation. Expertise in IFRS is in short supply in Ukraine. However, demand for knowledge of IFRS is also lacking, which provides little incentive for local Ukrainian accounting firms to develop expertise in this area. As a result, the top international accounting firms, mostly the Big-4, have captured most of the market for this expertise. Nearly all of the largest companies in Ukraine retain the services of one of the Big-4 and it is primarily the large

companies that can see any use for IFRS, since it is mostly the largest enterprises that are going to the international capital market in search of capital. International investors demand to see financial statements that are prepared using either IFRS or U.S. GAAP as a condition of providing investment capital and the Big-4 accounting firms are best prepared to provide guidance and expertise in this area. Much of the IFRS training of practicing accountants is done by the Big-4 accounting firms. They have developed extensive course materials over the years and have a competitive advantage in this area. However, the training they provide is mostly limited to their employees and their clients, which means that accountants who do not work for either a Big-4 firm or one of their clients do not have ready access to IFRS training. Ukrainian universities have started to incorporate IFRS into their accounting curriculums. The problem is that they cannot always find good learning materials. Some of the most prestigious universities in Ukraine still do not have a course devoted just to IFRS. IFRS is inserted into their course on foreign accounting. Ukrainian financial statements that are certified by accountants who possess only a Ukrainian certification do not have much credibility in international capital markets. One reason for this lack of credibility is the perception that the average Ukrainian accountant does not meet international standards when it comes to knowledge of IFRS and International Standards on Auditing (ISA). Another reason is because the accounting certification system is viewed as corrupt. There are rumors that Ukrainian accounting certification can be bought.

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*Walter Block*

For Professor James Buchanan, government is just one more player in the market, along with all others, such as consumers, landlords, farmers, etc. This view is subjected to sharp criticism by the present author, who makes the case that the government differs from all other participants in society

in that it and it alone enjoys a legal monopoly over initiatory aggression against person and property. No individual presumes to take on the role accorded the state (e.g., to "tax" anyone, or prevent businesses from merging under threat of fine or jail); the government does this every day.

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**Stock Option Plans for CEO Compensation** **88**

*Mª Dolores Álvarez Pérez, Edelmira Neira Fontela*

Stock options plans (SOPs) can be used as a CEO remuneration instrument. Our study examines the dimensions of SOPs, the types of SOP used by Spanish firms to reward the CEO, and the effect of different SOP types on CEOs' behavior. The results show that traditional options "at the money" are the most used by Spanish firms. Although this SOP type is not the most appropriate from the optimum contract theory approach, it offers high potential gains to the CEO. It may therefore increase the capacity of companies to attract and retain competent executives.

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*Costas Constantinou, Lenos Trigeorgis, and Nikos Vafeas*

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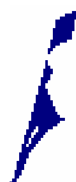
**НАУЧНЫЕ ИССЛЕДОВАНИЯ**
**И КОНЦЕПЦИИ**

**SECTION 1**
**ACADEMIC**
**INVESTIGATIONS**
**& CONCEPTS**



# ON THE WAY TO "GOOD" CORPORATE GOVERNANCE? A CRITICAL REVIEW OF THE GERMAN DEBATE

***Thomas Steger*, Ronald Hartz***

**Abstract**

Corporate governance was widely debated in recent years, in Germany as elsewhere. The question what "good" corporate governance constitutes and how it should be achieved stands in the centre of all those discussions. This paper critically draws on the German case. It tries to identify the key issues as well as recent changes in the character of this debate. It is argued that the reform spirit in Germany stands at the edge and needs some considerable refreshment in the near future.

**Key words**: Germany, "good" corporate governance, public debate, corporate governance code

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## Introduction

In recent years corporate governance has become one of the key topics, both of management research and of practitioners' discussions (Keasey, Thompson and Wright, 1999; Lazzari et al. 2001). This was especially promoted by several cases of firm crisis (e.g. Enron, Parmalat) and management misconduct (e.g. leaving compensations for ABB's Percy Barnevik or Mannesmann's Klaus Esser) undermining the taken-for-granted US concept. In this context normative aspect of corporate governance - what is "good" corporate governance and how should it look in practice? - has once more moved to the center of public interest.

This discussion also takes place in Germany. On one hand there is a broad debate about needed reforms of the traditional German system (Heinze, 2001; Höpner and Jackson, 2001), on the other normative and moral aspects deserve a growing role in the public discussion (Hartz and Steger, 2004). In this paper, we draw a critical review of the ongoing German debate about „good" corporate governance thus starting with a short description of the German institutional background, then highlighting the specific characteristics of the discussion and

identifying the main approaches for potential future developments.

## The Institutional Background

The German corporate governance system is both, deeply rooted in German history since 1945 and incorporated in German company and capital market law (Bernhardt, 2002; BDI/PWC, 2002). It can be sharply characterized by four main aspects:

Firstly, *the two-tier board organization* comprises a management board (Vorstand) with the chief task to direct the company and a supervisory board (Aufsichtsrat) assigned to appoint and control it. Cross-memberships are excluded by law.

Secondly, the mandatory *co-determination* created in the early 50s and enacted in the current form in 1976 reserves half of the seats on the supervisory board of large corporations for employees representatives (Peck and Ruigrok, 2000). To avoid impasses the chairman of the supervisory board who is elected by the shareholders is granted with a double vote. Moreover, co-determination is widely dispersed in smaller corporations and subsidiaries thanks to the largely developed information, consultation and co-determination rights of works councils.

Thirdly, the large German banks, usually *universal banks* engaged in both investment banking as well as commercial banking, hold a key position in the German system. This is based on their blocks of shares, the proxy votes which they command and their traditional role as lenders. Moreover, the numerous seats top bankers have on supervisory boards of large German corporations is a source and manifestation of their power (Hackethal, Schmidt and Tyrell, 2002).

Fourthly, among many of the largest German corporations large shares of stocks are held by other corporations (Schilling, 2001). Those are, moreover, often strongly connected with each other on the personal level and through interlinking directories. This traditional network is often addressed ironically as the "*Deutschland AG*".

Consequently, the German corporate governance system has a clear stakeholder orientation – Vitols (2003: 44) speaks about "bargained shareholder value" – and is targeted to ensuring stability and growth rather than maximizing shareholder value (Hackethal, Schmidt and Tyrell, 2002).

## The Code Development

Although some initiatives to fix principles for „good“ corporate governance have already been launched during the 90s (e.g. Werder 1996) they were only poorly reflected in the public opinion. It was in the aftermath of the publication of the OECD principles (OECD 1999) that also in Germany some diverse expert groups – based on private initiatives – started to think about respective regularities. The collapse of the internet bubble and the following downward spiral even catalyzed those activities.

In January 2000, the Frankfurt commission published its principles (Grundsatzkommission, 2000) while the Berlin commission (Werder, 2001) and the first corporate governance scorecard (DVFA, 2000) followed in June. In the same time the federal government appointed a commission which accomplished their work in July 2001 (Baums, 2001).

Among numerous recommendations the commission claimed for a code of best practice. Consequently the Federal Minister of Justice appointed a second governmental commission (hereafter: the code commission) which established the German Corporate Governance Code in February 2002 (Cromme, 2002).

Although not having the force of law, the new Transparency and Publicity Act which became effective nearly at the same time lends the code additional force: Each listed company is obliged to declare whether it has complied and to explain where it has not (principle of comply or explain) (Hutter, Devlin and Burkard, 2002).

The results of this reform are fairly heterogeneous: On one hand, the implementation of the code by the large corporations is quite well (Towers Perrin, 2004; Werder, Talaulicar and Kolat, 2004).

Moreover, several authors reported some slight indicators for the change of corporate governance practices in Germany, namely an increase in the legal protection of minority shareholders, the evolution of more offensive takeover regulation and a reconsidering among major blockholders of their monitoring approach (Beyer and Hassel, 2002; Hackethal, Schmidt and Tyrell, 2003).

On the other hand, however, there still remains a clear reluctance among the large corporations, e.g. with respect to key topics such as the transparency about board salaries (DSW, 2003). If one enlarges the focus of analysis on registered SMEs the level of implementation considerably decreases (Ergo Kommunikation, 2003; Oser, Orth and Wader, 2003). Moreover, several commentators frankly question whether the code and the reform process really hold their promises (e.g. Bernhardt, 2002).

## Research Design

This paper is based on three sets of data: Firstly, a thorough review of the existing *literature* has been done. Secondly, more than 500 articles of the most relevant German *newspapers* ranging from 1998 to the present were analyzed and interpreted. Thirdly, we conducted 31 qualitative open-ended *expert interviews* between March 2003 and April 2004 (Figure 1) which were all tape-recorded and transcribed.

| | |
|---|---|
| Baums, T. | Head of Governmental Commission / Professor of Public Law |
| Benner-Heinacher, J.S. | CEO, Deutsche Schutzgemeinschaft für Wertpapierbesitz e.V. (DSW) |
| Bernhardt, W. | Member of Berlin Commission / Co-Editor Frankfurter Allgemeine Zeitung |
| Breuel, B. | Former CEO, Treuhandanstalt / former Minister of Economy, Lower Saxony |
| Breuer, R.-E. | Chairman of supervisory board / former CEO, Deutsche Bank / Member of Code Commission |
| Buchheim, A. | Public relations officer, Lintec AG |
| Dallas, G. | Leading expert, Standard&Poors |
| Dornaus, K. | Member of management board, PriceWaterhouseCoopers (Dresden location) |
| Dreyling, G. | Leading expert, Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin) |
| Gosch, I. | Leading expert, ver.di |
| Grimm, R. | CEO, Sparkasse Chemnitz |
| Grosse, G. | CEO, Komsa AG |
| Horezky, J. | CFO, PCWare AG |
| Keußen, T. | Accountant |
| Köstler, R. | Leading expert, Deutscher Gewerkschaftsbund (DGB) |
| Mebus, O. / Müller, J. | Leading experts, Sparkasse Leipzig |
| Poggemann, N. | Investor relations officer, Fielmann AG |
| Reuter, E. | Former CEO, Daimler-Benz AG |
| Ringleb, H.M. / Kremer, T. | Executive assistants, Code commission / Legal experts, Thyssen-Krupp AG |
| Rosen, R.v. | CEO, Deutsches Aktien-Institut (DAI) / Member of Frankfurt Commission |
| Rotter, K. | Attorney-at-law |
| Schneider, K. | CEO, Schutzgemeinschaft der Kapitalanleger e.V. (SdK) |
| Schneider, S. | Investor relations officer, Jenoptik AG / DEWB AG |
| Schöttler, J. | CEO, Intershop AG |
| Stoecker, W. | Member of management board, Sparkasse Dresden |
| Strenger, C. | Member of supervisory board / former CEO, DWS Investment / Member of Governmental Commission and Code Commission |
| Voigt, R. | CEO, Ostdeutscher Sparkassen- und Giroverband |
| Wenger, E. | Professor of Banking and Finance / Shareholder activist |
| Werder, A.v. | Head of Berlin Commission / Member of Code Commission / Professor of Management |
| Wiesner, P. / Wulfetange, J. | Leading experts, Bundesverband der Deutscher Industrie e.V. (BDI) |
| Witzleben, A.v. | CEO, Jenoptik AG |

**Figure 1.** Persons interviewed

## Findings

To answer the main questions of this paper - What is the German discussion of „good“ corporate governance about? What are the main characteristics of the current and what are the main features of the future discussion? – some five propositions based on our data should be formulated and discussed herafter:

*Proposition 1: The German debate about corporate governance is very heterogeneous including a broad variety of different actors and positions.*

Heterogeneity was not only found in the literature and media analysis – what would nobody surprise – but impressively occurred during the expert interviews as well. To make it better visible all interviewees were classified along six main attributes on a 5-point-scale, namely the power of the institution standing behind them (from 1 = very powerful to 5 = nearly powerless), the amount of public perception of their opinion and accounts (high – low), the strategy they follow (offensive – defensive), the assessment of the corporate governance code (positive – negative), of the role of the media (positive – negative) and of the future developments (optimistic – pessimistic) (cf. Figure 2 and 3).

It becomes obvious that the variation in all attributes is considerably high reflecting the large diversity of the experts included as well as the German corporate governance debate in general. Furthermore, when the correlation between the different attributes is focused (cf. Figure 4), there is strong interrelationship between the assessment of the code and of future developments (0,72) which points out the key role of the corporate governance code. Moreover, correlation is also high between public perception and both, institutional power (0,70) and strategy (0,64), which stresses the character of the corporate governance debate as a “power game”.

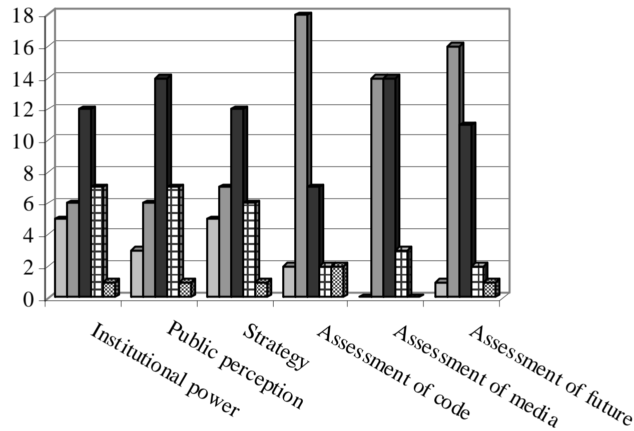


**Figure 2.** Distribution of interviewees' attributes

| | Institut. power | Public perception | Strategy | Assessm. of code | Assessm. of media | Assessm. of future |
|---|---|---|---|---|---|---|
| Average | 2,77 | 2,90 | 2,71 | 2,48 | 2,65 | 2,55 |
| Stand. dev. | 1,09 | 0,98 | 1,07 | 0,96 | 0,66 | 0,81 |

**Figure 3.** Average and Standard deviation of attributes

The only remarkable negative correlation could be found between institutional power and assessment of the media which can be taken as an indicator of the "counter power" of German media.

| | Institut. power | Public perception | Strategy | Assessm. of code | Assessm. of media | Assessm. of future |
|---|---|---|---|---|---|---|
| Institut. power | | | | | | |
| Public perception | .70 | | | | | |
| Strategy | .26 | .64 | | | | |
| Assessm. code | .46 | .33 | .24 | | | |
| Assessm. media | -.30 | .05 | .37 | .28 | | |
| Assessm. future | .45 | .20 | -.08 | .72 | .19 | |

**Figure 4.** Correlation between attributes

Considering all attributes we can identify four clusters of persons in the field: Firstly, the so called "pacemakers" (about 20% of the experts) who are the key players of the German corporate governance debate. They most often represent some very powerful institution (e.g. large corporation) and are in the focus of public interest. Consequently, they had remarkable influence on the process of code development and, therefore, perceive it very positive and so they think about future developments too. Secondly, the "followers" (about 40%) constitute the circle around the former group. They are similarly structured but slightly less "perfect" compared to the "pacemakers" (e.g. their institution is not that powerful or their public perception is less developed) but most often they are in close contact with the pacemakers and with the main road of the debate. Thirdly, the "active outsiders" (about 20%) are somewhat disadvantaged for the ongoing debate (e.g. through the lack of powerful institution). This group is characterised by a majority of critical people who try to actively engage in the debate although they often fail with their ideas. And fourthly, the "passive outsiders" (about 20%) are often not fully inclined in the corporate goverance debate. Even when they represent some considerable power (e.g. larger companies) they renounce on taking a more active role. Moreover, some fairly different perceptions and assessments can found here compared to the main stream opinion, however, this "hidden" voices do not really count at all.

*Proposition 2: The collapse of the internet bubble and the massive decline of the stock market prices provoked a significant change of the German corporate governance*

*debate. While it was highly influenced by neo-classical ideas before, the debate is now characterized by a clear focus on traditional values.*

The media analysis shows two public debates that completely differ from each other, the former taking place between 1998 and 2000, the latter from the year 2001 on. Due to the massive economic decline, the year 2000 marked a turning point. From 1998 until 2000 the public debate about „good“ corporate governance was dominated by the quest for a transformation of the German system of Corporate Governance. Diverse features of the German system (e.g. co-determination, two-tier system) were criticized for not meeting anymore the requirements of the international capital markets. At the same time, a certain “americanisation” – regarding the postulated concepts (e.g. unitary board, strict shareholder orientation) – could be identified. Consequently, the Old Economy was put in sharp opposition to the New Economy which stood as a symbol and model for the required corporate Governance.

*"If there is a symbol for the often cited decline of the Rhine Capitalism, then it is the New Market." (Die Welt, 9 March 2000)*

Moreover, in this context some new “heroes” occurred, namely the new type of a brave manager, who represented entrepreneurial spirit, innovation and imagination.

*"It seems, that this land awakes like Sleeping Beauty from a long deep sleep, as someone with a sword smashed the network under which the entrepreneurial spirit of the Germans had slumbered." (Süddeutsche Zeitung, 3 May 2000)*

With the end of the hype of share prices, the numerous profit warnings and some dramatic company breakdowns during 2000, the dominant characteristics of the public debate were changing as well. Although some commentators tried to keep watching the “great trend” a turnaround became more and more visible.

*"It is by no means everything great just because it is decorated with the name 'New Economy'. But this does not change the overall trend." (Die Welt, 30 December 2000)*

The new debate which was put through until spring 2001 was dominated by harsh critics about the “false” behaviour of managers, analysts, banks and start-up companies cumulating to a veritable confidence crisis.

*"The former heroes have become the bad guys." (Tagesspiegel, 24 June 2002)*

Moreover, the weaknesses of the Anglo-Saxon model were remarked in the debate. Consequently, a renaissance of traditional values such as modesty, trustworthiness and hard work – sketched in the concept of the “honourable merchant” – took place.

*"There are basic rules, which are valid for a 'honourable merchant' – and exactly these rules have to be re-established." (Handelsblatt, 21 July 2002)*

*Proposition 3: The German debate about „good“ corporate governance is dominated by a broad, although unofficial, coalition of actors who share the common will to keep the discussion under control and to prevent it from gaining broader relevance or even from producing some “extensive fire”.*

The coalition members (i.e. the “pacemakers” supported by certain “followers” as discussed above) represent some fairly different institutions, such as large corporations, employer-friendly private institutions, trade unions, saving banks and expert commissions. The coalition’s behavior is characterized by five main strategies: Firstly, they promote a clear pragmatism which becomes obvious through the current, fairly moderate corporate governance code or the coalition representatives’ attempts to downgrade the (formerly) emotional topics and to deny urgency for reforms.

*„In minimum, we already did a great step, and that other thing will have to be the topic of the next round. I mean, the life experience tells me that we should not tackle certain things too ambitiously.*

*From my point of view I must say it is better that the commission reached what they have instead of entering a clinch they could have never won...” (Interview 1)*

Secondly, the coalition members try to exclude some potential problems points from the discussion or even to make them taboo. The debate about co-determination, for example, just takes place in the media and looks more like a mock fight, while this topic remains officially excluded from the discussions of the code commission.

*„The task the commission received from the minister of justice, Ms. Däubler-Gmelin, was to develop a code in the given framework of the current law. Without any democratic legitimation the commission is well advised not to create any further rules. So far the question about co-determination did not exist...“ (Interview 5)*

Thirdly, the coalition members show a fairly specific scapegoating argumentation. To prevent the corporate governance discussion from touching at fundamental questions they use to declare the occurring scandals and examples of inappropriate behavior as single cases. Consequently, they recommend some traditional recipes as valuable solution to improve corporate governance.

*„I treat them as single cases and not as symptoms for a general epidemic. (...) There is no need for a discussion that I consider highly dangerous. Certain critics argued that those were examples of a system illness, that the capitalism as we understand it would not be okay, the market economy as we carry it on would not be okay. These criticisms are misplaced...” (Interview 4)*

Fourthly, some potential problems are denied or in minimum declared to be special cases. A typical example for this can be found in the discussion about the need of a corporate governance discussion or even a corporate governance code for small and medium sized enterprises. This still remains more or less an academic discussion (e.g. (Steger, 2004; Strenger, 2004) while many practitioners and practitioners’ representatives openly reject this topic (Bernhardt, 2003).

Fifthly, the coalition members downplay the discussion about alternative models of corporate governance. By just qualifying the respective strengths and weaknesses, on one hand they stablize the current German model while on the other they prevent any transfer of the own model or its characteristics abroad from taking place.

*„Well, the foreign countries should be careful about that. With the ban to sit on the management and the supervisory board at the same time we are miles ahead of them...” (Interview 3)*

*Proposition 4: The German discussion about „good“ corporate Governance has ceased to be a broad reform debate. It is rather an ongoing discussion clearly reflecting the key aspects of the structural inertia of the economic and political system in Germany.*

The end or just the non-existence of an intensive reform debate is marked by several different patterns: Firstly, there is a nearly complete lack of claims for rigid and spectacular steps to be taken in the corporate governance code. Although in sharp contrast to numerous earlier statements – e.g. regarding competitors on supervisory board, more independent directors, disclosure about compensations (Peck and Ruigrok, 2000) – consensus orientation dominates the current code discussion.

*„The economy will discuss it and will do it as far as possible. That’s why, I think, one will be able not until two or three years to measure this and to say if we have reached what we had intended. Either we will say, all in all, we reached it and we just need some minor revisions or it has not been realized and then we have to decide about whether we need a law. But we can’t say that yet.” (Interview 2)*

Another example are the rights of minority shareholders which are usually just treated on a rhetorical level. Claiming rights remain strictly limited and even rejected by several prominent experts. The same is true for shareholder activism in general which reminds at Sisyphus work as long as the majority of the large investment funds remain under control of banks and insurance companies. It is just logical, therefore, that minority shareholders are scarcely represented on the code commission.

*„Private investors attending the General Meeting with their own shares may sum up at maybe 1% of the total votes present. The rest are shares of banking depots and of any investment funds. And now you must ask, why do these people vote completely different than those whose money it is in the end. That’s the basic question... And, from here we only advance when a completely different reasoning occurs among the public prosecutors, that they prosecute this voting behaviour as disloyalty.” (Interview 8)*

Even the disclosure of salaries of managers and supervisory board members, although some further recommendations was published by the code commission, is far from being self-understandable. Rather than this there regularly occur some new and sometimes bizarre arguments to keep the traditional secrecy.

*“I am the boss of a small company, if compared internationally. But I have to live on the spot. And my salary of a few hundred thousands of Euro is just a peanut for international top managers, but here on the spot it is incredibly much. It is not enough to live in Zurich and to come over here by airplane. But in a region with a unemployment rate of 18% this is incredibly much. And I do not want to run the gauntlet here because of a relatively slight salary if compared internationally.” (Interview 27)*

Secondly, some typical corporatist arrangements (do ut des!) between representatives of capital and labour even strengthen the traditional power balance at the costs of some underprivileged groups (e.g. minority shareholders) and prevent some fundamental reforms from taking place.

*„…then the company lawyers said, it must be prevented that each shareholder can come along and claim. Thus we said: No, no, we can talk about this (…) but if so, they have to agree about some supervisory board affairs that need the employees’ approval. It must be included in the law that the supervisory board must have such a list of affairs.” (Interview 9)*

*Thirdly, no clear opposition of management and supervisory board (Interview 8)*

Last but not least, in spite of numerous claims for (independent and inaffected) self-curing processes of business corporations and actors several indicators show that we are still far away from that kind of improvement process: A prominent example can be found in the current Mannesmann trial against some former supervisory board members who decided and agreed about veritable payments in favor of former management board members and, partly, of their own pocket as well. On one hand, the longer the trial proceeds the more people recognize that a criminal court is not supposed and, therefore, can not judge about decency and good practice. On the other, the accused persons, from both the employers and the employees side, do not seem to feel as having done anything wrong. One of the accused persons, the Deutsche Bank CEO Joe Ackermann, even entered the courtroom showing the victory sign. Another example for this lack of self-criticism was recently given by Hilmar Kopper, chairman of the supervisory board of DaimlerChrysler.

*“DaimlerChrysler is one of only few German companies that is registered at the Big Board in New York (...). The respective transparency and density of supervision and control in accounting and corporate governance (...) will remain unique in Germany and Europe for a long time.” (Kopper, 2004: 16)*

*Proposition 5: The future discussion about „good“ corporate governance in Germany will most probably be characterized by three basic trends, namely pragmatization, professionalization and codification. All three clearly highlight some specific German traditions in the field of economy and politics.*

Against the background of the above mentioned developments it seems widely unrealistic to expect a thorough reform debate about „good“ corporate governance to occur in the near future. Much more probable is the continuation and reinforcement of the current pragmatic discussion. Consequently, this will



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include a) a clear decline of emotional and moralizing topics and aspects, b) the prevention of real, structural reforms of the German corporate governance and c) the protection of some taboo topics.

*„... Mr. Baums and his friends, and the people in the ministry, in the commissions, they consider the claiming minority shareholder as the main trouble maker. And the Frankfurter Allgemeine Zeitung even supports them by transporting their distorted perception to the public." (Interview 8)*

The professional handling of any problematic topic by selected experts within corporatist arrangements is a highly acknowledged German tradition.

Most probably we will face this pattern of behavior in the discussion of „good" corporate governance as well. This meets together with the above mentioned will to prevent "extensive fire". Moreover, it is supported by a declining public interest in the topic which is reflected by the media.

Last but not least, it is to be reminded that a non-legal agreement as problem solution – such as the German code of corporate governance – is fairly untypical in the German context.

*„I think you would strain yourself if you expect any private persons to act ethically where there is no respective regulation. In fact, this would be desirable but who should, let's say, how would you implement this?" (Interview 3)*

So, we can expect that the process to transfer the key points of the code into the federal company law will be continued and intensified in the future. Moreover, this process will even clarify the picture from above. While some commentators will probably argue that through this the principles of „good" corporate governance might be objectified and stressed, some others will claim it another hurdle where real reform steps could be stopped or at least be watered down.

## Conclusions

Finally, it is just modest and necessary to come up with the "so what"-question here. Moreover, it should be questioned hereafter whether the findings presented above may also deliver some value for further action in this field, both for practitioners and for management researchers.

Our paper so far should have provided some critical insights of an important process, namely the ongoing public discussion about „good" corporate governance in Germany, the largest economy in Europe. In more detail, it has accentuated several important points: Firstly, it presented a picture of the micro-political arena in which the development of „good" corporate governance is going on and of how several individual and institutional strategies impact on this. Thus, it became obvious that socio-economic events and processes (as the development of „good" corporate governance) and the discourse about it do not always proceed on parallel lines but undergo some specific "legacies". Secondly, it was clearly pointed out how the institutional and historical framework of a country influence the development process of „good" corporate governance as well as the discussion about it. What currently happens so far in Germany can hardly be understood without the knowledge of this constitutive framework. Thirdly, the importance and close connection of individual perceptions and action – as described by several theoretical approaches – was stressed – not only perceptions about current and future problems or partners and adversaries but also about organizational and societal norms and values that in the end constitute what „good" corporate governance means.

Against the background of our paper, several features for future action in this topic may be identified that might be taken as lessons for other countries as well: Firstly, since the media generally play an important role in public discussions of any kind it seems important that they took over a more active role in promoting „good" corporate governance. This could be done for example by making more transparent the respective practice of companies even for small shareholders which could improve the information situation and, thus, would enable the broad market to react. Secondly, the group of people dedicated with the task to create and develop further a national corporate governance code takes over a great responsibility and, therefore, will largely impact on the further process. However, these kind of institutions must be carefully safeguarded from becoming "over-politicized". If they do not fairly include all important actors they risk to loose their power balance and, furthermore, their legitimacy in the public opinion. Thirdly, one should assume that often the situative national framework can hinder or prevent needed corporate governance reforms from going on. Consequently, external multi-national institutions, such as OECD, EU or the Basel council, receive an important role in promoting and sometimes even subtly pushing forward national reform agendas. As our paper clearly detected this might be true not only for developing or emerging economies but also for some saturated, traditional market economies as well.

Last but not least, some opportunities for future research should be mentioned here: Firstly, it seems promising to more closely investigate the processes of implementing and putting through of „good" corporate governance instead of stopping at the moment when a certain code is created. In other words, it is important not just to watch the "norming" but also the following "performing" phase. Secondly, since corporate governance crisis and reform are definitively cyclical (Clarke, 2004), this topic does merit to be focused from a larger historical perspective. Quality and know-how in this respect might also be found in the past. Finally, some pure descriptions of „good" corporate governance development processes must not be the end of the

way. Some strong efforts should be made here to find out and develop further some economic and sociological theories that help us to understand and explain what is going on around here.

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# EARNINGS MANAGEMENT AND INTERNAL MECHANISMS OF CORPORATE GOVERNANCE: EMPIRICAL EVIDENCE FROM CHILEAN FIRMS

***Félix J. López Iturriaga*, Paolo Saona Hoffmann***

**Abstract**

We analyze the ability of the capital structure and the ownership structure as mechanisms of control of the managers of the firms and to reduce their accounting discretionary power for a sample of Chilean firms. Using earnings management and abnormal accruals as indicators of discretionary behavior, our results show that both debt and ownership concentration reduce the managers' discretionary behavior, so we corroborate the outstanding role both mechanisms play in a country with low protection of investors' rights. At the same time, we find that earnings management is fostered by institutional investor ownership.

**Keywords**: Accruals, capital structure, corporate governance, earnings management, ownership structure.

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## 1. Introduction

As pointed by Jensen and Meckling (1976), the managerial relation is one of the key agency problems since shareholders and managers can have fairly different interests and a conflict of interests is likely to arise between them (Fama and Jensen, 1983).

Whereas shareholders seek the maximization of their wealth and encourage the maximization of the firm's value, managers' interests are usually linked to the compensation both with money and perquisites. In turn, managers could be prone to run the company even in detriment of the firm's value provided that they could satisfy their own utility function through some decisions such as overinvestment (Stulz, 1990), over-optimal diversification (Lang and Stulz, 1994; Denis *et al.*, 1996) or taking risks beyond the optimal level for the company (Amihud and Lev, 1981).

This conflict of interests requires some mechanisms to ensure the protection of investors' rights and, therefore, corporate governance arises as a set of constraints to shape the bargaining over the quasi-rents generated (Zingales, 1998) or the way used by the suppliers of finance in order to assure the return on their investment (Shleifer and Vishny, 1997). More specifically, corporate governance focuses on the mechanisms to reduce the array of agency costs originated by the nexus of contracts in the firm.

The concept of corporate governance is broad and so are the mechanisms to protect investors' rights. A usual classification scheme makes a difference between external and internal control mechanisms. Whereas the market for corporate control is widely known as being the most outstanding external mechanism (Jensen, 1986) there is a number of possible internal mechanisms such as capital structure, ownership structure, dividend policy and the board of directors which have been proved to discipline firm managers (Jensen, 1993).

Our paper analyses some of these internal mechanisms. In recent years, discussions on capital structure have merged with the consideration of financial funds as instruments of decision and control. As a result, the capital structure puzzle has been enriched with the inclusion of ownership structure and its relevance on financial decisions and corporate valuation (Morck *et al.*, 1989; McConnell and Servaes, 1995). Following this approach, our paper is concerned with the role of both capital structure and ownership structure as mechanisms of corporate governance and their ability to reduce the

managers' discretionary choices in the accounting area (Bushman and Smith, 2002; Bushman *et al.*, 2004). This can be said to be the first contribution of our paper since we introduce a modern and suitable indicator of managers' discretionary decisions in order to evaluate the performance of corporate governance mechanisms. Another contribution of the paper derives from the geographical and institutional framework of the sample. Chile and Chilean firms are an interesting benchmark since the legal origin and the weigh of their financial markets are quite different from the Anglo-Saxon pattern of corporate control on which most of the empirical evidence is focused. One of our key points is the use of earnings management as an indicator of managers' discretionary behaviour. Based on the idea that accruals could be one of the signs of earnings management, we study to what extent leverage and ownership structure are able to discipline firm managers and to reduce their ability to manage earnings. Our results support previous literature and underline the impact of capital and ownership structure on managers' decisions. On the one hand, debt financing seems to be a more constraining framework that equity financing and consequently it reduces the manager's discretionary behaviour. On the other hand, the equity ownership structure is relevant so that the more concentrated is ownership, the more in-depth the control of managers becomes. Additionally, our results point at the influence of the identity of the main shareholder on managers' discretionary power.

We divide our paper into six sections. After the Introduction, in Section 2 we revise the two main theoretical fields on which the paper grounds: the literature on earnings management and the functioning of the internal mechanisms of corporate governance. In that section we also present the hypotheses we will try to test. Section 3 includes the explanation of the Chilean corporate system, highlights its specific features and provides reasons for the analysis of that country. In Section 4 we describe the sample and the methodology, whereas in Section 5 we show and comment the main empirical results. There is a last Section with the most important conclusions and with some directions for future research.

## 2. Managers' Discretionary Behaviour, Earnings Management, Corporate Governance

One of the most common characteristics of modern firms is the separation between ownership and control. The agency relations originated by such separation imply an asymmetric distribution of information since shareholders cannot efficiently monitor all the decisions made by managers. As a result, managers have incentives to run the firm discretionarily and to pursue their own utility even at the expense of the shareholders' interest or the firms' valuation. This is why, in order to protect the shareholders' interests some mechanisms have been established to reduce asymmetric information, to assess the managers' performance and to set compensation schemes (Brickley *et al.*, 1995). One of the mechanisms to disclose reliable information are financial statements (Kothari, 2001). Those statements allow assessing firm performance and thus, are optimal means to assess managers' decisions. In fact, the assessment of managers' performance on the basis of the firm's performance is usual nowadays and a series of compensation schemes based on firm earnings have become general (Watts and Zimmerman, 1986; O'Byrne, 1990).

A plausible reaction of managers is the choice of accounting methods according to their own interests to manage earnings (Smith, 1976; Jensen, 2003). The result of this process is the so-called earnings management or modification of accounting earnings to make a positive impression about managers' performance instead of conveying reliable information to markets. These decisions cover a wide range such as the choice of accounting methods (Moses, 1987), inventories valuation criteria (Niehaus, 1989), extraordinary expenses and incomes (Beattie *et al.*, 1994), R&D expenditures (Bange and DeBondt, 1998) or accruals (Bannister and Newman, 1996; DeFond and Park, 1997). One of the most outstanding of these procedures are accruals and literature has paid a special attention to them in recent years (Jones, 1991; DeFond and Subramanyan, 1998; Erikson and Wang, 1999; Healy and Wahlen, 1999). The aim of that kind of accounting adjustments is to improve the informational content of financial statements and to avoid the mismatching between cash flows and the flow of income and expenses. Despite this appropriate purpose (Hansen y Noe, 1998; Barth *et al.*, 2001), there is also a discretionary use of accruals because they enable to transfer positive or negative results through time and, in turn, to manipulate the information of financial statements. In fact, this is the most usual way to modify earnings due to their low cost and their difficult detection (Healy, 1985). In addition, another advantage of accruals is the ability to gather the joint effect of a set of accountant decisions (Peasnell *et al.*, 2000b).

Given the appealing of accruals, several means have been designed to identify the possible abnormal or discretionary use. As stated by Delgado (2003), there are a number of methods of earnings management through the use of accruals, although most of them have in common the distinction between two components: the abnormal or discretionary one and the normal or non-discretionary one (Dechow, 1994; Peasnell *et al.*, 2000a). Whereas non-discretionary accruals aim to improve the informational content of earnings, the abnormal accruals are means to manipulate earnings in favour of managers' interests. Since there are two

kinds of accruals, there are two different kinds of justifications of accruals.

Non-discretionary accruals are often related to the usual business of the firm and -as will be stated in Section 4.2- are frequently a function of the firm turnover and the depreciation of long-term tangible assets. On the contrary, abnormal accruals should be affected by the ability and incentives of managers to manipulate earnings and are likely to depend on the efficiency of corporate governance mechanisms. Indeed, literature shows that earnings management can be reduced by outside directors (Peasnell *et al.*, 2001), the auditing committee of the board of directors (Klein, 2002), institutional investors (Jiambalvo *et al.*, 2002) or the active role of inside shareholders (Delgado, 2003). This is the approach of our paper since we try to analyze the relation between the discretionary behaviour of directors and two mechanisms of corporate governance such as capital and ownership structure.

Regarding the effect of capital structure, it is widely known that debt financing reduces managers' power by reducing the cash flow available for spending at the discretion of managers (Grossman and Hart, 1982; Jensen, 1986; Harris and Raviv, 1991). From this point of view, a negative relation should be expected between financial leverage and the use of abnormal accruals since the higher the leverage the more in-depth is the control undertaken by lenders. Furthermore, the informational content of financial statements could play a less relevant role in this case because lenders are interested in debt service rather than in accounting information. Consequently, managers would have fewer incentives to manage earnings in the most leveraged firms. In spite of this, there is also empirical evidence which documents a positive relation between financial leverage and earnings management (Azofra *et al.*, 2002). These authors show that the impression made by financial statements can be useful to loose restrictive loan convenants and to raise funds in better conditions so that managers have incentives to manipulate earnings (Mohrman, 1996). Consequently, the fostering or constraining role of debt on earnings management seems to be an empirical issue and both a positive and a negative effect can be justified.

Regarding the link between abnormal accruals and ownership structure, the empirical evidence is scarce and can be divided into two main fields: the weigh of internal shareholders on the whole ownership and the identity of the main shareholder.

As far as the ownership of insiders is concerned, Warfield *et al.* (1995) show that it has a significant and non-monotonic effect on managers discretionary decisions. Consistent with Morck *et al.* (1988), in the lowest levels of insiders' ownership there is an alignment of interests which means a negative relation between abnormal accruals and insiders' ownership. Nevertheless, an entrenchment effect is found for the highest levels of insiders' ownership so that the higher the insiders' proportion of ownership, the more frequent abnormal accruals become.

Concerning the nature of the main shareholders, it has been proved to have an outstanding influence on the quality of accounting information. For instance, abnormal accruals are less usual when there are institutional investors (Jiambalvo *et al.*, 2002) or *block-holders* (Yeo *et al.*, 2002) among the shareholders. According to this literature, we try to test the possible influence of both the concentration of ownership and the nature of the main shareholder (Denis and McConnell, 2003) on the accounting decisions taken by managers. Ownership concentration is the most direct way to align ownership and control rights. In fact, in the countries with the lowest protection of investors' rights (La Porta *et al.*, 1998 and 2000) firm performance runs parallel to ownership concentration (Gorton and Schmid, 2000; Yafeh and Yosha, 2003). Large shareholdings allow coping with some problems of collective action such as the traditional free-rider problem and foster a more active monitoring so that managers' turnover could become more frequent. This is the core of our paper since we are interested in assessing the ability of ownership concentration as a mechanism of corporate governance in Chile, a country with a deficient protection of shareholders' rights. We aim to test to what extent ownership concentration can reduce managers' discretionary power and, in turn, earnings management. Our research relates to the some other papers which study the effect on earnings management of some factors such as legal tradition (Leuz *et al.*, 2003) and the role of capital markets (Gabrielsen *et al.*, 2002).

We are also concerned with another aspect of ownership structure such as the nature of the shareholder. Specifically, we try to test to what extent institutional investors or another kind of shareholders may affect the efficiency of corporate governance. There are two opposite approaches on this question (Rajgopal and Venkatachalam, 1997). On the one hand, institutional investors specialize in monitoring and are able to control managers more in depth than small shareholders (Black, 1992; Pound, 1992). On the other hand, institutional investors are most of the times *short-termed* and concerned with quarterly returns (Graves, 1988). This kind of investors does not engage in managers' control and they prefer selling their stakes instead of monitoring or removing inefficient managers (Coffee, 1991; Jacobs, 1991). Accordingly, institutional investors would be too lenient to monitor managers and their presence could even encourage their power.

As a summary and in order to introduce the hypotheses to be tested, we try to analyze the influence of two mechanisms of corporate control (capital structure and ownership structure) on earnings management, which reflects the managerial accounting discretionary power. Firstly, we study the effect of debt. It is an empirical question since there are theoretical explanations both for a positive and

for a negative influence. Secondly, we study the relevance of two issues of ownership structure: ownership concentration and the nature of the main shareholder. We expect a negative relation between ownership concentration and abnormal accruals since the more concentrated the ownership, the more in depth the monitoring and control of managers. Regarding the identity of the main shareholders, there are theoretical reasons both for a positive and for a negative impact on abnormal accruals when the main shareholder is an institutional investor.

The contribution or our paper is twofold. First, we introduce the concentration of ownership and the nature of the shareholders as mechanisms to reduce earnings management. Second, we expand the benchmark further than the Anglo-Saxon corporate system, on which most of the previous literature has focused. We analyse the Chilean corporate system due to its very different legal origin where investors' rights are not fully protected what could explain why the ownership structure and the capital structure of firms in this kind of countries are so different from those of British or U.S. firms.

## 3. The Chilean Corporate System

Unlike U.S. or U.K., to which most of the literature has paid attention, Chilean companies belong to the French branch of civil-law countries (La Porta *et al.*, 1998; Demirgüç-Kunt and Levine, 1999). In this framework, banks play an outstanding role in the allocation of financial resources in detriment of capital markets (Allen and Gale, 2001; Beck and Levine, 2004) and can even become reference shareholders in many firms (Krozner and Strahan, 1999). As a consequence of the failure of the civil-law system to protect the interests of minority shareholders, Chilean firms rely on internal control mechanisms (Filatotchev and Mickiewicz, 2001). This could explain why, as shown by Majluf *et al.* (1998), the ownership structure of Chilean firms is highly concentrated. In institutional frameworks where the hostile take-overs are not very effective and the banking system is well developed, firms with highly concentrated ownership often borrow from banks since banking debt and ownership concentration are complementary mechanisms of corporate governance (Dewatripont and Tirole, 1994; John and Kedia, 2000). This could explain why the banking system is dominant over capital markets in the allocation of capital in most civil-law countries.

To obtain a broad view of the Chilean corporate system, in Table 1 we report some data in order to establish a comparison with countries which belong to different legal roots and different corporate systems. Our data refer to the importance of banks in the whole financial system (bank credits to GDP), the importance of capital markets (market capitalization to GDP) and the financial structure ratio or relation between banks and markets (market capitalization to bank credits).

**Table 1.** Main characteristics of the Chilean corporate system

| Country | Bank credits to GDP | Market capitalization to GDP | Financial structure | Bank concentration | Shareholders ownership | Debt to total assets | Short term debt to total assets | Long term debt to total assets |
|---|---|---|---|---|---|---|---|---|
| Chile | 0.488 | 0.610 | 1.253 | 0.620 | 0.450 | 0.281 | 0.149 | 0.131 |
| Germany | 1.018 | 0.315 | 0.298 | 0.390 | 0.480 | 0.560 | 0.496 | 0.062 |
| Japan | 0.835 | 0.744 | 0.683 | 0.320 | 0.180 | 0.727 | 0.432 | 0.294 |
| France | 0.849 | 0.427 | 0.502 | 0.440 | 0.340 | 0.656 | 0.386 | 0.269 |
| UK | 1.043 | 1.108 | 1.062 | 0.650 | 0.190 | 0.166 | 0.084 | 0.082 |
| USA | 0.674 | 0.865 | 1.276 | 0.200 | 0.200 | 0.474 | 0.262 | 0.211 |

Source: Beck *et al.* (1999), Carlin and Mayer (2003), La Porta *et al.* (1998), Antoniou *et al.* (2003 and 2004) and BACH database.

Although in civil-law countries banks play usually a prevailing role over markets, that is not the Chilean case. As shown in the three left columns in Table 1, capital markets are more important than banks in financial allocation in Chile throughout the period 1987-2001. From this point of view, Chile would follow a similar pattern to common-law countries. This fact could be explained on the basis of the increasing opening and growth of Chilean economics in the 80's (Gallego and Loayza, 2000), which has led to a parallel development of capital markets and, in turn, of the whole financial system (Rajan and Zingales, 2003).

In spite of the fact that banks are not so important in Chile as in other civil-law countries, one cannot neglect their prominent role. The fourth column in Table 1 presents the banking concentration –measured as the market share of the five largest banks (Cetorelli and Gambera, 2001). As we can see, the banking concentration and, therefore, the market power of the largest banks in Chile are fairly higher than the concentration of their counterparts in the other countries with the exception of British banks. Chilean legal origins have also some influence on the ownership structure of Chilean firms. Table 1 shows that, consistent with the classification scheme by La Porta *et al.* (1998), after Germany, the French branch of civil-law countries have the most concentrated ownership – measured as the ownership of the three main

shareholders in the ten largest non-financial firms. This highly concentrated ownership is a feature of Chilean firms to which we will refer again later on.

The financial structure of the firms is another interesting feature of the Chilean corporate system. Table 1 reports that these firms are low-leveraged and that they are closer to Anglo-Saxon firms than to Continental ones. This similarity holds both for the short and the long-term debt. Whereas civil-law firms are prone to borrow short term funds, Chilean and Anglo-Saxon firms have a more balanced structure in terms of short *vs*. long-term debt.

In sum, we could say that the Chilean corporate system, in spite of being a civil-law system, deviates from the model of other civil-law countries such as Germany, France or Japan. At the same time, it has some characteristics in common with the Anglo-Saxon system of common-law. To some extent, Chile is a hybrid system amid the two main models: although it is bank-oriented, capital markets play a prominent role and firms are inclined to a concentrated ownership and low financial leverage.

## 4. Data and Methodology

### 4.1. Sample and Variables

Our sample is made up of 185 quoted Chilean non-financial firms throughout the period 1991-2001. Financial information was obtained from the audited financial statements supplied by the *Ficha Estadística Codificada Uniforme* (FECU) from the *Superintendencia de Valores y Seguros de Chile*, the Chilean Securities Exchange Commission. Since all the firms are listed, most of them are supposed to be large or medium-large firms.

The variables to be used and the main descriptive statistics are shown in Table 2. The variable which proxies managers' discretionary accounting power is abnormal accruals (AA) and is explained in Section 4.2. The explanatory variables, as previously stated, are financial leverage (LEV) -defined as the ratio of total debt to total assets (book value), and OC1 or the proportion of ownership owned by the largest shareholder. The first variable is aimed to measure capital structure while the second one should proxy ownership concentration. Five dummy variables related to ownership structure have been defined on the basis of the nature of the largest shareholder: a family (FAM), an institutional investor (INST) as mutual funds, assurance companies or pension funds, a domestic firm (DOM), a multinational firm (MULT) and the State (STA). Although five dummy variables have been defined, we will include only four variables in the regressions to avoid multicollinearity.

**Table 2.** Descriptive statistics of variables

Main descriptive statistics of the sample. We report mean, median, minimum and maximum values along with the variance of each variable. AA stands for abnormal accruals, TA for total accruals, LEV for leverage or total debt to total assets ratio, OC1 and OC5 for the proportion of shares owned by the largest and the five largest shareholders, DIFROA for the difference between firm performance and the average industry performance, ΔTURN1 for the firm's turnover growth and PPE for plant, property and equipment scaled to total assets.

| Variable | Mean | Median | Minimum | Maximum | Variance |
|---|---|---|---|---|---|
| AA | 0.000 | -0.005 | -1.352 | 3.158 | 0.136 |
| TA | 0.030 | -0.009 | -1.029 | 4.651 | 0.080 |
| LEV | 0.252 | 0.232 | 0.000 | 0.908 | 0.036 |
| OC1 | 0.452 | 0.449 | 0.000 | 100 | 0.064 |
| OC5 | 0.706 | 0.746 | 0.000 | 100 | 0.054 |
| LNSIZE | 17.369 | 17.441 | 11.728 | 22.058 | 3.585 |
| DIFROA | -0.002 | -0.006 | -0.460 | 0.584 | 0.008 |
| ΔTURN1 | 0.034 | 0.000 | -3.521 | 5.070 | 0.084 |
| PPE | 0.639 | 0.586 | -1.736 | 3.693 | 0.338 |

Table 3 shows the main features of Chilean firms that we have emphasized dependent on the nature of the main shareholder: ownership structure and capital structure. We report the proportion of firms in the sample according to the identity of the largest shareholder, the average size of the firms, the average proportion of shares owned by the largest shareholder and the average capital structure of the firms. Again we can see that Chile is a mixed corporate system since the main shareholders are domestic firms (as usual in the Continental model) and institutional investors (as often in the Anglo-Saxon model). The average size of the firms is quite similar among groups but we can appreciate big differences concerning the ownership of the largest shareholder (especially for State-owned firms) and financial leverage.

We have included some other variables which, from our point of view, are likely to be related to earnings management: firm size and firm performance. We measure firm size (LNSIZE) with the logarithm of total assets at book value[1] and firm performance with the return on assets or, more specifically, the difference between the firm's ROA

[1] Total assets are measured in thousands of Chilean *pesos* (logarithm). At the end of 2001, the exchange rate was one U.S. dollar for 679 *pesos* (one euro for 557.40 pesos).

and the average return of the firm's industry (DIFROA). The size of the firm can exacerbate agency problems from the separation of ownership and control (Ozkan, 2000) and incentive earnings management. In addition, earnings management should not be so usual when firm performance is high enough or when it exceeds the performance of the firm's competitors. Thus, one could expect a positive relation of firm size and a negative relation of firm performance with abnormal accruals.

Among the available statistical procedures, we have opted for the panel data regression. Our sample combines time series for 11 years with cross-section data from 185 firms allowing us to optimally make use of the panel data advantages. In our case, we have built an unbalanced panel data with 1,656 observations. Panel data methodology enhances the control of the so-called unobservable constant heterogeneity (Arellano and Bover, 1990), that is, some specific features of each firm which are kept along time and allow optimally exploiting the firm-level dimension. Additionally, panel data estimators are more efficient than ordinary least-squares estimators due to the lower collinearity among the variables and the higher number of degrees of freedom (Baltagi, 1995).

**Table 3.** Ownership, size and leverage of the firms in the sample according to the main shareholder

| | Family | Institutional investor | Domestic non-financial firm | Multinational firm | State | Whole sample |
|---|---|---|---|---|---|---|
| % firms | 7.91 | 39.43 | 44.02 | 6.28 | 2.36 | 100 |
| Average firms' size (log) | 15.57 | 17.36 | 17.71 | 17.18 | 17.59 | 17.37 |
| Largest shareholder's ownership (%) | 38.97 | 38.62 | 50.91 | 48.05 | 62.37 | 45.21 |
| Debt to total assets ratio (%) | 25.59 | 24.72 | 26.71 | 20.59 | 16.29 | 25.21 |

### 4.2. Methodology

As other authors, we use a two-stage approach to partition total accruals into their managed and non-managed components: we first estimate abnormal accruals as the residuals of total accruals regression and then we find out the impact of corporate governance on abnormal accruals. Total accruals are defined according to Jones' model (Jones, 1991). Although there are different alternative models of earnings management (Delgado, 2003), the choice of the model is not relevant since it does not bias the results (Dechow *et al.*, 1995). In any case, later on we will test the robustness of the results to alternative specifications of earnings management.

The departing point of Jones' accrual model is the idea that the manipulation of non-monetary current assets and liabilities is easier than the modification of payments which directly affects the firm's cash flow[2]. The calculation of depreciation can be also chosen among different methods and that is why total accruals are calculated as the variation of non-cash working capital minus amortization and depreciation of PPE.

Once we have obtained total accruals, we have to split them into normal and abnormal accruals. Non-discretionary accruals are aimed to improve the informational content of financial statement, so we could wonder about the factors that cause these normal adjustments. To answer this question we should keep in mind that, according to Jones' model, total accruals are affected by the firm's usual business –which can affect non-cash current assets and liabilities- and by plant, property and equipment –which can affect depreciation.

Consequently, we regress TA depending on the change in sales ( TURN) and the gross level of PPE. All the variables are scaled by total assets at book value. So we estimate the following equation

$$TA_{it} = \alpha + \beta_1 \Delta TURN_{it} + \beta_2 PPE_{it} + \eta_i + \varepsilon_{it}.$$

As regards the forecast sign of these variables, there is a clear difference: whereas the second one is obviously negative –since depreciation has been included with a negative sign in the definition of accruals-, it is not easy to predict any sign for the change in sales. On the one hand, the higher the sales revenues the higher the receivables but, on the other hand, increases in sales usually imply increases in short-term commercial debt, so the net effect on working capital is uncertain.

The value of TA in equation [1] could be considered as the level of normal accruals depending on the firm's activity and the composition of the firm's assets. Consequently, the error of the regression -the difference between observed and estimated TA as stated in equation [2]- would become the part of total accruals due to managers' discretionary decisions and will be identified with abnormal accruals:

$$AA_{it} = TA_{it} - (a + b_1 \Delta TURN_{it} + b_2 PPE_{it}).$$

where a, $b_1$ and $b_2$ are the estimators for , $_1$ and $_2$ coefficients.

It is true that income-increasing accruals are not the only way to manage earnings and that firms can also try to reduce accruals when times are good. Nevertheless, as shown by Peasnell *et al.* (2001),

[2] This approach implicitly assumes that earnings management can be undertaken by modifying the assessment of inventories, receivables or current liabilities.

there are two reasons to explain why the role of the mechanisms of control is more pronounced for income-increasing accruals. Firstly, penalties linked to discretional increase of earnings are usually more costly that penalties from income-decreasing earnings management, so managers' control is more exhaustive in the first case. Secondly, it is more difficult to identify a critical threshold -which could evidence earnings discretionary manipulations- for downwards earnings management due to factors specific to each firm.

Abnormal accruals allow assessing managers' ability to modify financial statements in their own interests so they are very helpful to test the efficiency of corporate governance mechanisms. Therefore, we will test the influence of capital structure and ownership structure on discretionary accounting adjustments. Our second step will be, in turn, explaining abnormal accruals as a function of capital structure, ownership structure and control variables. That regression will be: *(see formula 3)*

## 5. Results

As previously stated, the first stage in the empirical analysis tends to measure discretionary accruals as the residuals of the estimation of equation [1]. Results reported in table 4 show, as theoretically forecast, a negative impact of PPE on total accruals and a positive effect of sales. These results, however, are not relevant here and have only instrumental interest as long as they proxy the manager's power as abnormal accruals.

$$AA_{it} = \alpha + \beta_1 LEV_{it} + \beta_2 OC1_{it} + \beta_3 LNSIZE_{it} + \beta_4 DIFROA_{it} + \beta_5 DUMMY\ INVESTOR_{it} + \eta_i + \varepsilon_{it} \quad [3]$$

where $\eta_{it}$ is the fixed-effects term which is firm-specific and $\varepsilon_{it}$ represents the random component.

**Table 4.** Panel data estimation of total accruals

Estimated coefficients and standard errors (in parentheses) of the estimation of equation [1]. TA stands for total accruals according to Jones' model. Explanatory variables are the growth of sales (ΔTURN1) and plant, property and equipment (PPE). Variables have been scaled by total asset. F-statistics is a test for the joint significance of all the independent variables. (***) stands for significant to a confidence level higher than 99%, (**) for a level higher than 95% and (*) for a level higher than 90%

| Variable | Coefficient (Std. error) | | Coefficient (Std. error) | |
|---|---|---|---|---|
| Intercept | 0,4207 | *** | 0,4187 | *** |
| | (0,0106) | | (0,1063) | |
| ΔTURN | 0,1566 | *** | | |
| | (0,0184) | | | |
| ΔTURN2 | | | 0,1607 | *** |
| | | | (0,2009) | |
| PPE | -0,6205 | *** | -0,6159 | *** |
| | (0,0150) | | (0,0150) | |
| | | | | |
| F statistics | 8,05 | *** | 7,91 | *** |
| $R^2$ | 0,5407 | | 0,5367 | |
| | | | | |
| # obs | 1,656 | | 1,656 | |

These results are the basis for estimating the effect of some mechanisms of corporate governance on managers' accounting decisions as presented in equation [3]. To do so, we have regressed abnormal accruals on capital structure (LEV) and ownership concentration (OC1). Results are displayed in table 5 and some issues should be stressed.

Concerning capital structure, column 1 in Table 5 shows a negative and significant influence of LEV on discretionary accruals. Consistent with our hypotheses, this relation underlines the disciplinary role of debt and stresses that financial leverage reduces the discretionary range of managers' accounting decisions. This fact could be understood as evidence that the service of debt discloses more and better information than financial statements and, as a result, managers have less incentive to manage earnings.

Column 1 in Table 5 is also informative about the effect of ownership concentration. Consistent with our hypothesis, OC1 has a negative coefficient so that higher ownership concentration reduces discretionary accruals. Moreover, LEV and OC1 are simultaneously significant, suggesting that capital structure and ownership structure work as complementary and not as alternative mechanisms of corporate governance.

This first impression about the ability of leverage and ownership concentration to limit the managers' discretionary accounting decisions is reinforced by a simple descriptive analysis. We have split the sample into three thirds depending on the

value of AA and we compare the mean values of LEV and OC1 between the upper and the lowest third (Table 6). One can see that firms in the group 1 (the firms with the largest earnings management) have significantly lower ownership concentration and financial leverage than firms in group 3 (the firms with the highest abnormal accruals).

**Table 5.** Discretionary accruals and corporate governance

Estimated coefficients and standard errors (in parentheses) of the within-groups estimation of equation [3]. The dependent variable is abnormal accruals (AA) according to Jones' model (1991). The explanatory variables are financial leverage (LEV), the proportion of shares owned by the main shareholder (OC1), the logarithm of total assets (LNSIZE), the differential ROA (DIFROA) and eight interacted variables (FAMLEV, INSTLEV, MULTLEV, STALEV, FAMSIZ, INSTSIZ, MULTSIZ, STASIZ) defined as a function of the nature of the main shareholder (family, institutional investor, multinational firm or the State). F-test of joint significance for all the estimated coefficients, adjusted-$R^2$ coefficient and Hausman test for the random *vs*. fixed effects hypothesis are reported too. (***) stands for significant to a confidence level higher than 99%, (**) for a level higher than 95% and (*) for a level higher than 90%

| | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|
| Intercept | 0.0871*** | 0.0839*** | 0.7346*** | 0.6658*** | 0.6972*** |
| | (0.0252) | (0.0253) | (0.2337) | (0.2337) | (0.2353) |
| LEV | -0.1999*** | -0.1808*** | -0.1289** | -0.2178*** | -0.1318** |
| | (0.0516) | (0.0534) | (0.0564) | (0.0638) | (0.0570) |
| OC1 | -0.0008* | -0.0008* | -0.0007 | -0.0007 | -0.0006 |
| | (0.0005) | (0.0005) | (0.0005) | (0.0005) | (0.0005) |
| DIFROA | | 0.1044 | 0.1148 | 0.1173 | 0.1109 |
| | | (0.0763) | (0.0762) | (0.0761) | (0.0765) |
| LNSIZE | | | -0.0385*** | -0.0347** | -0.0381*** |
| | | | (0.0137) | (0.0137) | (0.0138) |
| FAMLEV | | | | -0.0996 | |
| | | | | (0.1301) | |
| INSTLEV | | | | 0.2331*** | |
| | | | | (0.0696) | |
| MULTLEV | | | | 0.0951 | |
| | | | | (0.1489) | |
| STALEV | | | | 0.0597 | |
| | | | | (0.2619) | |
| FAMSIZ | | | | | 0.0026 |
| | | | | | (0.0026) |
| INSTSIZ | | | | | 0.0033** |
| | | | | | (0.0015) |
| MULTSIZ | | | | | 0.0004 |
| | | | | | (0.0036) |
| STASIZ | | | | | -0.0005 |
| | | | | | (0.0043) |
| Adj.-$R^2$ | 0.0127 | 0.0139 | 0.0192 | 0.0294 | 0.0227 |
| F-test | 22.90*** | 22.87*** | 20.11*** | 19.34*** | 18.60*** |
| Hausman test | 17.57*** | 21.22*** | 23.01*** | 61.87*** | 51.05*** |
| # observations | 1,656 | 1,656 | 1,656 | 1,656 | 1,656 |

The simplest version of our model (column 1 in Table 5) has been broadened in order to introduce some other firms' features which could affect managers' discretionary accounting choices. So, column 2, on top of LEV and OC1, includes DIFROA. Despite the possible negative relation that we hypothesized, our empirical results do not support that idea, although both leverage and ownership concentration keep their impact.

Another feature to be considered is firm size, according to the hypothesis that larger size usually fosters earnings management and, thus, one could expect a positive coefficient. The results reported in column 3 of Table 4 are just the opposite: LNSIZE

has a negative and quite significant effect on discretionary accruals. Furthermore, the introduction of LNSIZE makes the effect of ownership concentration non significant and this could suggest some kind of link between ownership concentration and the size of Chilean firms.

**Table 6.** Mean differences

Test of mean differences when the simple is divided according to AA. Group 1 stands for the lowest abnormal accruals and group 3 for the largest abnormal accruals.

| Variables | Group | Media | p-value |
|---|---|---|---|
| OC1 | 1 | 42.396 | 0.0150 |
| | 3 | 46.139 | |
| LEV | 1 | 0.0865 | 0.0000 |
| | 3 | 0.1644 | |

To shed some light on this apparent paradox we should remember that Chilean legal system belongs to the French branch of civil law and has not very good investor protection. The shareholders' reaction to this weak protection is concentrated ownership so that shareholders are in better situation to assert themselves. In fact, Table 2 shows that the average ownership of the main shareholder in Chile is 45%, quite higher than their British and North-American common-law counterparts.

Therefore, to some extent, the ownership structure of Chilean firms seems to be an outcome of the Chilean legal system and is fairly different to the ownership structure of Anglo-Saxon firms. Additionally, unlike Anglo-Saxon firms, the largest firms in Chile are those with the most concentrated ownership (Majluf *et al.*, 1998) through pyramidal ownership structures which allow holding the control rights in large firms in spite of diminishing the cash flow rights. Consequently, and as far our results are concerned, we could assert that firm size and ownership concentration run parallel and are closely interrelated so that the inclusion of LNSIZE implies the drop of OC1 significance.

Thus, the results reported stress the relevance of capital and ownership structure as mechanisms of corporate governance to monitor managers' accounting discretionary decisions. It could be now pertinent to test whether the nature of the shareholders has any noticeable impact on these results. For this reason we have defined four interacted variables (FAMLEV, INSTLEV, MULTLEV and STALEV) as leverage times each one of the dummy variables about the nature of the main shareholder (family, institutional investor, multinational firm or the State). By doing so we can know whether financial structure has a differential effect on abnormal accruals depending on the identity of the main shareholder, with a special emphasis on the role of institutional investors.

The results of this regression are reported in column 4 in Table 5. Two facts should be underlined. Firstly, financial structure and firm size keep their influence. Secondly, when the main shareholder is an institutional investor, the role of debt changes so that it fails to be a disciplinary mechanism. Moreover, leverage in those companies owned by an institutional investor is positively related to earnings management. This fact corroborates the preference of institutional investors for financial statements with high returns even though it should be achieved by earnings management.

In the same way, four additional variables have been defined to test any differential effect of firm size depending on the nature of the shareholders (FAMSIZ, INSTSIZ, MULTSIZ and STASIZ). These interacted variables have been calculated as size times each one of the dummy variables about the nature of the main shareholder (family, institutional investor, multinational firm or the State). Results of this new specification are reported in column 5 of Table 5 and are very consistent with previous ones. Again, two comments are worthwhile. Firstly, both the financial structure and the size of the firm keep their sign and continue to be significant. Secondly, although firm size has a negative impact on earnings management, INSTSIZ shows a positive and significant coefficient. It could be understood in terms of the specific features of the institutional investors' ownership: institutional investors again seem to pay more attention to optimistic or positive financial statements than the other kind of shareholders and thus they are transient with earnings management[3].

In Table 5 we present the adjusted-$R^2$ coefficient, the F-test for the hypothesis of joint significance and the Hausman test for the random vs. fixed effects hypothesis. Although adjusted $R^2$ is very low, the explanatory variables are significant and the null hypothesis of lack of significance of the whole set of variables is rejected with a very high level of confidence[4]. The Hausman test allows rejecting the null hypothesis of random effects at a high confidence degree. It means that the random

[3] Another set of interacted variables was constructed to test whether ownership concentration has a differential effect depending on the nature of the shareholders. The results are irrelevant for this research but are available from the author.

[4] For a high number of observations (1,656 observations in our case), a high value of the F-test is compatible with low values of $R^2$ coefficient without any discredit about the significance of the explanatory variables.

component in equation [3] is correlated with the independent variables and, consequently, the within-groups panel data technique provides with consistent estimations.

Along with these basic results, some comments about their robustness seem pertinent. We like to test their sensitivity to different specifications of managers' accounting decisions or to new measures of the variables. Our purpose is to know to what extent the relations we have found can be due to methodological issues or, on the contrary, are robust and remain unaffected in a broader framework. That is why Table 7 presents a number of additional estimations.

OC1 has been replaced by the ownership of the five largest shareholders (OC5). Results of that estimation are reported in columns 1-3 in Table 7 and show that ownership concentration is no longer significant. Besides the link between firm size and ownership concentration to which we have already referred, this fact is also explained by the high concentration of ownership in Chile. Taking into account that ownership is so much concentrated, OC5 scarcely provides any significant information in comparison with OC1.

**Table 6.** Discretionary accruals and corporate governance: sensitivity analysis

Estimated coefficients and standard errors (in parenthesis) of the within-groups estimation of equation [3]. The dependent variable is always abnormal accruals (AA) according to Jones' model (1991) or Jones' modified model. The explanatory variables are financial leverage (LEV), the proportion of shares owned by the main or the five largest shareholders (OC1 and OC5), the logarithm of total assets (LNSIZE), the differential ROA (DIFROA), and four interacted variables (FAMLEV, INSTLEV, MULTLEV and STALEV) defined as leverage times each one of the dummy variables about the nature of the main shareholder (family, institutional investor, multinational firm or the State). F-test of joint significance of all the estimated coefficients, adjusted-$R^2$ coefficient and Hausman test for the random *vs.* fixed effects hypothesis are reported too. (***) stands for significant to a confidence level higher than 99%, (**) for a level higher than 95% and (*) for a level higher than 90%

| | (1) | | (2) | | (3) | | (4) | | (5) | | (6) | | (7) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Intercept | 0.0921 | ** | 0.0871 | ** | 0.7252 | *** | 0.0842 | *** | 0.0809 | *** | 0.7152 | *** | 0.6499 | *** |
| | 0.0426 | | (0.0427) | | (0.2337) | | (0.0253) | | (0.0254) | | (0.2349) | | (0.2350) | |
| LEV | -0.2006 | *** | -0.1831 | *** | -0.1334 | ** | -0.1913 | *** | -0.1711 | *** | -0.1205 | ** | -0.2064 | *** |
| | 0.0518 | | (0.0536) | | (0.0564) | | (0.0518) | | (0.0537) | | (0.0567) | | (0.0642) | |
| OC1 | | | | | | | -0.0008 | | -0.0008 | * | -0.0007 | | -0.0007 | |
| | | | | | | | (0.0005) | | (0.0005) | | (0.0005) | | (0.0005) | |
| OC5 | -0.0006 | | -0.0006 | | -0.0002 | | | | | | | | | |
| | 0.0006 | | (0.0006) | | (0.0006) | | | | | | | | | |
| DIFROA | | | 0.0972 | | 0.1093 | | | | 0.1102 | | 0.1203 | | 0.1224 | |
| | | | (0.0762) | | (0.0762) | | | | (0.0766) | | (0.0766) | | (0.0766 | |
| LNSIZE | | | | | -0.0391 | *** | | | | | -0.0375 | *** | -0.0339 | ** |
| | | | | | (0.0142) | | | | | | (0.0138) | | (0.0138) | |
| FAMLEV | | | | | | | | | | | | | -0.0884 | |
| | | | | | | | | | | | | | (0.1308) | |
| INSTLEV | | | | | | | | | | | | | 0.2242 | *** |
| | | | | | | | | | | | | | (0.0700) | |
| MULTLEV | | | | | | | | | | | | | 0.0956 | |
| | | | | | | | | | | | | | (0.1498) | |
| STALEV | | | | | | | | | | | | | 0.0486 | |
| | | | | | | | | | | | | | (0.2634) | |
| | | | | | | | | | | | | | | |
| Adj.-$R^2$ | 0.0115 | | 0.0126 | | 0.0117 | | 0.0116 | | 0.013 | | 0.018 | | 0.0272 | |
| F-test | 22.45 | *** | 22.43 | *** | 19.98 | *** | 22.36 | *** | 22.33 | *** | 19.62 | *** | 18.84 | *** |
| Hausman test | 21.93 | *** | 24.61 | *** | 24.75 | *** | 17.12 | *** | 20.64 | *** | 22.49 | *** | 59.75 | *** |
| # obs. | 1,656 | | 1,656 | | 1,656 | | 1,656 | | 1,656 | | 1,656 | | 1,656 | |

Another proof of the robustness of our results refers to the method to measure abnormal accruals. We have replaced the traditional Jones' method (1991) with its modified one (Dechow *et al.*, 1995). This new model is especially suitable when abnormal accruals affect sales and that is why in this model total sales are modified by the variation in receivables due to sales (ΔTURN2). The new variable has been introduced in equation [1], whose estimation is reported in column 2 in Table 4. As previously explained, the residual of this regression identifies with abnormal accruals and is used as the dependent variable in columns 4-7 in Table 7. Broadly speaking, results remain unaffected and the significant impact of financial structure and ownership concentration is corroborated along with

the relevance of the institutional investors' ownership on earnings management.

## 6. Concluding Remarks

The conflict of interests between shareholders and managers due to the separation of ownership and control leads the managers to pursue their own utility instead of the firm's value maximization. The so-called earnings management is a consequence of that conflict of interests and can be understood as the discretionary alteration of income statements to convey information about the firm's performance with the aim of improving managers' recognition. Earnings can be managed in a number of ways and our paper focuses on accruals, that is, accounting adjustments to correct timing mismatches between payments and cash flows.

Accruals have a non-discretionary component, aimed to improve the informational content of financial statements, and a discretionary component as a result of managers' biased decisions. Consequently, discretionary or abnormal accruals are key to assess the efficiency of corporate governance mechanisms. Our paper focuses on two of those mechanisms, namely, capital structure and ownership structure. More specifically, we try to test the effect that financial structure, the concentration of ownership and the nature of the shareholders of Chilean firms have on managers' accounting decisions.

Chile is an interesting country to test the efficiency of corporate governance because of the features of the corporate system, quite different from the Anglo-Saxon framework, on which most of the research has focused. Chile belongs to the French branch of civil-law countries, with a substantial development of capital markets and with low leveraged firms whose ownership is highly concentrated. As regards the effect of leverage, our results show that debt plays a disciplinary role on managers so that financial leverage restrains earnings management. This evidence can be explained by the better informational content of debt financial commitments compared with accounting information. We have also tested the efficiency of ownership structure. Our findings show that ownership concentration encourages managers' monitoring and restrains earnings management. This fact could explain the high concentration of ownership in Chilean firms as a reaction to the lack of investors' protection endemic to this kind of countries. As a consequence, shareholders try to protect their interests by block-holders and majority shareholders.

Our results also deal with the influence of the nature of the shareholders since we have analysed the effect of the main shareholder as an institutional investor, a family, the State or another firm. Our findings support the view of institutional investors as excessively short-termed oriented and looking too much for quarterly returns, and show that debt has an opposite effect: financial leverage encourages earnings management when the main shareholder is a mutual fund, a pension fund or an assurance company. There are several directions for future research. For instance, it could be interesting to go on extending the analysis to a framework broader than the Anglo-Saxon one, to which most of the literature has paid attention. From this point of view, countries from the different branches of civil-law tradition are good institutional contexts. At the same time, future research should complement earnings management with some other measures of managers' power and test the influence of other mechanisms of corporate governance.

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# ACCOUNTING REFORM IN UKRAINE

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**Abstract**

This paper summarizes the results of interviews conducted at accounting firms and educational institutions in Kiev and Odessa during the summer of 2004, supplemented by later correspondence via the internet. Topics discussed include the adoption and implementation of International Financial Reporting Standards (IFRS), education for accounting practitioners, recent changes in accounting education in Ukrainian universities, accounting certification and taxation. Expertise in IFRS is in short supply in Ukraine. However, demand for knowledge of IFRS is also lacking, which provides little incentive for local Ukrainian accounting firms to develop expertise in this area. As a result, the top international accounting firms, mostly the Big-4, have captured most of the market for this expertise. Nearly all of the largest companies in Ukraine retain the services of one of the Big-4 and it is primarily the large companies that can see any use for IFRS, since it is mostly the largest enterprises that are going to the international capital market in search of capital. International investors demand to see financial statements that are prepared using either IFRS or U.S. GAAP as a condition of providing investment capital and the Big-4 accounting firms are best prepared to provide guidance and expertise in this area. Much of the IFRS training of practicing accountants is done by the Big-4 accounting firms. They have developed extensive course materials over the years and have a competitive advantage in this area. However, the training they provide is mostly limited to their employees and their clients, which means that accountants who do not work for either a Big-4 firm or one of their clients do not have ready access to IFRS training. Ukrainian universities have started to incorporate IFRS into their accounting curriculums. The problem is that they cannot always find good learning materials. Some of the most prestigious universities in Ukraine still do not have a course devoted just to IFRS. IFRS is inserted into their course on foreign accounting. Ukrainian financial statements that are certified by accountants who possess only a Ukrainian certification do not have much credibility in international capital markets. One reason for this lack of credibility is the perception that the average Ukrainian accountant does not meet international standards when it comes to knowledge of IFRS and International Standards on Auditing (ISA). Another reason is because the accounting certification system is viewed as corrupt. There are rumors that Ukrainian accounting certification can be bought.

This problem is being overcome in two different ways. Several internationally recognized accounting certification exams are now being offered in Ukraine. Any Ukrainian accountant who can pass these exams earns instant credibility. The problem is that these exams are given only in English, which greatly limits the number of Ukrainian accountants who can take and pass the exams. This language barrier is being overcome by a group of accounting associations in several former Soviet republics, which began offering a high quality certification program in the Russian language. This certification started with a pilot program in Central Asia and has recently spread to Ukraine, Russia and Moldova. As this program spreads, the credibility of Ukrainian accountants who can pass these certification exams will be greatly enhanced.

**Keywords:** audit, credibility, IFRS

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## Introduction

Much of the information gathered for this paper was obtained by conducting interviews with accounting practitioners and educators in Kiev and Odessa during the summer of 2004. This study replicates an earlier study by McGee and Preobragenskaya (2005) of accounting reform in Russia. Similar questions were asked to similar segments of the accounting community. The main difference between this study and the earlier McGee and Preobragenskaya study is that the questions for the present study were asked of accounting practitioners and educators in Ukraine rather than Russia.

The following firms and institutions were interviewed:

All About Accounting (newspaper, Kiev) www.vobu.com.ua

Ukraine Accounting Reform Project (Kiev) www.capcipa.biz/

Deloitte & Touche (Kiev) www.deloitte.com.ua

Ernst & Young (Kiev) www.ey.com/ukraine

KPMG (Kiev) www.kpmg.com.ua

Auditorckoe Agentstvo Margo (Ukrainian accounting and audit firm, Odessa)

Odessa State Economic University (Odessa) www.oseu.odessa.ua

Odessa National I.I. Mechnikov University (Odessa) www.odnu.edu.ua

KIMI (Kyiv Investment Management Institute) (Kiev) www.kimi.edu

## Adoption and Implementation of International Financial Reporting Standards

Ukraine started to adopt national accounting standards along the lines of International Accounting Standards (IAS) in 1999. IAS was translated into Ukrainian in that year but some explanations were deleted, which caused some problems. There is not much literature in the Ukrainian language that explains how to use the standards. This lack of Ukrainian language materials does not cause much of a problem in the Eastern part of Ukraine, since the main language there is Russian and there are some Russian language materials available, although the quality of those materials has been criticized. But lack of Ukrainian language materials is somewhat more of a problem in the western part of Ukraine, where the Ukrainian language is more prevalent. Although all Ukrainians can understand Russian, some of them prefer to use Ukrainian.

The conversion process has been somewhat successful although the degree of success could not be agreed upon by the interviewees. According to one account by a local practitioner who was knowledgeable about IFRS, the Ukrainian national standards are now about 80 percent like IFRS and the tax rules are in about 98 percent compliance with IFRS. But an accounting professor stated that the national standards and IFRS are far apart, citing inventory as just one example. Many Ukrainian enterprises load all overhead costs into the cost of inventory for financial reporting purposes, even selling and administrative costs. It could not be determined whether this practice is in keeping with national accounting standards but it is apparently common in practice. This treatment of inventory may be widespread among former centrally planned economies. At least one study has found the same technique to be prevalent in Bosnia (Pekmez and McGee 2004).

Ukrainian standards require companies to maintain a specific chart of accounts, a requirement that does not exist in the developed market economies. In a market economy, companies are free to construct their own chart of accounts, based on what makes the most sense for the particular company.

The IFRS on hyperinflation accounting standards is not applied retroactively in Ukraine. It is not used in practice. Expenses are classified by function in Ukraine. Some transactions, such as foreign currency translation, are recorded gross in Ukraine. Ukraine does not have a standard on government grants. Ukraine's financial instrument standard is not as detailed as the IFRS standard. Ukraine's standard on financial statement disclosure is not as detailed as the IFRS standard. Ukraine's standard on deferred taxes is similar to the IFRS standard. However, it is difficult to calculate the amount of the deferred tax and many companies simply don't do it.

The lack of educated people is slowing down the accounting reform process. There is a lack of educated young people and many of the older generation are not sufficiently familiar with IFRS, or even with national standards. Five years after the start of accounting reform nothing has changed. Accounting graduates still do not know national standards, according to one journalist. Only a few hours of lectures are devoted to IFRS at the universities.

The need for capital drives the market. Internal sources of capital are exhausted. There is no public equity in Ukraine. Private equity exists. Ukrainian companies often do not go to the debt market for capital because it is too expensive. However, those companies that have IFRS financial statements are able to obtain capital at lower interest rates than companies that have only Ukrainian financial statements. There is a need to rationalize business and clean up the financial statements to obtain equity capital, which is the cheapest source of capital.

There are some regulatory and political impediments to rationalizing businesses. For example, a chain of 25 supermarkets might be set up as 23 different businesses for political reasons. The local governments want them to set up separate businesses so they can tax them and give them permits. Such a structure is inefficient and too complicated. No one wants to invest in such a business.

Having poor financial statements is not necessarily an insurmountable obstacle to raising capital. Banks prefer to know their clients well. If the client has repaid loans in the past there is a tendency to lend money again. Knowing a client well is more important than IFRS financial statements. Adequate collateral is also an important criterion that bankers consider.

The political process is intertwined with business in Ukraine. Members of Parliament often have business interests and those interests are usually placed ahead of those of the country.

The conversion to IFRS is an ongoing process. National Ukrainian standards include some topics

that are not addressed in IFRS and IFRS addresses some topics that Ukrainian national standards do not address. However, most Ukrainian accountants do not follow the national financial reporting rules. They follow the tax rules instead. Many Ukrainian accountants do not see a need for financial statements.

However, in some cases Ukrainian financial reporting standards are not much different from IFRS. Some clients that use Ukrainian standards do not require any adjustments at all to comply with IFRS, according to one interviewee.

Most Ukrainian clients choose Ukrainian standards that are as close to the tax rules as possible. Ukrainian standards are broad. It is possible to choose from several choices. Ukrainian financial reporting standards are rules-based, like U.S. GAAP, whereas IFRS are principles based. Thus, whenever a Ukrainian accountant seeks an answer to an accounting question, he or she looks for a rule that covers the situation rather than thinking about which accounting principle might apply.

About 700 Ukrainian enterprises have converted their books from national standards to IFRS, with the assistance of USAID. Professor Goloff developed a methodology for converting Ukrainian statements into international statements. He also wrote several books on the subject. He became famous and respected by the practitioner community as a result.

All of the top 25 banks prepare financial statements using IFRS. Commercial businesses have less likelihood of having IFRS financial statements. Companies owning about 40 percent of the total assets in Ukraine have IFRS statements.

All listed companies must present their financial statements in IFRS format to the National Security Commission. By the end of 2005 it is expected that all companies will be required to use only IFRS, although no one knows for sure whether they will have to prepare two sets of statements or just one. Companies that want to raise capital in the U.S. market will also prepare financial statements using U.S. GAAP. Many companies that have to prepare financial statements for statistical purposes feel that they do not serve any other purpose. Some companies use accounting information for management decision making purposes but the practice is not as widespread as it is in the developed market economies. Companies are not penalized much for making mistakes on their financial statements. Penalties are more severe for making mistakes on their tax statements.

Minority shareholders do not have access to financial information. Most people don't know how to read financial statements. Majority shareholders have access to insider information. There is a very low level of corporate governance in Ukraine. There is no one or no organized group to push for minority shareholder rights.

Ukraine is lagging behind Russia in the area of corporate governance. Ukrainian companies are just starting to have their internal auditors report to management. Audit committees are practically nonexistent. The stock market is practically nonexistent. As of June 2004, not a single Ukrainian company had had an initial public offering (IPO). The majority of funding comes from private sources. Conversations are one-to-one. When such financing is readily available, there is not much need for corporate governance.

Ukraine has adopted International Standards on Auditing (ISA) as of 2004. It decided not to have separate national auditing standards, so ISA have become the national standards. There is thus no need to reform national standards or do comparison studies to determine how closely the national standards correspond to ISA. Another interesting feature of adopting ISA is that whenever the ISA are amended or new standards are issued, Ukraine adopts them automatically. There is no need to introduce them as new legislation. That is not the case with IFRS, which must be introduced in the legislature, debated, etc. before passage and implementation.

There is a shortage of accountants in Ukraine who are experts on International Financial Reporting Standards (IFRS). However, the shortage is not noticed by a large segment of the Ukrainian accounting community because there is also a lack of demand for knowledge of IFRS. Demand for IFRS expertise comes mostly from the large enterprises, which need financial statements prepared in accordance with IFRS or U.S. GAAP in order to attract foreign investment capital. Small and medium size enterprises usually do not obtain their investment capital in the international capital market, so there is not as much demand for IFRS prepared financial statements among the small and medium size enterprises. As a result of this lack of demand except at the top level, the Big-4 accounting firms have captured a major market share of the audit and accounting work for the largest corporations in Ukraine. The Big-4 firms are practically the only firms that have the needed expertise, and they are practically the only firms that international investors will trust for audit opinions. Thus, the Big-4 has a monopoly among large Ukrainian enterprises.

This near monopoly has had a positive effect on Big-4 firms' growth rates. Ukraine's economy grew by 10 percent in 2003. One of the Big-4 accounting firms reported that its growth in Ukraine in 2003 was 20 percent. Another Big-4 firm stated that it grew by more than 30 percent and that growth would have been even higher if the firm had not been more selective in determining which clients to accept and which to reject. The Big-4 rejects potential clients based on their reputation and integrity. The third Big-4 firm said that it almost doubled clients and staff during the previous year.

Practice development consists mostly of just picking up the telephone when it rings, although the Big-4 firms also hold seminars and breakfast

meetings to attract potential clients. One firm reported that it is very difficult to find good employees. This lack of good employees is the main obstacle to growth. The number of people the firms can train is also limited. And many of their employees leave the Big-4 to work for large enterprises after they are trained. The large enterprises offer experienced Big-4 accountants two or three times the salary that the Big-4 is willing to pay.

Some practitioners expressed the view that it is difficult to find experienced accountants and that it is difficult for recent accounting graduates to find jobs. However, some of the university administrators interviewed said that it is not as difficult for accounting graduates to find jobs as it is for graduates in other fields. Faculty and administrators at the two universities interviewed as part of this study were uniformly of the opinion that their graduates did not have a hard time finding accounting jobs. However, the two universities chosen for interviews were both above average in terms of perceived quality, so perhaps the success of their graduates in finding accounting positions is not representative of the country as a whole.

All of the Big-4 firms have offices in Kiev, the capital, and none of them have offices in other Ukrainian cities, although they do have clients in other cities. Odessa, another large Ukrainian city, has only one international firm, and it is not one of the Big-4. Thus, there still is a place for local Ukrainian firms, although the Big-4 seems to have a controlling market share of the largest enterprises, many of which are headquartered in Kiev.

The accounting practitioner community also does not see much need to be familiar with IFRS. When subscribers to All About Accounting, a large accounting newspaper in Ukraine, call the newspaper to ask accounting questions, they almost never ask financial reporting questions. Practically the only questions they have revolve around tax accounting. Even the tax officials do not require IFRS financial statements as part of their audits.

Where there is no demand, there will be no supply. Thus, the shortage of IFRS trained experts does not appear to be a problem for a major segment of the Ukrainian accounting community. However, that perception may change soon, since many Ukrainian enterprises will be required to prepare financial statements that comply with IFRS as of the end of 2005.

Accounting is not held in high regard by business owners because they do not see the value of accounting information, according to some interviewees. This perception will likely change as an increasing number of companies are required to issue financial statements and as an increasing number of Ukrainian accountants pass the various certification exams that are discussed below. Some interviewees indicated that accounting is considered a prestigious job. So there seems to be a divergence of opinion about the need for accounting information and the status of the profession within Ukraine.

One might say the same about Russia. Enthoven et al (1998) report that a survey of secondary school students ranked accounting 91st out of 92 occupations on the list of potential occupations in terms of prestige. However, that survey was taken early in the transition process. Accounting has since risen in terms of prestige as demand for accounting services has increased rapidly, due to the shift from a centrally planned economy to a market economy.

Public companies, insurance companies and banks are required to have an annual audit. Other companies are not required to have any audit and many enterprise owners and managers do not see the need for an audit in the absence of a legal requirement. This perception will change only slowly.

The concept of transparency is new in Ukraine, as it was in Russia (Preobragenskaya and McGee 2004). Not all Ukrainian accountants and enterprise managers have become accustomed to the idea that their main audience is shareholders, bankers and other providers of capital. Many of them retain the old Soviet mindset that their main audience is the tax authorities (government).

The accounting culture in Ukraine is deeply imbedded, especially among the older practitioners. This old Soviet mentality continues to cause problems. Accountants are accustomed to working with documents. Accruals are difficult for them to understand. Accruals do not require documents, which presents a problem because making entries where there are no documents goes against their mindset. Failure to make accruals is a common mistake for many companies. These mistakes are usually uncovered during the course of an audit. However, things have improved in recent years. The situation is getting better.

Revenue recognition is another problem for Ukrainian accountants. They prefer to get documents and to record revenue only when they have the documents. They prefer to use the cash method to recognize revenue rather than the accrual method.

There is also a problem with substance versus form. If a lease agreement says that it is an operating lease, the company will treat it as an operating lease even though it might be a financing lease in substance. The question about the substantive nature of the lease is never asked. Enterprise accountants go with whatever the lease language says.

Most contracts Ukrainian enterprises have with the Big-4 accounting firms are for just one year. Having contracts of such short duration limits the accounting firm's ability to do pre-audit work during the summer.

Companies also change auditors more frequently in Ukraine than in developed market economies. However, that is not a cause for concern because companies raise most of their capital through debt markets rather than equity markets.

## Education of Accounting Practitioners

Accounting practitioners have to keep current with developments in the areas of accounting, auditing and taxation to maintain their certification. Although local Ukrainian accounting firms provide some training, much of the IFRS training is provided by the Big-4 accounting firms. The reason for this preponderance of IFRS training is quite simple. It is mostly the Big-4 firms that have the expertise to conduct such training. They have excellent training materials, which have developed and evolved over several decades of trial and error and use.

However, the training the Big-4 provides is not readily available to the local Ukrainian accounting community. Much of the training is limited to employees of the Big-4 and their clients. Furthermore, most of the training materials, for their employees at least, are available only in the English language. That does not present a problem because the Big-4 only hires individuals who are fluent in English. In cases where course materials are used to train clients, some translation is done, but these materials generally are not made available to non-clients.

There are some exceptions. For example, some of the Big-4 firms use training as a practice development tool. They hold some seminars and breakfast training sessions for potential clients. The training materials they distribute at these sessions are used not only for training but also to introduce potential clients to the quality of the training they offer, training that could be available to their employees if they became clients.

The Big-4 firms provide ACCA, CPA and CFA training to their employees. One of the firms interviewed said it uses the Becker CPA Review materials. In the past it flew its staff to Moscow for training because there were no local training providers, but that situation has changed.

There is a 40-hour annual continuing professional education (CPE) requirement. Accounting training in the Ukrainian language "is a disgrace, a complete joke," according to one interviewee who has taken both Ukrainian CPE and English language CPE courses offered by one of the Big-4. This interviewee also mentioned that the professors who teach the Ukrainian language CPE courses do not know what they are talking about.

## Accounting Education in Ukrainian Universities

Many new accounting departments have been started since the breakup of the Soviet Union. Accounting was not such a popular subject before the breakup and many universities did not offer accounting programs. The growth of accounting departments in universities is the result of the increase in demand for accountants in the private sector. It is now fair to say that most Ukrainian universities have accounting departments.

The number of accounting journals has also increased in recent years and they are very popular. They tend to be practitioner oriented rather than scholarly, in the American sense of that term. Stated differently, the gap between practitioner journals and scholarly journals in Ukraine is not nearly as wide as is the case in the United States.

Ukrainian universities have started to incorporate IFRS and ISA into their accounting curriculums. However, they face several problems in this regard. One problem is the lack of good course materials. Local language materials were not available in the early stages of the transformation from central planning to a market economy. However, this problem is being alleviated in two ways. Initially, accounting course materials were provided by translating books from English into Ukrainian and Russian. However, some of those translations were mediocre. The translation problem can be overcome by having local professors write texts in the local languages. Such texts did not exist in the early stage of the transformation but such texts are now becoming more common. Some texts are available in both Russian and Ukrainian.

Some of the texts have become out of date, due to the rapid changes in Ukrainian national accounting standards and the adoption of IFRS. The universities deal with this problem by assigning readings from accounting journals and newspapers as supplementary material.

One complaint some practitioners have about accounting education in Ukrainian universities is that the lectures are too theoretical and not sufficiently practical. This problem is prevalent where the professor giving the lecture does not have any practical experience. This problem is being partially overcome by hiring professors who are practitioners and by allowing full-time professors to engage in accounting work outside of the university.

The practitioners interviewed in Odessa perceived the professors to be up to date as far as course material and content were concerned. The professors and administrators interviewed at two of the top accounting departments in Ukraine also said that professors are up to date with recent developments in accounting. However, some of the practitioners interviewed in Kiev did not hold this opinion, at least when it came to lectures delivered as part of continuing education courses.

Some of the most prestigious universities in Ukraine still do not have a course devoted just to IFRS. IFRS is inserted into the course on foreign accounting.

Sixty or seventy universities in Ukraine participate in the accounting Olympics each year. These Olympics consist of conferences where students present their papers. Sometimes there are competitions between teams in the third year. These events are highly competitive and serve to create

friendships between students and improve their view of accounting. Such competitions serve to make the material less dry and boring and make it come to life.

The prestige of accounting has increased in recent years, according to the university professors and administrators interviewed, because enterprises need tax specialists and people who can create and interpret accounting information. Directors are starting to recognize the importance of accounting.

This enhanced prestige is having an effect on students and the way they study and view themselves. Students now read extra articles that are not required reading and discuss them. Most students are enthusiastic about their studies, which is a relatively recent phenomenon.

Every university has its own approach toward accounting education. However, there are only so many ways to reform the accounting curriculum or to teach accounting, so there are many common features.

Odessa State Economic University is a case in point. It now offers a four-year bachelor's degree in accounting and a fifth-year master's degree. The State gave them the option of offering either a fifth-year specialist degree or a master's degree, so they chose the master's degree for prestige purposes. Almost everyone who completes the bachelor's degree goes on for the master's. It also has a one year specialist designation for people who have already completed a bachelor's degree in another field. In contrast, many universities in Russia now offer a four-year bachelor's degree, a fifth-year specialist degree and a sixth-year master's degree (Preobragenskaya and McGee, 2005).

The accounting curriculum has undergone major changes in recent years because of the changes in national accounting standards and the adoption of IFRS. Before, the university used to offer just a course in the theory of accounting and some specialized accounting courses, such as agricultural accounting. They now offer a fuller range of courses, including financial accounting, financial reporting, management accounting, accounting for international enterprises and accounting for foreign countries. Starting in the 2004-2005 academic year they will offer a course in tax accounting and reporting. Formerly, the tax course was offered as part of the financial accounting course but it will now be a separate course. There is no special course in IFRS. However, there are courses about international companies. The university also now offers electives. Under the former Soviet system, there were no electives. All students in accounting had to take the same exact courses throughout their program.

There is a special course in the fourth year that requires students to work with accounting documents for three weeks. The documents replicate the documents that exist in a real accounting department, from original invoices through the various stages of the accounting process. The documents are posted to ledgers, with the end result being the preparation of financial statements. Students must work in all areas of accounting.

In the fifth year students receive practical training. They work with real documents from real companies. Each student works in a certain area, with some of the documents. The end result is the production of financial statements. The work involves more documents and more transactions than was the case in the fourth year. Students also make tax declarations based on their work.

The curriculum is as follows:

1st year - general subjects

2nd year- basic accounting

3rd and 4th year - other accounting – all the main accounting subjects.

5th year - advanced financial accounting and analysis.

Students also write a diploma project in the fifth year after they have received practical training in real companies. They do their diploma project after getting experience. They must defend their diploma project like a thesis.

The delivery format is a combination of lectures, seminars and case studies. Students also study using computer software and there are special courses in computer software. All examinations are written and usually take the form of practical exercises. Some exams require students to produce financial statements. This practice differs from that used during the Soviet era, when some exams were oral.

The language the lectures are delivered in depends on the students. At the start of the semester each professor asks the class whether they would prefer the lectures to be in Ukrainian or Russian. The lectures are delivered in whichever of the two languages the majority of the class prefers. Such an option may seem strange, or at least interesting, to an American audience, since American professors never give such options. But apparently this option is not so unusual in Ukraine. Some Swedish universities have a similar option, except that in the case of Swedish universities the professor asks the students whether they would prefer the lectures to be in Swedish or English.

The accounting faculty does not specialize to the extent of accounting faculties in other countries. Most of the accounting professors at Odessa State Economic University can teach any of the accounting courses. They do not teach just financial accounting or just managerial accounting or just auditing. One benefit of this approach is that they are forced to keep current on developments in all areas of accounting. The drawback is that they have to spend more time preparing their lectures. Also, they cannot become specialists, although that is probably not necessary at the undergraduate level.

The university does not have difficulty finding people to teach. Accounting professors earn about $200 a month, which is considered adequate. They also qualify for better pensions – 90 percent of salary – compared to about $32 a month for the majority of

the population. Some people become professors for the prestige. It is also possible to do consulting and many professors have businesses or consulting practices outside of the university.

About 45-50 percent of their students receive full tuition scholarships, which means that their education is free. Scholarships are awarded on the basis of merit. Students not receiving scholarships have to pay tuition of 3600 greven per year, which is about $700. Such an amount may seem small to people from developed economies, but to many Ukrainians it is a large amount.

Students do not have difficulty finding jobs after graduation because most of them already have jobs. The fact that the university is prestigious also helps them in the job search. Salaries for new graduates are about $100 a month. Experienced accountants can earn up to $800 per month.

Odessa National I.I. Mechnikov University also has a strong accounting program. Some members of the faculty there are trying to spread the idea that accounting can be used as a tool for decision making, an idea that most managers and even many teachers still do not understand.

In the two years prior to the interviews, the university instituted some major changes to its accounting and business curriculum. New courses were offered for the first time. This change was motivated by the appearance of new kinds of enterprises. Courses like financial management, insurance, the stock market and management accounting were taught for the first time. However, there is no special course in IFRS. This topic is incorporated into their course on accounting in foreign countries.

Tax accounting is another new subject. All enterprises are now required to compute taxes, so the university offers a tax course to meet market demand. The emphasis is on the ability to solve tax problems.

The professors and administrators interviewed at Odessa National I.I. Mechnikov University confirmed some of the statements made by practitioners and the professors and administrators at Odessa State Economic University. They also agreed that the prestige of the accounting profession has increased because businesses are starting to realize how important accounting information is for them. Managers are starting to recognize how much value a good accountant can add to their business.

Many of their students also work in the field of accounting during the course of their studies, which gives them an opportunity to earn income while gaining practical experience. Their students do not have difficulty finding jobs after graduation because of the practical experience they have gained and also because Odessa National I.I. Mechnikov University is one of the more prestigious universities in Ukraine. Their students participate in the accounting Olympics and often score well. At the beginning of the semester professors ask their students whether they would like to have the lectures delivered in Russian or Ukrainian.

Odessa National I.I. Mechnikov University offers three levels of accounting credentials – the four-year bachelor's degree, the fifth year specialist designation and the sixth year master's degree. Practically all of their students study for five years and earn the specialist designation.

Many of the accounting texts they use in their classes were written by Prof. Butenyetz Franz Franchevich, a Ukrainian professor. Thus, there is no need to deal with books that were translated from English, eliminating the problems that invariably result from mediocre translations. His books filled the gap that was created when the Soviet Union collapsed but before the new accounting system took hold. The professors like his books, but they supplement his books with newspaper and journal articles when preparing their lectures. Professors who write textbooks also often incorporate material from articles into their text books. Many books have been translated from English into the local languages, which enables students and professors to have access to the accounting literature of other countries.

## Accounting Certification

Financial statements that are certified by accountants possessing only a Ukrainian certification do not have any credibility in international capital markets and do not have much credibility even within Ukraine. That is because of the widespread impression that audit opinions can be sold. The interviews seemed to confirm this perception. In fact, the interviews revealed that even accounting certification can be sold in Ukraine, which is similar to the situation in Russia (McGee and Preobragenskaya, 2005) and perhaps other former Soviet republics.

Ukrainian certification is not highly regarded for other reasons as well. The exam is thought to be much less rigorous than the various international exams like the ACCA (Association of Chartered Certified Accountants) and American CPA and the Ukrainian exams do not test on IFRS to the extent that the ACCA does. However, the national Ukrainian certification exams are somewhat ACCA based. The national exams contain some topics that are also tested in the ACCA exams.

The national certification system has three levels, introductory, intermediate and advanced. However, only the first two levels were ever developed. Students were supposed to receive a certificate after completion of the exams for each level. After all the exams at all three levels were passed, candidates were supposed to be able to exchange their certificates for one diploma. However, the third level exams were never developed and the process stopped because no books were translated and because Ukrainian accountants do not use the level three topics in their work. The

topics tested in the first two exams are used in practice but the level three material is not yet used in practice because the Ukrainian economy is not yet sufficiently developed to use advanced accounting concepts.

The lack of a credible Ukrainian accounting certification is being overcome in several ways. For Ukrainians who have a strong knowledge of English, it is possible to take either the ACCA exams or the American CPA exam. The ACCA is an old and reputable provider of accounting certification. It has been in existence since 1904 and has certificate holders in 160 countries. It has well over 300,000 candidates and is truly international in terms of recognition. It offers three levels of certification consisting of a total of 14 exams. It tests on IFRS and International Standards on Auditing (ISA). It is possible to take the exam in many countries and on all continents. The main problem with the ACCA exams is that they are offered only in the English language, which precludes the vast majority of otherwise potential exam candidates from taking the exams.

The ACCA exams are very popular among the subset of Ukrainian accountants who have a good command of the English language. The majority of the ACCA exam candidates work for or want to work for international firms. Those who can pass the ACCA exams have good job prospects.

The Certified Management Accountant (CMA) exam is another possibility for Ukrainian accountants who want to earn an internationally recognized certification. However, this certification is not very popular in Ukraine, mostly because of a lack of understanding about what management accounting is. Another reason for the relative lack of demand is because the Institute of Management Accountants (IMA), the organization that organizes this exam, has not marketed the exam to any great extent in Ukraine (McGee, Preobragenskaya and Tyler, 2004).

Another way for Ukrainian accountants to gain an internationally recognized accounting certification is to take the American CPA exam. Passing the CPA exam gives instant credibility. However, there are several drawbacks to the American CPA exam. For one, it is offered only in English, which precludes the vast majority of potential candidates from taking the exam. Another problem with the American CPA is that exam candidates must travel to the USA to take the exam.

The travel requirement greatly increases the cost of taking the exam, but that is not the only difficulty. It is not always easy for Ukrainians to obtain a visa and some potential candidates cannot obtain permission to enter the United States. Also, only a few American jurisdictions will permit Ukrainians to take the exam in their state. Although the exam is theoretically open to individuals of any nationality, many states require 150 semester hours of university education, consisting of a certain minimum number of hours in accounting. Many graduates of Ukrainian universities cannot meet this requirement. Alaska is a popular state because it requires just one year experience with an audit firm. However, CPA exam candidates do not have to go to Alaska to take the exam. Since the exam is now on computer, they can take the exam in any state.

The American CPA exam is not completely relevant to the Ukrainian situation. Part of the CPA exam tests on US tax and business law, which Ukrainians must learn on their own, since no such courses are available in Ukraine. Thus, there are a number of obstacles to be overcome for Ukrainians who want to earn the American CPA designation. The ACCA exams also test on British tax and business law, but the ACCA allows candidates to take alternate exams in these subjects if the local testing authority can convince the ACCA that the local tax and business law exams are the equivalent of the comparable ACCA exams.

Until recently, there was no internationally recognized accounting certification exam that was offered in a language other than English that Ukrainian accountants could understand, thus limiting their opportunities to earn a credible certification credential. However, that situation is changing.

In 2001, a group of accounting associations in several former Soviet republics, with the assistance of the United States Agency for International Development (USAID), gave a regionally recognized accounting certification exam in the Russian language for the first time. The content of the exam is similar in many ways to the ACCA and American CPA exams.

In 2002 an examination network was formed to supervise, manage and spread the exam. This association now consists of 14 accounting associations from 8 countries. Certificates are issued by the ICCAA. Individuals must be a member of one of the 14 sponsoring associations to keep their certificates. The exams are processed mostly by Accels, the same organization that offers the TOEFL and CMA exams. The exams are graded in Tashkent, Uzbekistan, although this may change after the headquarters moves to Moscow. The Center for Business Skills Development (CBSD) processes the exams in Moscow. Surveys have found that people are satisfied with the quality of the exams. The exams have also proven to be very popular. About 2400 people were trained within 12 months of the start of the program in all countries. As of mid-2004 there were 6500 people in the database for all countries.

Certification is at two levels and consists of a total of seven exams. There is also an experience requirement. The lower level is called Certified Accounting Practitioner (CAP) and consists of three exams, Financial Accounting 1, Management Accounting 1 and Tax & Law. Level two, called Certified International Public Accountant (CIPA) consists of four additional exams, Financial

Accounting 2, Management Accounting 2, Financial Management and Auditing.

The CAP and CIPA exams started as a pilot program in the five Central Asian republics – Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, with plans to expand the program into other former Soviet republics after the exams had been offered a few times in Central Asia. The original headquarters was in Almaty, Kazakhstan. The certification programs have since spread to Ukraine, Russia and Moldova. The headquarters for the exam programs moved to Moscow in mid-2004. Thus, it is now possible for Ukrainian accountants who cannot speak English to earn an internationally recognized and highly regarded accounting certification. As this program spreads, the credibility of Ukrainian accountants who can pass these certification exams will be greatly enhanced.

Although the exams are well received, there have been some minor problems or complaints. The study materials provide examples using American companies. Some students would like those examples to be replaced with local company examples. Russians, Ukrainians and other former Soviets are not accustomed to standardized exams, so there is a bit of culture shock. Candidates in Russia want the exam to test on Russian audit standards rather than international auditing standards. Testing on International Standards on Auditing (ISA) is not a problem in Ukraine, however, because Ukraine adopted ISA. There are no separate Ukrainian auditing standards.

All exam preparation courses are offered through the private sector and are a good source of income for trainers and training providers. Trainers earn between $100 and $500 per course, which compares favorably to the $200 a month they earn as university professors. USAID is not involved in the training aspect of the certification program although it does provide other kinds of support. For example, it trains the trainers and gives free books to students. It has also given a small cash award to the training providers for each student who passes an exam.

The courses vary in length but the recommended length is a total of 60 hours, consisting of 15 sessions of 4 hours each. However, some exam preparation course providers cram the 60 hours into a few days of 10 hours each.

USAID also facilitates the training effort by providing lists of potential trainers to exam preparation course providers. But USAID does more than merely providing a list of possible trainers. It also publishes a list of pass rates for each class, which makes it possible for training providers to determine which trainers had the most success in past training courses. Presumably, this puts pressure on trainers to do a good job so that they can attain a high pass rate for their students and get hired to teach future training courses. USAID also gives each trainer a letter stating the pass rate achieved for each of the courses they teach. These letters serve as a marketing tool, which they present to the private exam preparation companies when they apply for teaching positions.

However, evaluating the pass rates of trainers as not as easy as might first appear. The main problem with straight pass rate comparisons is that different courses have different degrees of difficulty. The CAP exams are easier to pass because of the nature of the questions and the availability of good exam preparation materials. The CIPA exams are more difficult and the training materials are not of the same quality. Thus, one cannot automatically conclude that a trainer with a lower pass rate for CIPA exam prep courses is necessarily a worse instructor than someone who has attained higher pass rates for a CAP exam.

These certifications are already being recognized in the marketplace. Some employers will hire only those individuals who have either passed all or some of the certification exams. The Central Bank of Kazakhstan requires internal auditors to have the CAP. The Central Bank of Ukraine requires their internal auditors to pass Financial Accounting 1 and Management Accounting 1 or pass the ACCA or CPA. Azov Steel Company requires all their accountants to have the CAP designation. Some employers will reimburse their employees for the cost of taking the exams. Some employers will increase the pay of employees who pass the exams. The largest bearing company in Ukraine gives employees a 25 percent raise when they pass all parts of the CAP. Prior to the June 2004 exams there were 871 CAP holders and one CIPA in Ukraine.

Most of this employer recognition to date has occurred in Central Asia, since the reputation of these exams is better known there. However, as the exams spread to Ukraine and other former Soviet republics, it is expected that the marketplace will start to recognize the value of these certifications in other countries as well. It is expected that some certificate holders might do business in Poland and Romania, since these two countries provide access to the European Union. Thus, CAP and CIPA holders might start permeating the EU in the near future.

During the course of the interviews it was learned that the CAP and CIPA exams were not generally well known in Ukraine. The individuals interviewed at the Big-4 firms either were not aware that these exams existed or had only heard about their existence but were not aware of any details. This lack of familiarity is to be expected, given the fact that the exams are relatively new even for Central Asia, and are even newer in Ukraine. At the time the interviews were conducted, only a few Ukrainian accountants had taken the CAP and CIPA exams.

However, the CAP and CIPA exams are not totally unknown, especially among the local Ukrainian accounting and audit firms. Furthermore, the CAP and CIPA exams are known not only by the firms in Kiev, the capital, but also in other Ukrainian

cities. The one local firm that was interviewed in Odessa proudly stated that all of its accountants had passed all of the CAP exams. The first individual to earn the CIPA in Ukraine was the director of that Odessa-based firm.

The CAP exams are given quarterly, or at least that was the case until recently. CAP exams will no longer be offered in September starting in 2005 because of low turnout for previous September exams. The reason for the low September turnout is because it is too soon after summer vacation (Kenney 2004). So starting with the 2005 exams, the CAP exams will be offered three times a year, in March, July and November.

The CIPA exams are offered twice a year, in July and November. The exams are given over a three-day period. The financial accounting exams are five hours in length. The other exams are four hours long.

From the tenor of the comments made by interviewees at the Big-4, the interviewers got the impression that it would be a long time before the CAP and CIPA exams would be viewed as the qualitative equivalents of the ACCA and American CPA exams. One reason for this discounting of the CAP and CIPA is undoubtedly because of their newness. Another reason for discounting their quality, or even their credibility, is the fact that they are not in English. The partners at the Big-4 accounting firms in Ukraine are mostly from English speaking countries such as the USA, England and Australia. They are involved in the hiring process. They are more familiar with the ACCA and American CPA exams and they naturally place more trust in the quality of exams they are familiar with than with new exams that they are unfamiliar with. The fact that the CAP and CIPA exams are not in English also casts a shadow on their quality because of the perception that exam candidates do not have access to the same quality of exam preparation materials as do their ACCA and CPA exam counterparts.

There may be some truth to this perception, although the difference in the quality of study materials can be expected to narrow with the passage of time. Many of the study materials used to prepare candidates for the CAP and CIPA exams are Russian translations of English language texts. The Kieso intermediate accounting text is used for the Financial Accounting 2 course, supplemented by additional materials on IFRS, since the Kieso book gives U.S. GAAP examples. The Drury and Horngren books are used for Management Accounting 2. A more complete list of study materials is provided in the appendix. With the passage of time, local authors will publish Russian language materials to prepare candidates for the exams, which will do away with the problem of mediocre translations.

Another source of study material is the exams themselves. Two sample exams for each course are posted on the www.cipa.org.ua/eng/downloads/ website, which makes it possible for exam candidates to see in advance what to expect on the exams. The ACCA also makes its prior exams available to candidates, but the AICPA, the organization that makes the CPA exam, no longer makes its exams available.

There may be some future reciprocity between the CAP and CIPA exams and the ACCA and CPA. The ACCA has indicated that it will grant some exemptions for the ACCA exams if the organization offering the CAP and CIPA can provide evidence that its exams are the equivalent of the corresponding ACCA exams. The State of Michigan may exempt CIPA holders from the experience requirement.

Perceptions on the part of the Big-4 partners may also change as the partners from English speaking countries admit local Ukrainians to their partnerships. At present there are very few Ukrainian partners at the Big-4 firms in Ukraine. The main reason for this lack of local partners is that it takes about 10 years to train someone for partnership and not many Ukrainians have that much experience working for one of the Big-4.

As more Ukrainians achieve partnership in the Big-4, the perception of the CAP and CIPA exams may become enhanced. However, it is unlikely that the CAP and CIPA will attain strict equivalence with the ACCA and CPA in the foreseeable future. The Big-4 will likely continue to require their employees to be fluent in English, and these employees will likely continue to favor taking the ACCA and, to a lesser extent the CPA, rather than the CAP and CIPA exams, although some Ukrainian accountants may take the CAP and CIPA in addition to one of the English language exams.

However, the lack of perceived equivalency of the CAP and CIPA to the ACCA and CPA exams does not mean that the CAP and CIPA will never attain credibility or value in the marketplace. Since the vast majority of Ukrainian accountants cannot speak English well enough to pass the English language certification exams, the only game in town, so to speak, will be the CAP and CIPA exams. Because these exams test on IFRS and ISA, knowledge of these subjects will be able to spread rapidly throughout Ukraine and the other former Soviet republics, which will greatly enhance financial reporting in Ukraine. As the number of Ukrainian CAP and CIPA holders reaches some critical mass, the credibility of these certifications will be greatly enhanced. It is not necessary for the CAP and CIPA to gain equivalency with the ACCA and CPA exams to have a major and positive impact on the quality of financial reporting in Ukraine.

Curiously, some of the major resistance to the CAP and CIPA exams is coming from within the Ukrainian accounting profession. The old guard is resisting change. The younger generation of accountants, on the other hand, is welcoming the change that the introduction of the CAP and CIPA will provide. The president of the national

accounting association in Ukraine issued a letter to the regional accounting executives instructing them not to send anyone to the June 2004 CAP and CIPA exams. They ignored this command from on high. About 1,800 individuals took those exams. The regional accounting associations ignore the national association. The accounting association president, who never took an exam but who is well connected to the Finance Ministry, was so embarrassed that there was speculation he may have to resign.

Sustainability of the examination program is a concern. USAID has been subsidizing the program since its inception. However, it plans to end the subsidy and turn everything over to the ICCAA in 2005. There is a great deal of demand for these certification exams, so there is a fair probability that the program will be able to sustain itself without USAID involvement. However, financing the program is seen as a problem.

Because of the low level of income in the region, USAID hesitated to charge exam fees that were sufficient to cover all costs of the program. In fact, it did not charge any exam fees in the early stages of the program and even gave away books and other exam materials for free. These subsidies will end in 2005 and some way to meet costs will have to be found if the program is to be sustainable.

Each exam costs between $28 and $35 to prepare. It costs another $7 per exam to grade. There are also some fixed costs involved, such as the cost of providing a trainer to teach each course. Students are currently charged $7 to take each exam. The break even point is estimated to be $30, so some way will have to be found to either bring down the cost or increase the fees charged to students. Tables 1 and 2 show the CAP and CIPA exam statistics for the June 2004 exams in Ukraine.

**Table 1.** June 2004 CAP Exam Statistics. Ukraine

| | FA-1 | T&L | MA-1 | Total CAP |
|---|---|---|---|---|
| # participants | 283 | 232 | 271 | 786 |
| # passed | 149 | 158 | 112 | 419 |
| Pass Rate | 52.7% | 68.1% | 41.3% | 53.3% |

Source: Kenney; Mino

**Table 2.** June 2004 CIPA Exam Statistics. Ukraine

| | FA-2 | MA-2 | Audit | Fin | Total CIPA |
|---|---|---|---|---|---|
| # participants | 183 | 150 | 137 | 143 | 613 |
| # passed | 9 | 31 | 24 | 19 | 83 |
| Pass Rate | 4.9% | 20.7% | 17.5% | 13.3% | 13.5% |

Source: Kenney; Mino

As can be seen, the number of participants for the CAP exams is much higher than for the CIPA exams. That is because candidates must first pass the CAP exams before proceeding to the CIPA exams. The pass rates for the CAP exams are also much higher than the CIPA pass rates. There are two reasons for the lower CIPA pass rates. For one, the nature of the material is more difficult. The other reason is because the exam preparation courses for the CIPA exams were not as strong. In some cases, CIPA candidates had to study on their own without the benefit of preparation classes (Kenney 2004).

Table 3 shows the statistics for the September 2004 CAP exam in Ukraine. The level of participation for the September 2004 exams is much lower than for the June exams because the September exams were offered too close to the summer vacation. The CIPA exams are offered just twice per year, in June and November. Thus, CIPA exam statistics are not given for the September 2004 exam.

**Table 3.** September 2004 CAP Exam Statistics. Ukraine

| | FA-1 | T&L | MA-1 | Total CAP |
|---|---|---|---|---|
| # participants | 95 | 103 | 122 | 320 |
| # passed | 47 | 55 | 57 | 159 |
| Pass Rate | 60.3% | 63.2% | 58.8% | 60.7% |

Source: Kenney

The results for the November 2004 CAP and CIPA exams were not available by the deadline for submitting this paper. However, statistics on the number of exam participants were available. The following tables summarize the turnout statistics for the November CAP and CIPA exams in Ukraine.

**Table 4.** Turnout Statistics. CAP Exams in Ukraine. November 2004

| City | Financial Accounting 1 | Managerial Accounting 1 | Tax & Law | Totals |
|---|---|---|---|---|
| Dnepropetrovsk | 95 (21.7%) | 34 (10.7%) | 40 (13.6%) | 169 (16.1%) |
| Donetsk | 48 (11.0%) | 42 (13.2%) | 39 (13.2%) | 129 (12.3%) |
| Ivano-Frankovsk | 38 (8.7%) | 18 (5.7%) | 26 (8.8%) | 82 (7.8%) |
| Kharkov | 58 (13.2%) | 58 (18.2%) | 47 (16.0%) | 163 (15.5%) |
| Khmelnitsky | 16 (3.6%) | 14 (4.4%) | 14 (4.8%) | 44 (4.2%) |
| Kiev | 156 (35.6%) | 117 (36.8%) | 109 (37.1%) | 382 (36.4%) |
| Odessa | 27 (6.2%) | 35 (11.0%) | 19 (6.5%) | 81 (7.7%) |
| Total | 438 (100.0%) | 318 (100.0%) | 294 (100.0%) | 1050 (100.0%) |

Source: Kenney

Table 4 shows that a total of 438 individuals took the Financial Accounting 1 exam in Ukraine and that the largest number of exam takers (156) was in Kiev. More than 35 percent of the total exam takers for this exam were in Kiev, which is a significant number, and also a revealing number. While it could be expected that Kiev would be the largest exam center, what is also significant about this statistic is that nearly two-thirds of all exam takers took the exam in a city other than Kiev. This statistic reveals that the regions outside of Kiev are not accounting wastelands. A different conclusion might be reached if one were to look at other information. For example, all of the Big-4 accounting firms have offices only in Kiev and the ACCA exams are offered only in Kiev. If one were to consider only this information, the conclusion might easily be drawn that Kiev is the only city in Ukraine where IFRS knowledge exists. But the CAP and CIPA exams are offered in 7 Ukrainian cities and most exam takers took the exam in a city other than Kiev. Thus, the accounting profession in Kiev does not have a monopoly on accounting expertise. Knowledge of IFRS and ISA are spreading to the regions outside of Kiev, a fact that would not be readily apparent if one were to confine the analysis to looking only at the locations of the Big-4 accounting firms and ACCA exam centers.

Table 5 shows the turnout statistics for the CIPA exams in Ukraine.

**Table 5.** Turnout Statistics. CIPA Exams in Ukraine. November 2004

| City | Financial Accounting 2 | Managerial Accounting 2 | Audit | Finance | Totals |
|---|---|---|---|---|---|
| Dnepropetrovsk | 52 (37.4%) | 45 (36.6%) | 21 (16.9%) | 33 (31.1%) | 151 (30.7%) |
| Donetsk | 17 (12.2%) | 9 (7.3%) | 12 (9.7%) | 12 (11.3%) | 50 (10.2%) |
| Ivano-Frankovsk | 0 | 6 (4.9%) | 14 (11.3%) | 3 (2.8%) | 23 (4.7%) |
| Kharkov | 0 | 25 (20.3%) | 11 (8.9%) | 11 (10.4%) | 47 (9.6%) |
| Khmelnitsky | 0 | 6 (4.9%) | 3 (2.4%) | 2 (1.9%) | 11 (2.2%) |
| Kiev | 70 (50.4%) | 29 (23.6%) | 40 (32.2%) | 27 (25.5%) | 166 (33.7%) |
| Odessa | 0 | 3 (2.4%) | 23 (18.6%) | 18 (17.0%) | 44 (8.9%) |
| Total | 139 (100.0%) | 123 (100.0%) | 124 (100.0%) | 106 (100.0%) | 492 (100.0%) |

Source: Kenney

Table 5 shows that Kiev again tended to dominate in terms of exam takers. However, Dnepropetrovsk actually had more exam takers for the Managerial Accounting 2 and Finance exams than did Kiev. Another fact that Table 5 reveals is that the number of CIPA exam takers was much lower than the number of CAP exam takers. The probable reason for this lower turnout is because candidates must first pass the CAP exams before they can sit for the CIPA exams. The CAP exams serve as a screening process.

## Finance Certification

The Kyiv Investment Management Institute (KIMI) is the official training center for the Ukrainian Society of Financial Analysts. It is the only exam site in Ukraine for the CFA exam. The CFA exam is given twice a year internationally but only once a year, in June, in Ukraine. KIMI proctors the exam but does not prepare students to pass it. The Association of Certified International Investment Analysts (CIIA) does the training. The CIIA is in about 70 countries. Exams are offered in 9 languages, including Russian. About 100 people took the CFA exam in Ukraine in June 2004. There is also a certification in Financial Risk Management (FRM) but there is not much demand for this certification at the moment. KIMI is trying to establish national finance qualifications in addition to the international qualifications. There are four levels in finance and financial analysis, all offered in Russian. The exams are devised by KIMI specialists.

KIMI offers several programs to prepare students for the various accounting and finance certification programs and also offers the MBA as a branch of the Kiev Business School. There are two versions of the MBA program. The National

Advantage MBA is taught in Russian. There is also an MBA taught in English under arrangement with Stanford University, some universities in Holland and some local experts, who provide the training.

KIMI also offers a five-year program that covers the topics that are on the CFA exam. CIIA modules are also integrated into the curriculum. Students who already have a five-year degree can earn a second degree in two years. KIMI is also developing educational modules for the CAP and CIPA exams. Three CAP modules were incorporated into their first degree program as of September 2004.

## Taxation

The accounting system in Ukraine is driven by the tax rules. Ukrainian tax officials are not concerned with financial accounting rules, whether Ukrainian or international. The same situation exists in Russia (McGee and Preobragenskaya, 2005).

Although accounting firms in Ukraine can develop a tax practice, and while there are tax clients to be had, many Ukrainian enterprises prefer to pay the tax authorities directly rather than some accounting firm to make sure they won't have any tax problems. From the interviews it was unclear whether these payments to tax officials were for consulting or bribes but the perception was that it was a little bit of both.

Ukrainian national financial reporting standards are very flexible, according to some interviewees. Where there are options, Ukrainian firms almost always choose the option that is close to, or identical to the tax rules. Of course, some firms do not follow the national standards at all. There is a tendency to use the tax rules for financial reporting. This tendency causes some problems at times. For example, the tax rule allows companies to deduct the cost of inventory when they pay for it, even if they have not yet received it. That is because the tax rules often follow a cash basis approach rather than the accrual basis. The present tax system has been evolving since about 1993. The most rapid changes have taken place since 2001. The tax law is now 60-70 percent understandable, according to one interviewee. The tax law is basic and subject to interpretation. The law as applied is different from the law as written. There is no precedent and tax court cases are not published. One must find out about them informally.

## Corporate Tax

The present corporate tax rate is 25 percent. It was 30 percent in 2003. It was reduced to enhance incentives for foreign investors. The starting point for computing taxable income is financial statement income, followed by many adjustments. Large companies make these adjustments. Small companies prefer to keep two sets of books, one for tax and one for financial reporting.

There are some nondeductible expenses, such as advertising and publications. Although advertising costs are not deductible or amortizable, companies can deduct the cost of hiring an advertising agency. Thus, rather than incur the cost of advertising themselves, they hire an advertising agency to do it for them, which enables them to deduct the cost.

There are no advance rulings. If the tax authorities give a company a written statement that something is deductible this year, the company cannot use that document next year to justify the same deduction. Other companies also cannot use it. There is no precedent. Losses can now be carried forward indefinitely. Under the former rule there was a five-year maximum. There was a feeling that the law needs to be more transparent and more sophisticated, especially in the areas of transfer pricing and thin capitalization. It was also thought that the law needs to be applied more consistently.

## Personal Income Tax

The rate used to be progressive with a top rate of 40 percent. Ukraine now has a flat rate of 13 percent. There is an exception for individuals who are temporarily in Ukraine (26%). Interest is excluded from tax. Dividends and royalties are taxed at 13 percent. Capital gains are taxed as ordinary income (13%) with no adjustment for inflation. The tax rate is expected to increase to 15 percent in 2006. A person is a tax resident if in Ukraine for 183 days. If so, he is subject to worldwide taxation. It is not clear how income from other countries is taxed.

More people are now paying taxes. Tax officials are not looking into where unreported income came from in prior years, which amounts to a sort of unofficial tax amnesty.

## VAT

The Value Added Tax (VAT) rate is now 20 percent but will be reduced to 18% and perhaps later to 15%. The rate is 0% for export services and medicines. There is no exemption for food.

The Ukrainian VAT is based on the EU 6th Directive. It has been referred to as the black sheep of taxes in Ukraine, the bad tax among the good taxes. The law is badly applied and poorly administered, according to one of the tax specialists interviewed. Ukraine has a huge amount of VAT tax refunds due to taxpayers, about $10 billion collected between 2000 and 2004, but the government does not like to pay refunds, so the refunds have not been made. The IMF gave the government the funds needed to pay the refunds, yet the refunds have not been paid, which is causing the IMF to be very upset.

There is a scheme to convert VAT refunds into government bonds as a means of payment over five years. This has created a secondary market in VAT bonds, which sell at a 30% discount. The bonds are being sold to financial institutions.

The VAT rules place a tremendous burden on banks, which need to have separate VAT accounts set up. The banks are liable for those accounts. The banks have, in effect, become tax collectors for the state. There is a big debate over this issue. Various proposals have been made and later taken off the table. Several laws have been introduced. It was the opinion of at least one tax specialist that these new laws, if enacted, will impose a huge burden without solving the problem. The VAT is expected to be a big problem for the next few years, at least. One problem that will not be solved in the near future is the place of supply rules. These rules are not clearly defined. The VAT law appears to be stagnant. It is not getting worse but it is not getting better either.

## Tax Evasion and Tax Planning

Some individuals and companies pay a bribe for the tax officials to lose their file, with the result that they don't have to pay taxes. Some people build a relationship with the tax authorities. They negotiate taxes, an approach that would be unheard of in most developed countries, but a practice that is fairly common in many developing countries.

As taxpayers become familiar with the tax law they can do tax planning, which is a new concept. There is a special rule for entrepreneurs. They can pay a flax tax of $200 a month regardless of income. Some individuals try to qualify as entrepreneurs rather than employees so that they can pay the $200 per month. This technique is being used less frequently now that there is a 13% flat tax. Tax evasion in customs is still widespread. Tax evasion is common in other areas as well. Punishment for evasion depends on the region. There is a 100% maximum penalty. However, taxpayers can pay a 5% penalty if they resubmit their tax return and pay the tax due. The tax specialist who mentioned this point said he could not think of anyone who went to jail for tax evasion. Cases are generally settled out of court. The fairness of the court depends on the judge, the size of the case and how hard the taxpayer is willing to push. Sometimes making a contribution to the judge helps. There is a general feeling that the judge will rule in favor of the government.

Sometimes bribes are paid in the form of advertising. A company pays a large advertising fee but receives little or nothing in return.

## Social Security

Payments to private pension funds are not yet deductible, but payments to the state pension fund are deductible. The employer contribution to the state fund is 35-37% of the first 2600 grebnas per month [5.3 gribnas to the dollar]. The employee portion is 3%. It is now possible to make contributions to a private pension fund. However, there are no regulations on how to register a private pension fund. Once regulations are written, it is thought that pension funds will emerge. The age to qualify for a pension is 55 for women and 60 for men. People can continue to receive a pension if they work beyond pensionable age. The amount of their pension is not enough to live on, about 160 gb per month, or $30. People cannot hold investments in a foreign country without approval of the Ukrainian National Bank. They cannot invest in foreign pension funds.

## Other Tax Topics

It is difficult to guess how the tax authorities will interpret the law because the law is unclear and the law, as applied, is often different from the law as written. Tax forms are easy to understand but there are too many of them. The corporate income tax is collected quarterly. The VAT is collected either quarterly or monthly. Individuals submit their tax returns on April 1. Corporate tax audits are regular, every year or two. The government must give 10 days notice. Audits are of specific items. The general director and the chief accountant can be personally liable for taxes. As a result, some companies don't take all legitimate deductions. Companies pay higher taxes so that corporate officials can avoid personal liability. Whether this practice constitutes a breach of fiduciary duty is an open question. Losses in four consecutive quarters lead to an automatic audit. Companies that have no tax liability are encouraged to pay taxes anyway to get the auditor off the hook with his boss. Auditors are under pressure to collect taxes. Auditors exert extra pressure to squeeze taxes out of people before elections to pay for election campaigns. The World Bank is helping to fund tax modernization. The level of tax education leaves something to be desired. Officials know the basics but not the more technical items. The World Bank is offering training to tax officials. The transfer pricing rules are often applied incorrectly to transactions involving unrelated parties within Ukraine (transfer pricing rules should apply only to related parties). Foreign companies are not taking advantage of the transfer pricing rules and the Ukraine's relatively low tax rates. The Big-4 accounting firms have given advice about pending tax legislation but their advice is usually ignored. They want to receive drafts of pending legislation so that they can provide comments and suggestions, a practice that is common in the developed market economies, but absent in Ukraine. This situation is starting to change, but the practice of providing drafts is still far from a regular practice. Parliament does not ask for feedback. It is an alien concept for them. Members of Parliament do not have that mindset. Also, there is no comment period for pending legislation, since providing comment periods is also an alien concept in Ukraine. The corporate tax system is moving toward an accrual basis but it is not there yet. Inventory is deducted as purchased, with adjustments

for the beginning and ending balances. But some companies do not make these adjustments.

There are several book/tax differences that the tax authorities do not know how to deal with. In the case of inventory, for example, adjustments have to be made between weighted average and FIFO but the tax officials do not know what adjustment must be made. They accept whatever adjustments the companies make. The currency exchange rules are different for book and tax purposes. The tax authorities accept whatever adjustments companies make because they do not understand the rules. Tax officials accept taxpayer calculations.

There is no estate tax in Ukraine. Inheritances are considered income and are taxed as such. An inheritance to the spouse is exempt from tax.

## Concluding Comments

The accounting reform process in Ukraine is like the reform process in Russia in many ways. Both countries got off to a slow start and both experienced problems translating accounting materials into the local language. Both countries experienced some difficulty implementing the new accounting into their university curriculum. Neither country has an internationally recognized accounting certification. Many practitioners in both countries do not have much knowledge of IFRS and many do not think that such knowledge is required. In both countries, the demand for IFRS financial statements comes mostly from the international investment community, which often requires IFRS prepared financial statements as a condition of investment. Both countries have a low level of corporate governance (McGee and Preobragenskaya, 2004). However, there are also some differences between the Russian approach and the Ukrainian approach. Whereas in Russia much of the accounting change started at the top, from the government, accounting change in Ukraine started at the grass roots, from the private sector accounting profession, at least to a certain extent. That is true of accounting certification, at least. The driver of professional accounting development in Ukraine was the private sector accounting profession. Russia, on the other hand, does not have an effective developed private sector accounting body at the national level. Russia's accounting profession consists of a plethora of poorly organized and largely ineffective local accounting organizations, the leaders of which often use their position to further their own interests rather than that of the accounting profession. That is not to say that some leaders of the various Ukrainian accounting organizations do not also use their position to further their personal interests. But the situation in Russia seems to be more obvious, since there is a near total absence of public interest present in the Russian accounting organizations.

Another difference is that Ukrainian tax authorities do not require the submission of financial statements, whereas Russian tax officials do. However, the Russian tax officials require financial statements mostly for statistical purposes. Financial statement numbers are not used in either country to determine tax liability.

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## Appendix

### Exam Materials for the CAP and CIPA Exams

The following study materials are available in the Russian language and are used to prepare candidates for the CAP and CIPA exams.

Financial Accounting 1

Needles, Anderson and Caldwell, Accounting Principles 4th edition [main text]
Golov, S.F., International Accounting Standards 2001, Kiev, FPBA Ukraine
Welch, Glen., Daniel G. Short. Elementary Accounting, Kiev, Asnovi, 1999
Golov, S.F., Kostuchenko, V.M. Accounting and International Standards: Implementation and Comments, Kiev, Libra, 2001
R. Anthony, G. Reese, Accounting, Situation and Examples, Moscow, Finance and Statistics, 1998.

Management Accounting 1

Horngren, C.T., Foster, G. Accounting: A Managerial Emphasis, 6th edition. [main text]
Nikolai O.E., Shuskova, T.V. Management Accounting, 2nd ed., Moscow, Editorial URSS, 2001.
Suvchuk, V.P. Financial Management of Enterprises: Practical Cases and Analysis of Real Business Situations, Kiev, Maximum, 2001.
Golov, S.F. Management Accounting, Kiev, Libra, 2003.
Needles, Anderson and Caldwell, Accounting Principles 4th edition, Moscow 1997.

Tax and Law

36 tax items and 133 law documents and 49 other recommendations items listed as sources

Financial Accounting 2

Kieso, Weygandt and Warfield, Intermediate Accounting. [main]
Golov, S.F. International Accounting Standards 2001, Kiev, FPBA Ukraine
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Management Accounting 2

Drury, Management and Cost Accounting, 5th edition [main text]
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# CORPORATE GOVERNANCE AND COMPETITION: CONCEPTUAL THOUGHTS

**Masrur Reaz, Thankom Arun***

**Abstract**

**This study attempts to explore the theoretical and empirical evidence on the relationship between competition and corporate governance in the broader back ground of economic reforms in developing economies, and analyses the problems that may occur due to inadequate corporate governance practices in an enhanced era of competition. The paper also discusses the areas of corporate governance that required immediate attention in developing countries such as protecting shareholder rights and market for corporate control, which are emerging issues in the context of rapid privatisation and deregulations.**

**Keyword:** Corporate Governance, ownership, competition

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## 1. Introduction

The expanding role of the private sector and the recent global financial crises have generated the discussion on competition and corporate governance in developing countries, and provided impetus for implementing adequate corporate governance practices. Until recently, only a few firms held majority share of the product and service markets in most of the developing countries, owned by a small group of large shareholders[1]. The interest in promoting competition has increased as part of the 'move to the market' wave initiated as part of economic reform in many countries. The idea was that the deregulation/privatisation process stimulates the process of competition by allowing more players in competitive market conditions[2]. Also, an added emphasis was given to the private sector development which improves allocative and productive efficiency, and enhances the scope for competition. However, the contemporary wave of mergers and anti-competitive practices has further raised the awareness of effective corporate governance practices to maintain competitive market conditions. There is a need for change in corporate governance related policies as the intensity of market competition changes, or else the economies may not attain the benefits of deregulation, rather it could lead to collapse of more firms as it is difficult for inefficient firms to survive in strong competition. How the corporate governance practices in developing countries needs to be reformed to address the concerns on efficiency and competition is the main concern addressed in this paper.

Although, as a concept corporate governance has been in practice for a long time, the term 'Corporate Governance' has been in use since late 1980s only. More than two hundred years ago, Adam Smith echoed the need for the separation of ownership and control in his famous book The Wealth of Nation (1776). Later on, Berle and Means (1932), considered to be the pioneers in the contemporary thinking about corporate governance, drew attention to the growing separation of power between the executive management of the major public companies and their increasingly diverse and remote shareholders .With many seminal studies in the following years such as Mace (1971) on director behaviour, Jensen and Meckling (1976) which led to development of Agency Theory, added with events in the economic and corporate world such as financial crises in different parts of the world and failures of companies like Maxwell and BCCI, the term corporate governance gained fame and

[1] In contrast, in UK 100 per cent of the top 20 publicly traded companies are widely held and in USA it is 80 per cent (Singh et al, 2002). In another study, World Bank (1993) shows that market concentration (four- firm ratio) for United States is 40 per cent but for Pakistan, Brazil, Turkey, Chile, all of who fall under the developing bracket, the ratio is above 50 per cent.

[2] However, some are arguing that intense competition exerts negative effect on productivity growth that could affect the level of private investments (Singh and Dhumale, 1999).

generated immense interests by the decade of 1980 (Corporate Governance, 2000).

The issue of corporate governance deals with the ways in which suppliers of finance to corporations make ensure fair return on their investments (Shleifer and Vishny, 1997). Corporate governance deals with mechanisms within which a corporation conducts its basic operations. Thus we can say that corporate governance itself is a mechanism through which it is ensured that corporations are directed toward the right way, which will take best care of parties concerned. Monks and Minnow (1995) say that corporate governance seeks to deal with systems, mechanisms and modalities of exercising power and control over the corporation's direction, behaviour and performance. Turnbull (1997) suggest the corporate governance as a set of influence which affects the institutional processes such as appointment of regulators, organizing the production and sale of goods and services and also noted that corporate governance includes all types of firms whether or not they are incorporated under civil law. Section 2 of the paper provides a conceptual discussion on the interrelationship between Corporate Governance and Competition. Section 3 analyses the issues on shareholding policies and governance mechanisms such as policies on incentives and disclosure. Section 4 summarises the main conclusions of the study.

## 2. Corporate Governance and Competition

The central issue of how to construct rules and incentives to effectively align the behaviour of managers with the desires of principals was the leading research agenda in corporate governance until 1970s. In 1970s, Alchain & Demsetz (1972) and Jensen & Mecklings (1976) came up with new theories, which changed the focus of corporate governance from the so called 'managerialism' to the concept of 'firm' itself. This approach confers the importance of the internal dynamics of the firm and considers the firm as a bunch of contracts between different partners of factors of production. This is a notable variation from the previous view of firm as a single product entity committed to profit maximization only (Learmount, 2002, Shleifer & Vishny, 1997), and a view which has significant implications on competition at the firm level.

The market based approach has further advanced thoughts in this direction and engaged a view that the firms always take the best care of its shareholders. However, the Stakeholder theorist such as Clarkson (1994) argues that the firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The key to achieving this is to enhance the ownership-like incentives to those participants in the firm who contribute or control specialized inputs (firm specific human capital) and to align the interests of these critical stakeholders with the interests of passive shareholders (Blair 1995, pp 322). There is a criticism is that the stakeholder theory supports to passive shareholders who would like to have free lunch without accountability. In recent days, the role of competition as a governance mechanism meant a shift in the focus to the capital market as a way of disciplining managers and ensuring that managers pursue the shareholders interest. The stewardship approach of corporate governance presupposes that managers or the board of a firm are self-motivated to serve the best interest of the firm and its owners. Donaldson and Davis (1994) assume that managers are good stewards of the corporations who work very hard to increase the corporate profit and shareholder return.

Many studies have identified that competition in product markets is a very powerful force for implementing good corporate governance practices (Alchian 1950, and Stigler 1958 quoted in Allen and Gale 2000). The problems of asymmetric information, transaction cost and other capital market imperfections are ubiquitous in developing economies and most of them have no active market for corporate control (Glen, Lee and Singh 2000). Despite the high levels of competition, even in large corporations the interests of managers and owners may differ on optimal strategies to deal with competition (Schliefer and Vishny 1997). The effective competition with desired positive effects would be possible only with the adequate development of supporting structures such as sufficient and appropriate legal back up, regulatory policies and policies regarding good governance of firms. Sound corporate governance practices ensures that a firm is run by its management as well shareholders in the right direction which upholds the interest of owners and stakeholders. Enhanced competition without improving the quality of corporate governance may create opportunity for corrupt entrepreneurs and managers to embezzle peoples' hard earned savings.

The role of the political marketplace is also an important variable to understand the dynamics of capital market mechanisms in ensuring corporate governance particularly to determine the allocation of power, privileges, and profits are allocated between owners, managers and other stakeholders (Turnbull, 1997). Firms which survive intense competition are thought to have optimal governance structure and firms which fail to acclimatize their governance structures to changes in the business environment supposedly face extinction, leading to a natural selection of efficient organizations (Alchian, 1950). During the period of deregulation, the systems of management incentives and monitoring needs to change significantly to avoid the chances of extinction due to bad decisions, which is higher in a competitive environment (Kole and Lehn, 1997). Also studies have proved that if the corporate

governance practices and competition were complementing each other then the impact of product market competition would be greater in firms with efficient governance structures (Grosfeld and Tresse, 2001). This conceptual discussion underlines the need for strengthening corporate governance practices of firms as the markets are liberalized to enhance the nature and patterns of competition. One area of corporate governance which requires an immediate attention as a determinant to competitive market condition is that on the pattern of shareholding in firms, which is discussed next.

## 3. Shareholding Policies and Governance Mechanisms

The economic reforms have initiated wider debate on the relationship between the pattern of shareholding in firms and the firm performance in developing economies. In US, large outside shareholders increases the likelihood that a firm is taken over and forces the management to work in line with the shareholders' interest (Shivdasani, 1993). Two studies on Japan by Kaplan and Minton (1994) and Kang and Shivdasani (1995) shows that firms with large shareholders are more likely to replace managers for poor performance compared to those firms without large investors. In Germany, 80 per cent of the large companies have an average of over 25 per cent non-bank large shareholder (Gorton and Schimid, 1996). Smaller German companies are usually controlled by family through majority ownership or pyramids in which the owner controls 51 per cent of a company which will in turn control 51 per cent of its subsidiaries (Frank and Mayer, 1994). However large investors may be motivated by their own self interests such as possible expropriation of the investments when the large investors own equity with greater voting rights or through the pyramid structure (Shleifer and Vishny, 1997; Grossman and Hart, 1988; Harris and Raviv, 1988).

The Corporate sector in developing countries is typically characterised by heavily concentrated shareholdings in the hands of large investors such as families or the government (La Porta et.al, 1998, 1999). The nature of shareholding in deregulated markets largely depends on external factors such as legal systems and institutional frameworks. The appropriate mechanisms that protect shareholders' right such as market for corporate control, effective audit and disclosure policies are important to encourage dispersed shareholding in a deregulated market environment. Otherwise, the managers of firms may misappropriate shareholders' money by taking advantage of small shareholders' lack of power and motivation to closely monitor the executives. Stiglitz (1999) emphasised that with dispersed ownership, one needs to see the rapid evolution of effective securities market and clear protection of shareholder rights. Black (2000) has outlined five institutions for effective monitoring in a dispersed ownership scenario - effective regulation of securities market, accounting rules, independent audits, and extensive financial disclosure, a sophisticated accounting banking profession, a stock exchange with meaningful listing standards, and, company and insider liability for false or misleading information.

Increased competition seeks the benefits of spreading products or services to a greater number of populations at a more reasonable price level. In order to attain this vital goal, firms operating in the liberalized market must strictly conduct their business in ways which primarily aim at boosting the firms' efficiency and performance. The ownership pattern and structures have a determining role in the functioning of firms. Although the large shareholders have been cited as efficient monitors, there are concerns that such block holders, taking advantage of their large voting rights, may direct the firms in a way which are only beneficial to themselves at the expense of other stock and stakeholders (Shlifer and Vishny, 1997). Similarly, executives may be acting in a way which is most beneficial to them as well where shareholding is much dispersed. In both cases self dealing by owners and/or management could lead to the inefficient performance of the firms and their possible extinction.

The other issue which needs immediate attention in deregulated environment is on the changing dimensions of public-private and foreign firms. This issue becomes a sensitive one in many countries where the public/government ownership comes into focus. In most cases private and the foreign firms employ governance mechanisms better than public sector, to enhance or maintain high levels of efficiency. However publicly owned firms still dominate the markets with large market shares in most of the deregulated markets. For example in Bangladesh banking sector which was liberalized in early 1980s, four publicly owned commercial banks still control 50 per cent of the assets and deposits while the rest is shared by 30 local private and 10 foreign banks. The reasons for the large government ownership in the banking sector may be due to solve the inherent informational problems in developing financial system, aiding the development process or supporting vested interests and distributional cartels (Arun and Turner, 2002). However, in the absence of market provided incentives, the managers of the public sector organisations may be able to engage in opportunism at the tax payer's expense, which supports the need for reforming the public sector organisation in developing countries in a time bounded manner.

The ownership pattern and structures of firms plays a crucial role in achieving the desired positive outcomes of enhanced competition in developing countries. Markets with presence of large shareholders whether it is public or private must

develop effective regulations. Similarly a strong and active capital market must be enacted in order to have optimum ownership benefit under enhanced competition. The dominant market positions of the publicly owned firms demand special attention in their quality of corporate governance as these players can still influence the outcomes of a liberalized industry.

As competition in the markets increases, more entrepreneurs are investing in businesses. Regardless of their size of investment, shareholders must be treated equally and each shareholder deserves protection from any potential embezzlement of their funds by the executives or any other parties (OECD, 1998). This can be achieved through sufficient regulatory and legal back up. Governments can set up regulatory agencies whose principal responsibility would be monitoring the firms' business or corporate behaviours and make corrective interventions whenever the conducts of executives or large shareholders work against the interest of general stock and stake holders. For publicly traded companies, example of such regulatory agency is Securities and Exchange Commission. For financial institutions this regulatory job is usually carried out by central banks. So while governments open up competition in their markets, they must also take necessary steps to set up and strengthen regulatory agencies such as Securities and Exchange Commission (SEC) or Central Bank with appropriate legal back up.

Other than the regulatory and legal back up, the second mechanism through which the rights of share holders can be upheld is the 'market' mechanism. In countries where there is a market for corporate control, hostile takeover has emerged as a particular mechanism for consolidating ownership (Jensen and Ruback, 1983 and Franks and Mayer, 1990). Martin and McConnell (1991) argues that the managers of the poor performing firm will be replaced by more efficient management after the takeover process is completed. Hart (1983) claims that capital market competition provides discipline for manager via takeover mechanism in capital market particularly when firms' environments are interdependent. In US, the series of takeovers in late 1980s have changed the attitude of the US managers support the argument that takeover as the most effective check on management autonomy ever devised which breathed new life into public corporations (Rappaport, 1990). Jensen and Ruback (1983) argued that takeovers typically increase the combined value of the target and acquiring firm, which indicates that profits are expected to increase later.

However there are criticisms as to how effective takeovers are in solving the corporate governance related problems. Herzel and Shepro (1990) suggested that takeovers are very expensive and imprecise solutions to the governance problems. Shleifer and Summers (1988) criticised takeover from a social perspective and said takeovers destroy valuable corporate cultures, which lead to serious allocative consequences. But for takeovers to occur and thus correct corporate governance problems, a liquid market for corporate control or in other words an active capital market is required. Shliefer and Vishny (1997) argue that takeovers are so costly that only significant large performance failures are likely to be focused on. Grossman and Hart (1980) argues that target firm's shareholders will continue to hold their shares if the bidding firm does not pay them for the expected increase in profit under the bidder's management with the hope that shares would become more valuable once the takeover succeed. Most of the developing countries do not have strong, active and liquid stock markets while many of them do not have any stock market at all. For its potential of limiting agency problems through take over mechanisms, policy makers attempts to strengthen active capital markets while deregulating the markets.

In a deregulated era, enhanced competition envisages the growth of new businesses in developing economies which necessitates the need for an enhanced supply of funds either through banks or capital markets. Banking institutions are playing a dominant role in financing businesses in the developing countries in the absence of strong and liquid capital markets. However, most of the banking institutions in developing countries are having the problem of high levels of non performing loans. Also, banks may follow a conservative approach towards financing new businesses due to the perceived risks attached to lending new projects. Since the capital market invests in firms as equity, the risk is relatively lower for the capital market to invest in emerging firms. However, the capital market's interest and active participation in financing new businesses would largely be determined by the fact that how well the rights of investors and shareholders are protected in the markets. The policies on disclosure and incentives are significant in developing appropriate shareholder policies.

Many experts are calling for performance-based incentives in the privatised firms, which could work as a measure to ensure good governance of the firms. Incentives are particularly effective in aligning and motivating the behaviour of those executives who did not face disciplinary actions for job failures and who did not receive anything in addition to their salary for business successes, which could work as their motivations. Many studies have outlined a positive relationship between pay and performance (Murphy 1985, Coughlan & Schmidt 1985). Sometimes attractive incentive packages are used by investors to keep the behaviour of the managers in line with the investors' interest and such incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Jensen & Meckling 1976, and Fama, 1980). Cash incentives could play a powerful motivating role in boosting the executive morale and

interest within a short period of time as it happens to be liquid and readily available to render benefit. However in the long run incentives through stock remuneration such as stock options may play a more effective role as the benefit flowing to the executives would only increase with the increase in share value of the company which would reflect an overall improvement in a firm's market and financial position. But this is only possible where an active and strong capital market is present. The developing countries in general lack such equity market and as a result cash incentives may be the more effective way of motivating the corporate management of those countries until their capital markets reach a sound and efficient stage. However, the high-powered incentive contracts may enable managers to self deal as well (Shliefer and Vishny, 1997). This may be possible if the managers are dealing with board of directors who represent dispersed small shareholders and posses very low motivation. But it would still be worthwhile to encourage the new firms under deregulated environment to offer performance based pay systems or incentive packages to the executives in order to tackle the governance problems related to efficiency enhancement and competition.

In a pre reform era, the information of firms available to the public domain is very limited, a practice conducive to encourage corruption and hides failures resulting from wrong decision-makings, at least in the short term, which has changed later on as part of the reform process. The implementation of timely disclosure methods and regular auditing of the firms are essential for firms to become efficient, accountable and transparent. The development of capital market may help in this regard as it is a usual practice for listed companies to disclose corporate information through annual reports as well as audit reports.

## 4. Conclusion

Competition, having gone through different evolutionary stages in past couple of centuries, is now being widely perceived as a force, as a consequence of liberalisation policies, to achieve efficient production and resource allocation. The financial crises in several developing and emerging economies has provided an opportunity to have a better appreciation of corporate governance and its role in national economies particularly in boosting investor confidence, improving the quality of investment decisions and fostering the resiliency of corporate sector. Although there is no one-size-fits-all system of corporate governance, some common features as discussed in the paper are demanding attention in an era of competition. In the wake of rising number of deregulation and privatization-ownership structure and pattern will play a crucial role in steering corporate goals in line with the benefits of the greater spectrum of stock and stakeholders. Along with that the role and contribution of boards, effective monitoring and incentive systems for the managers added with greater transparency in firm activity and decision makings are demanding equal attention in any corner of the world. Addressing these issues through sound policy making and effective regulatory back up would certainly lead to successful consequences of competition through deregulation and privatization in the emerging economies.

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# WHAT ABOUT THE DEBT GOVERNANCE STRUCTURE AND STOCKHOLDERS' INTERESTS IN TRANSITION MARKET? PERSPECTIVES FROM EGYPT

***Tarek Ibrahim Eldomiaty****

**Abstract**

**This study examines the relationship between debt governance structure at three levels (high, medium and low) and firm's performance in the stock market. The debt structure classifies debt into short-term debt and long-term debt at each debt level. The results indicate that in the high debt firms, the short-term debt helps improve the PE ratio. As for the medium debt firms, the results show also that the short-term debt helps improve the market value added. The results of the low debt firms are similar to those of the high debt firms indicating that the short-term debt can be used to improve the PE ratio. The regression characteristics show that with the exception of medium debt in the PE equation, the explanatory power for the other performance measures are relatively high which indicates a relatively high degree of association between both types of debt with the MB and MVA respectively. The overall results show that (1) debt governance structure in Egypt is characterized by the dominance of short-term debt, (2) the latter can be used to improve the firm's performance in the stock market, which shows that the association of interests between short-term debtholders and stockholders is highly likely, and (3) the negative relationships of long-term debt indicate to the presence of an agency problems between long-term debtholders and stockholders. The contribution of this paper is that it shows the extent to which either type of debt can be used to address the debtholder-stockholders agency relationships.**

**Keywords:** Agency Relationship, Debt Structure, Stock Market Performance, Egypt

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## Introduction

The literature on corporate governance in conjunction with corporate finance deal with debt and equity as alternative governance structures. The relative dependence on each comes about with the formation of explicit or implicit contracts that delineates the benefits and resources available to the suppliers of finance. The benefits available represent the property rights due to their claims over the return stream from assets while the resources available is in the form of their control rights over managerial decisions. The financing structures of debt and equity can be compared with respect to the characteristics of control and property rights (Kochhar, 1997). The debt instrument carried with it fixed rules and covenants that usually monitor the lending process such as the repayment schedule (principal and interest) plus an obligation to the firm to meet liquidity tests to ensure that the lender's investment is not jeopardized. These characteristics imply that debt has strong property rights, making it similar to the market exchange mechanism (Williamson, 1991a,b). On the other hand, equity owners are the residual claimants over the cash flow from asset earnings and asset liquidation. That is, they obtain the cash flows that are left after paying off the debt claims which means that equityholders have weaker property rights similar to hierarchical control. (Williamson, 1991a,b).

This paper hypothesizes the view that the residual claims call for converging interests between debtholders and stockholders. An agency problem arises when the residual earnings are zero. In this case, stockholders are not in any better off position than the debtholders. The convergence of interest is highly likely to happen when the stockholders end up with residual earnings equal to or greater than the average in the market. The two sources of financing, then, will be complementary rather than competing with each other with the use of debt adds to the stockholders value. It is clear, then, that it is up to the use of debt. The proper use of debt can safeguard the stockholders-debtholders convergence of interests.

This argument is supported by recent view of capital structure decisions as a strategic decisions. That is, the choice of capital structure is less a matter of predefined alternatives and more a search for alternatives in a complex and uncertain environment (Simerly and Li, 2000). In a world of relatively high asymmetric information, debt financing is accompanied by some benefits. Myers and Majluf (1984) show that, because management has superior information, external finance is costly. Moreover, they argue that this adverse selection problem is minimized by the issuance of the "safest" security, i.e., the security whose pricing is least sensitive to the manager's private information. Thus highly rated debt with a fairly certain payoff stream is issued before equity. Debt is particularly easy to value where there is abundant collateral, so that investors need only concern themselves with the value of the collateral and not with the valuation of the entire firm, as equity investors would need to.

Several other articles model the costs and benefits of debt contract. The benefit is usually the reduction in the agency cost such as preventing the manager from investing in negative NPV projects, or forcing him to sell assets that are worth more in alternative use. The main costs of debts are that firms may be prevented from undertaking good projects because debt covenants keep them from raising additional funds, or else they may be forced by creditors to liquidate when it is not efficient to do so. Stulz (1990), Harris and Raviv (1990), Diamond (1991) and Hart and Moore (1995) present some of the main models incorporating these ideas, whereas Lang et al., (1996) present evidence indicating that leverage indeed curtails investment by firms with poor prospects. It is worth to note that the literature review in this paper focuses primarily on debtholders-stockholders interest in developed markets. The reason is that the global economic transition of developing countries is characterized by a clear tendency towards capitalist markets in developed countries. This offers an opportunity to examine the extent to which debtholders-stockholders relations in developed markets can offer lessons to learn in transition markets. The empirical results in this paper show that extent.

## Why debtholders-stockholders interests in transition market?

The relationship between the two sources of financing is specially important in transition markets for certain reasons. First, information asymmetry between suppliers of finance in transition market is relatively higher than in developed markets. This requires the examination of the extent to which the stock market participant appreciate the debt financing, therefore, its possible role in mitigating the information asymmetry. Second, transition/ developing market are generally characterized as less efficient than those of developed markets. Considering that debt financing is a firm-level decisions, the effects of debt decisions on firm's performance in the stock market is highly likely to affect the stock market efficiency positively. Third, generally, market incompleteness in transition markets posits debt financing, especially bank financing, as a major financing source. This requires the examination of the extent to which banks can work on supporting the stockholders' interests in these markets and especially in an economic transitional stage. It is worth to note that bank financing is the dominant financing source in Egypt.

The paper is organized as follows. Section II discusses the many studies that show a significant association between the interests of debtholders and stockholders. Section III describe the variables examined the paper. Section IV describes the data and the methodology. Section V discusses the results. Section VI concludes.

## I. The Association between Debtholders-Stockholders Interests: Lessons from Developed Markets

The literature on corporate governance is rich of numerous studies on the agency relationships focusing more frequently on the stockholders-managers possible conflicts. The most two cited works on the agency relationships are Jensen and Meckling (1976) and Jensen (1986)TP. In the EBSCO research database, Jensen and Meckling (1976) was cited 1797 times and Jensen (1986) was cited 625 times for the period since each work has appeared to May 2005. This is according to the statistics of the EBSCO research database PT in which they use the agency framework to analyze the effects of conflicts of interest among stockholders, managers and debtholders on the investment and financing decisions of the firm. Jensen (1986) discusses the lenders' governance role that if the firm fails to meet debt obligations, the lenders can take steps to terminate the employment of the managers. This implies that to the extent that managers are concerned with the debtholders' claims, and that managers are agents to stockholders, their (managers) financing decisions must be adapted to meet the interests of debtholders and stockholders as well. In this sense, firm's managers can truly play a custodian role to protect the rights of both stockholders and debtholders. Cable (1985), for example, finds a significant, positive relationship between the degree of bank involvement in a firm and its financial performance. As a result, bank involvement supposedly improves the profitability of firms. There has also been a growing literature that focuses on firm's growth as a determinant that causes a stockholder-debtholder agency relationship to arise. The agency theory tells that equity-controlled firms have a tendency to invest suboptimally to expropriate wealth from bondholders and the cost associated with this agency relationship

is likely to be higher for growing firms. Accordingly, firm's expected future growth should be negatively related to long-term debt levels. This negative relationship has been reached by Kim & Sorensen (1986), Harris & Raviv (1991) and Ghosh et al. (2000) suggesting that when firms are expecting high future growth, they (firms) use greater amount of equity financing. However, Myers (1977) indicates that this agency problem is mitigated when the firm issues short-term rather than long-term debt. Jensen & Meckling (1976), Smith & Warner (1979) and Green (1984) add one more dimension to the agency problem arguing that the agency costs will be reduced if firms issue convertible debt. These studies provide a general evidence that the interests of stockholders and debtholders are reachable and convergable. The literature on corporate governance characterize debt financing with the privilege of specific control rights. This is due to the fact that debt is a contract in which a borrower gets some funds from the lender, and promises to make a prespecified stream of future payments to the lender. In addition, the borrower typically promises not to violate a range of covenants such as maintaining the value of the assets inside the firm (Smith and Warner, 1979). This implies that the control rights adhere to lenders can eventually protect stockholders value under the condition that the lenders would intervene on the right time well before the firm's stockholders lose the value of their stocks. Here, the possibility of an association of interests between the debtholders and stockholders is highly likely.

The benefits of Landers' intervention are discussed in Gale and Hellwig (1985). They consider models in which the borrower can abscond with the profits of the firm. However, if the lender is not repaid, he has the right to investigate the books of the firm, and grab its cash before the borrower can steal it. Thus failure to repay triggers the transfer of control over the assets from the borrower to the lender. It is obvious that these rights protect the stockholders' interests at early stages on insolvency and business troubles. Therefore, Gale and Hellwig (1985) show that the optimal contract that minimizes the expected investigation costs is a debt contract.

As debt contracts are characterized in the literature as incomplete, Aghion and Bolton (1992) use incomplete contract theory to characterize debt as an instrument whose holders take control of the firm in a bad states of the world. They show that if the managerial benefits of control are higher in good states of the world, then it may be efficient for managers to have control of assets in good states, and for creditors to have it in bad states. This also shows that the interests of both debtholders and stockholders can be associated to each other. Because the rights of creditors are clearer, and violations of those rights are easier to verify in courts, the existing literature describe debt as providing better protection to outside investors than equity. However the focus on large investors sheds new light on the relative powers of debt and equity. This is true considering that the dominant form of lending around the world is bank lending. Banks are usually large investors, who gain numerous control rights in the firm at the time of, or even before, default. For example, the main bank, as in Germany, can often take physical control of the firm's bank account - which resides at that very bank - if it misses a payment, thereby assuring fairly complete control of the firm by the bank without much involvement of the courts. This control is often guaranteed by direct equity ownership in the firm (OECD, 1995). Thus, the corporate governance system in Germany ensures that debtholders' interests and stockholders' interests are complementary to each other and banks, as debtholders, are able to protect their interests in the firm as well as the stockholders' interests. Unlike equity, debt in a peculiar way may be tougher when it is not concentrated. If a borrower defaults on debt held by a large number of creditors, renegotiating with these creditors may be extremely difficult, and the borrower might be forced into bankruptcy (Bolton and Scharfstein, 1996). In contrast, it may be easier to renegotiate with a bank. The difficulty of renegotiation, and the power of dispersed creditors, might explain why public debt is an extremely uncommon financing instrument, used only in a few developed countries, and even there much less than bank debt. Triantis (1994) and Bowers (1999) argue on a theory of free cash flow that when the lender is given either a security interest in assets of the borrower or some other form of priority rights, these features constrain the ability of the managers to liquidate non-cash assets which acts for the stockholders' interests as well. Considering the inevitable information asymmetry between firm's insiders and outsiders, banks can play a significant informational role lessen the agencyasymmetry based problems. For example, the most recent study by Iacobucci and Winter (2005) con clude that in both hidden-information theories, asset securitization is driven by the propensity of the market to allocate assets to investors who are best informed about asset values. In this case, on a loan arrangements, banks are better informed about asset securitization than other investors. Therefore, as far as banks are concerned with the firm's assets value and securitization, it achieves and protects the stockholders' interest as well. Levmore (1982) shows the informational effects between debtholders and stockholders arguing that the failure of a firm to pay a dividend to preferred shareholders and enforcement by secured creditors communicates valuable information to common shareholders. The informational role is supported as well by the findings reached by James (1987) that stock prices reacted positively to announcements of bank debt-financing arrangements, while they fell upon announcement of other credit arrangements, notably public straight-debt offerings and privately placed

debt. Lummer and McConnell (1989) extended James's study to distinguish between the effects of announcements by banks of new and revised loan arrangements. They found out that most of the positive effects on share prices were due to favorable announcements of revisions of existing financing arrangements. Lummer and McConnell concluded that the benefits to shareholders is derived from the bank's access to private information acquired during its relationship with the borrower rather than its advantage in screening the borrower at the time of the initial financing. Triantis and Daniels (1995) present a foundation to a theory of debt as an interactive corporate governance mechanism. They argue that debt is a potent and flexible governance instrument and that banks are effective governance players. One advantage is that by lending to a number of different firms in the same industry, banks develop a broadly based benchmark against which to evaluate the performance of each borrower. Other stakeholders benefit not only from the ability of banks to deter and detect managerial slack by monitoring, but also from the actions (exit and/or voice) taken by banks following the detection of slack (Hirschmann, 1970). Scott (1986) was the first to present a corporate governance mechanism based on relational financing (banks) for owner-operated firms in which the financers take broad security interests in order to enhance their leverage over their borrower decisions. PT Banks' loans play a significant role in the possible agency problem between debtholders and stockholders. That is, in the economic model of the corporation, financial agency problems exist because managers (as agents of stockholders) have incentives to make decisions that transfer wealth from debtholders to stockholders. In this case, the exit rights of debtholders deter this type of borrower misbehavior. Whereas dispersed shareholders may be unable to discipline management effectively through their voting rights, a bank with a large enough investments will have sufficient incentive to intervene effectively (Teger, 1980; Whyte, 1986). Nevertheless, Triantis and Daniels (1995) argue that a bank that detects managerial slack will not always choose to exit and use the threat of exit as a lever to intervene in the firm's decisions. This means that, as far as the bank is able to correct the slack, it goes to the best interests of the firm's stockholder as well since firm's bankruptcy comes against the stockholders' interests. That is, bank's intervention many help reach a debtholders-stockholders congruence of interests. Triantis and Daniels (1995) argue that the bankruptcy law in the U.S. restricts the lender's ability to exit after the borrower has become insolvent. Therefore, the voidable preference rule encourages timely monitoring and pre-insolvency action by threatening to reverse any attempt to exit after the debtor has become insolvent. This implicitly ensures that the interests of debtholders and stockholders are highly likely to converge since the debtholders can the borrower's fall of market value. The bank's exit may prompt some existing shareholders for whom exit is difficult to intervene in the management of the firm. Levmore (1982) argues that secured creditors that monitor their collateralized assets can provide signals about the financial stability of the firm to its outside shareholders. These signals may work to the benefit of the firm's shareholders since Booth (1992) provides empirical evidence that the cost of bank loans is lower when there is a public trading of shares in the borrowing firm.

Jensen (1989) refers to debt as a powerful agent for change because, if managers can not meet their interest obligations out of the firm's cash flow, they are forced to rethink their strategy and structure. Debt's power of change to the benefits of stockholders is supported in the literature. Gilson (1990) concludes that financial distress is accompanied by an increase in the proportion of common stocks held by blockholders. It is here assumed that they intervene to correct firm's financial health. Altman (1991) discusses the potentials that a group of investors can be specialized in lending to troubles firms and purchasing distressed debt securities. Ofek (1993) provides further support to the association between the interest of debtholders and stockholders that highly levered firms respond earlier to declines in firm value. In this sense, banks can provide a viable communication link to stockholders when firms' management has a discretionary disclosure attitudes. Verrecchia (1983) provides support that managerial discretion in disclosure is a function of disclosure cost. For example, a bank may use its threat of exit or its voice not only to redress slack, but also to obtain a favorable renegotiation of the lending terms.

In sum, the literature above mentioned includes many studies that show a considerable degree of association of interests between debtholders and stockholders. In an economic environment generally characterized by global converginism, the question that arises is the extent to such association could exist in transitional markets setting. The results in the empirical part of this paper using data from Egypt stock market provide insights into an answer to that question.

## III. Research Variables & Proxies. Dependent variable

This paper utilizes two types of dependent variables as it runs into two stages. First: the paper attempts to examine those determinants of debt structure that are relevant to transitional market settings. This is due to the well-know understanding that the literature on determinants of capital structure has evolved and been examined and tested using data about developed markets mostly the U.S. This requires to take into account that the financial institutions and infrastructure in developed markets differ from those

in transitional markets. Therefore, the search for determinants of capital structure in transitional markets requires an examination of those determinants of capital structure that are relevant to transitional market settings. In so doing, the first dependent variable is firm's debt ratio which is split into its two common parts; long-term debt and short-term debt. Both parts of debt are measured in book value. The debt ratio is measured in book rather than market value. Two studies have presented theoretical and empirical justification for the use of book value. Myers (1977) argues that the debt book value is related to the value of assets in place. Taggart (1977) finds that there is very little to choose between the book and market value formulations.

Second: This paper explores the possible association between firms' debt structure and firms' performance in the stock market. The latter is the dependent which is measured by three measures of stock market performance; Market-to-Book Ratio ( t MB )TP MB = market value per share ÷ book value per share PT, Percentage of Market Value Added ( t MVA% )TP. MVA% = (Market value of outstanding shares- book value of equity) ÷ book value of equity PT, and Price/Earnings Ratio (t PE Δ)TP. PE = price per share ÷ earnings per share. Each of the three dependents is to measure firm's adjustment to a target value; therefore it is measured as the changes in Market-to- Book Ratio (1 - t MB), Percentage of Market Value Added (1 - t MVA%), and Price/Earnings Ratio (1 - t PE Δ). The three measures present comprehensive perspective regarding firm's performance in the stock market in the literature of corporate finance and investments. The market-to-book ratio is a measure of shareholder value. The market value added is a measure of investments added value, and the price-earnings ratio is a measure of value (commonly as an indicator of overvalued and undervalued stocks).

## Independent Variables

The literature on the determinants of capital structure lends itself to firms' debt structure. The literature is rich of numerous research papers that discus the determinants of capital structure mostly focusing on using the debt ratio as a proxy for capital structure. The relevant literature on the determinants of capital structure provides number of factors that have been examined. It has been realized that the number of factors differs from one study to another. Therefore, this study examines as a comprehensive number of determinants of capital structure as possible. Some determinants could not be included due to the lack of relevant data. Table (1) shows the common determinants of capital structure cited in the relevant literature and the ratios and/or proxies used for the measurement. (Modigliani & Miller, 1963; Bosworth, 1971; Toy et al., 1974; Myers, 1977; Martin & Scott, 1974; Marsh, 1982; Castanias, 1983, Auerbach, 1985; Jensen & Meckling, 1986; Titman & Wessels, 1988; Harris & Raviv, 1991; Homaifar et al., 1994; Lasfer 1995; Gilson, 1997; Ghosh et al., 2000). The Debt ratio (short-term debt and long-term debt) measures the debt structure. The speed of adjusting firm's operating performance is measured by taking into account that the amount of changes in the measure of operating performance in a certain period (t) is affected by the amount of changes in the previous period (t-1). According to the agency theory, we test the hypothesis that "a negative relationship exists between firm's debt and its stock marketperformance." The main proposition in this case is that debt is less costly than equity financing, thus has a positive effect on firm's operating performance. Debt financing, therefore, may help resolve the agency conflicts between firm's managers and other stakeholders.

## IV. Data and Methodology. Data

The data used in this paper is extracted form many sources. The data related to firms' income statement and balance sheet are obtained from Kompass Egypt Financial Year Book (Fiani & Partners). The interest rate data is published by the IMF: International Financial Statistics. The data covers seven years 1997-2003. The total number of firms included in the study is 99 firms, which they cover fourteen different non-financial industries. Firms were selected based on two criteria. First, the non-financial firms amongst the 100 actively trading firms in Egypt stock market. Second, the non-financial firms amongst the 100 firms with the highest market value.

## Methodology

The first stage is concerned with determining the determinants of capital structure that are relevant to transitional market settings. The general estimating equation (stepwise) in the first stage is as follows.

$$y_{tk} = \alpha_k + \sum_{i=1}^{n} \beta_{ik} X_{itk} + \varepsilon_{tk}$$

$$\text{where } t = 1,\ldots,5 \qquad k = \text{number of firms in each group}$$

$$y_t = \Delta STDR_t = (STDR_t - STDR_{t-1}) \text{ and } y_t = \Delta LTDR_t = (LTDR_t - LTDR_{t-1})$$

The next stage is concerned with examining the effects of changes in firm's debt structure, and its relevant determinants, on firm's operating performance. The general estimating equation (partial adjustment) in the second stage is as follows.

$$y_{tk} = \alpha_k + \beta_k y_{t-1,k} + \sum_{i=1}^{n} \beta_{ik} X_{itk} + \varepsilon_{tk}$$

$$\text{where } t = 1,\ldots,5 \qquad k = \text{number of firms in each group}$$

$$y_t = \text{Measures of firm's performance the stock market.}$$

It is worth to note that, according to the correlation coefficients, the correlation between the hree measures is very low. This ensures that the results are very distinct and the possibility of the overlap is very low as well.

**Table 1.** List of Determinants of Capital Structure examined in the study. The Δ is measured as 1) - (t - (t) for all variables except for) t DR 1 t * DR (* DR − + = Δ).

There are alternative approaches to calculate the target ratios such as (1) the average over certain number of years; (2) by fitting an autoregressive function; (3) by taking the maximum debt ratio in the past (Marsh, 1982). However, the three approaches result in one estimate for the target ratio which gives the impression that firms look at only one certain estimate (ratio) and plan their capital structure accordingly. The method used in this paper is based on the assumption that the firm changes its target ratio generically, then the ratio a firm could achieve is considered as if it was the target ratio. This point of view takes into account the generic aspects of planning for capital structure changes. According to the literature, floatation costs, firm's size, asset structure and the market conditions change over time which necessitate planning for capital structure generically, and the target ratios are changed accordingly. However, we experimented with the three methods plus our suggested one which utilizes the two ratios (1 t DE + and * DR Δ). The results showed slightly significant increase in the 2 R for our suggested measures.

$$ECTR_t = \frac{\text{Estimated taxable profits} \times \text{Corporate tax rate}}{\text{Pre - tax profits}}$$

$$NDT = OI - i - \frac{T}{CTR}, \text{ where : OI = Operating Income, i = Interest payments, T = Income tax payments}$$

$$\text{CTR = Corporate tax rate}$$

| | | |
|---|---|---|
| | $DCR_t$ | Debt Coverage Ratio. A proxy for firm's failure |
| Agency Costs | $ER_t$ | Expense Ratio = Operating expenses scaled by annual sales.[11] A measure of how effectively the firm's management controls operating costs, including excessive prerequisite consumption, and other direct agency costs. |
| | $AUR_t$ | Assets Utilization Ratio = Annual sales/Total assets. A measure of how effectively the firm's management deploys its assets. |
| Uniqueness | $SES_t$ | Selling Expenses/Sales. The relationship between specialized products and capital structure. |
| Industry Classification | $IC_t$ | Dummy variables for types of industries. The industry effects on firm's capital structure. |
| Size | $LnAssets_t$ | The natural logarithm of total assets and sales (Dummy variable). The effects of firm's size on the composition of capital structure. |
| | $LnSales_t$ | |
| Profitability | ΔEBITDA | Earnings Before Interest, Taxes, and Depreciation over Total Assets. |
| | ΔOIS | Operating Income over Sales. |
| | ΔOIA | Operating Income over Total Assets. |
| | ΔPM | Profit Margin |
| | ΔROI | Return on Investment |
| Financial Flexibility | $REA_{t+1}$ | The expected effect of 'Retained Earnings Ratio' as a proxy for the retention rate. |
| | ΔREA | A measure of the cumulative effect retained earnings, thus the extent of firm's financial flexibility. |
| Liquidity Position | ΔQR | Quick Ratio. |
| | ΔWCR | Working Capital Ratio. |
| | ΔCashR | Cash Ratio. |
| | ΔCR | Current Ratio. |
| Interest Rate | $IR_t$ | Interest Rate on bank loans. The relationship between market interest rate and borrowing decisions. |
| Timing Effect | ΔPE | Price/Earnings Ratio. The relationship between stock prices and equity financing. |
| Transaction Costs | $DPR_t$ | Dividend Payout Ratio. The effects of transaction costs of debt financing decisions. |
| Free Cash Flow | $FCF_t$ | Operating free cash flow that shows the excess of cash used for financing. |

$$\text{Bankruptcy risk} = \frac{\text{Fixed charges - Earnings before income and tax}}{\sigma \text{ of earnings}}$$

The expenses ratio is not assumed to measure all agency costs as discussed in the literature. Nevertheless, and according to the availability of data, this ratio can be considered a first-order estimate and easy-to-measure indicator of the presence of agency costs at the firm level.

## V. Results and Discussion

This section is divided into three subsections. First, the results of the OLS estimates (stepwise) for the determinants of capital structure that are relevant to transitional market settings. These results are reported in table (2). Second, the results of the OLS estimates that show the debt structure, which is dividend into three classes; high, medium and low debt. These results are reported in table (3). Third, the results of the association between the firm's debt structure and firm performance in the stock market. These results are reported in table (4).

### First: The Relevant Determinants of Capital Structure to Transition Market Settings

Table (2) shows the stepwise regression coefficients of the determinants of long-term debt and short-term debt. In general, the explanatory power for the shortterm debt equation is relatively higher than for the long-term debt equation. This means that the determinants of capital structure cited in the literature are relatively very associated with short-term debt financing.

**Table 2.** Determinants of Long-term Debt and Short-term Debt

| *Dependents*: Long-term Debt Ratio & Short-term Debt Ratio | | Debt Ratio | |
|---|---|---|---|
| | | Long-term Debt Ratio $\Delta LTDR_t$ | Short-term Debt Ratio $\Delta STDR_t$ |
| *Independents*: Constant | | -0.09 | -0.33 |
| Target Debt Ratio | $DE_{t+1}$ | 0.001 (1.43) | - |
| Average Industry Leverage | $\Delta DR_{AVGt}$ | 0.018 (1.29) | - |
| Structure of Tangible Assets | $FATA_t$ | -0.018 (-3.91)$^{***}$ | - |
| Relative Tax Effects | $\Delta NDTAX_t$ | - | 0.64 (16.78)$^{***}$ |
| | $\Delta NDTA_t$ | -0.072 (-1.92)$^{*}$ | - |
| Growth | $CETA_t$ | 0.0003 (2.21)$^{**}$ | - |
| | $GTA_t$ | -0.01 (-3.40)$^{***}$ | - |
| | $SG_t$ | 0.003 (2.37)$^{***}$ | -0.005 (-2.44)$^{***}$ |
| Profitability | $\Delta EBITDA_t$ | -0.002 (-2.24)$^{**}$ | - |
| | $\Delta PM_t$ | - | -0.006 (-11.14)$^{***}$ |
| Financial Flexibility | $\Delta REA_t$ | - | -0.066 (-2.97)$^{***}$ |
| Liquidity Position | $\Delta WCR_t$ | - | 0.001 (10.26)$^{***}$ |
| | $\Delta CashR_t$ | -0.008 (-2.91)$^{***}$ | - |
| | $\Delta CR_t$ | - | 0.0002 (2.13)$^{**}$ |
| Interest Rate | $IR_t$ | 0.76 (2.24)$^{**}$ | 2.61 (1.74)$^{*}$ |
| Industry Type | Textiles, Garments & Consumers Goods | 0.005 (1.71)$^{*}$ | - |
| | Paper, Packaging & Plastics | - | 0.009 (1.34) |
| | Housing & Real Estate | -0.003 (-1.18) | - |
| | Tourism & Leisure | -0.005 (-2.20)$^{**}$ | 0.007 (1.21) |
| | Utilities & Other Services | 0.013 (2.45)$^{***}$ | - |
| Corporate Size | Small Size | -0.004 (-1.75)$^{*}$ | - |
| | Medium Size | -0.002 (-1.09) | - |
| Time Effect | Time Dummy | - | -0.004 (-1.97)$^{**}$ |
| $N$ | | 477 | 484 |
| F statistics | | 4.81$^{***}$ | 115.34$^{***}$ |
| $\bar{R}^2$ | | 0.11 | 0.70 |
| D-W test | | 2.16$^{****}$ | 2.33$^{****}$ |
| Theil Inequality Coefficient | | | |

**Note:** Stepwise regression coefficients for the long-term and the short-term debt ratios. The dependent variables are the long-term debt ratio (t LTDR Δ) and short-term debt ratio (t STDR Δ). The *t*-statistics are shown between brackets. The two

regression equations are free from multicollinearity (VIF<5). The heteroskedastic effects are corrected using the White's HCSE,
which improves the significance of the OLS estimates.
**** D-W test significant at 2% two-sided level of significance
*** Significant at the level 1%
** Significant at the level 5%
* Significant at the level 10%

This explains a true fact about bank financing in Egypt that the short-term borrowing is referred and in most cases is renewed at multiple points of time that it turns out after few years to be long-term borrowing. This is evidenced since the results also show that many determinants of capital structure are significant determinants of both long-term and short-term debt. Firm's growth, profitability, interest rate and liquidity are shared determinates of both long-term and short-term debt. Some differences are realized that financial flexibility and relative tax effects are significant determinants of short-term debt. In the latter equation, the time dummy has a significant negative coefficient which indicates that the short-term debt is affected by time; as time passes by, short-term debt is decreasing. As for the long-term debt, the results also show some distinct differences that the structure of tangible assets, type of industry and size are significant determinants of long-term debt. It is worth to note that the inverse relationship between firm's tangible assets and long-term debt indicates that fixed assets are not considered a collateral for long-term debt. The explanation is that this could be true only when the long-term debt is originally a short-term debt that has been renewed at several previous periods and that does not requires collaterals. This explanation supports the relatively high association between the determinants of capital structure and short-term debt financing. It is interesting to note that the relevant determinants of capital structure (mostly growth, profitability, interest rate, liquidity and financial flexibility) shown in table (2) are associated with a considerable validity. That is , there is a relatively high similarity with the results of other related studies such as Booth's et al., (2001) study in other ten developing countries and Eldomiaty and Ismail (2005a,b,) in Egyptian firms although the methodology differs from one study to another. The relatively high similarity of the determinants of capital structure between developed and developing countries called Booth et al., (2001) to claim that the theory of capital structure is "portable."T

## Second: The Structure of Debt Financing in Egypt

Table (3) shows the results of the OLS estimates for three classes of debt; high, medium and low. This classification aims at showing the extent to which firms depend on either long-term or short-term debt financing or both of them at each debt level. The dependent variables are long-term debt and short-term debt respectively. The analysis utilizes the partial adjustment model where it shows at each debt level the speed of adjusting long-term debt (1 - t LTDR Δ) to a target level (t LTDR Δ), and so does for short-term debt (1 - t STDR Δ).

With the exception of the speed of adjusting long-term debt at low level (-0.027), the other speed of adjustments indicate that firms at each debt level is concerned with adjusting both long-term and short-term debt to a target level since the coefficients speed of adjustment are statistically significant. Number of implications can be drawn from table (3). First, the direction of the adjustment matches considerably the results shown in table (2). For example, at the high and medium debt levels, firms adjust short-term debt negatively (-0.136 and -0.319) to a target level. This supports the results reported in table (2) where the time dummy has a negative coefficient for the short-term debt equation. This implies that short-term debt decreases by time. At the low level, firm depends considerably on short-term debt for financing purposes. Second, compared with long-term debt at each level, firms depend relatively more on long-term debt than on short-term debt. This is an additional evidence of the claim that the maturity of the short-term loans is extended to a long-term basis. This is true since the estimates of the speed of adjusting longterm debt are positive. Third, the speed of adjustment at each debt level supports the second implication. That is, at the high debt level, firms depend relatively higher on long-term debt (0.122), where at the medium debt level, firms depend relatively on less long-term debt (0.052). This indicates that the higher the debt level, the higher the long-term debt in firms capital structure. Fourth, at a cross section debt levels (high, medium, and low) the common determinants of long-term debt are target debt ratio and growth. As for the short-term debt, the common determinants are relative tax effects, profitability and liquidity. Up to this point, it is interesting to note that the results just mentioned in third and fourth match considerably the results in other related studies (Booth et al., 2001 for other ten developing countries) regarding the determinants of capital structure. This adds to the credibility of the results obtained in this study. Fifth, at the low debt level, most of the determinants of long-term and short-term debt are not statistically significant. This could be an expected result since firms that do not depend significantly on debt financing are not expected to be that concerned with either the distinction between both sources of debt or

with making borrowing decisions rationally enough to match any of the theory of determinants of capital structure. Sixth, it is worth to note that at the high debt level, the negative estimate of interest rate indicates that firms time the borrowing decision. Nevertheless, the other significant estimates for the short-term debt have positive sign which indicate that firms do not time the borrowing decisions, i.e., borrow when interest rate is high. Seventh, type of industry has a significant effect on long-term debt. Two industries; the textile and Utilities depend relatively on long-term debt. So has the size effect on long-term debt since medium debt firms do not depend on long-term debt.

**Table 3.** The Structure of Long-term Debt and Short-term Debt

| *Dependents*: Long-term Debt Ratio & Short-term Debt Ratio | | Debt Ratio | | | | | |
|---|---|---|---|---|---|---|---|
| | | High Level | | Medium Level | | Low Level | |
| | | $\Delta LTDR_t$ | $\Delta STDR_t$ | $\Delta LTDR_t$ | $\Delta STDR_t$ | $\Delta LTDR_t$ | $\Delta STDR_t$ |
| *Independents*: Constant | | 0.11 | -0.80 | -0.13 | 0.38 | -0.12 | -0.16 |
| Long-term Debt Ratio | Speed of adjustment $\Delta LTDR_{t-1}$ | 0.122 (2.07)$^{**}$ | - | 0.052 (1.66)$^{*}$ | - | -0.027 (-0.89) | - |
| Short-term Debt Ratio | Speed of adjustment $\Delta STDR_{t-1}$ | - | -0.136 (-2.38)$^{**}$ | - | -0.319 (-3.62)$^{***}$ | - | 0.051 (2.51)$^{***}$ |
| Target Debt Ratio | $DE_{t+1}$ | 0.001 (1.67)$^{*}$ | - | 0.006 (3.27)$^{***}$ | - | -0.001 (-0.50) | - |
| Average Industry Leverage | $\Delta DR_{AVGt}$ | 0.049 (0.86) | - | 0.165 (2.56)$^{***}$ | - | 0.002 (0.11) | - |
| Structure of Tangible Assets | $FATA_t$ | -0.030 (-2.17)$^{**}$ | - | 0.002 (0.22) | - | -0.015 (-2.19)$^{***}$ | - |
| Relative Tax Effects | $\Delta NDTAX_t$ | - | 0.74 (9.51)$^{***}$ | - | -0.247 (-0.78)$^{***}$ | - | 0.080 (2.56)$^{***}$ |
| | $\Delta NDTA_t$ | 0.009 (0.12) | - | -0.116 (-1.38) | - | -0.038 (-0.75) | - |
| Growth | $CETA_t$ | 0.001 (1.43) | - | 0.001 (0.10) | - | 0.001 (1.82)$^{*}$ | - |
| | $GTA_t$ | -0.019 (-3.82)$^{***}$ | - | -0.041 (-2.24)$^{**}$ | - | -0.007 (-1.37) | - |
| | $SG_t$ | 0.005 (2.03)$^{**}$ | -0.011 (-1.72)$^{*}$ | 0.003 (1.32) | -0.006 (-0.95)$^{***}$ | -0.001 (-1.23) | 0.001 (0.41) |
| Profitability | $\Delta EBITDA_t$ | -0.022 (-0.45) | - | 0.043 (0.87)$^{***}$ | - | -0.001 (-0.80) | - |
| | $\Delta PM_t$ | - | -0.009 (-7.09)$^{***}$ | - | 0.113 (2.77)$^{***}$ | - | 0.008 (1.35) |
| Financial Flexibility | $\Delta REA_t$ | - | 0.035 (0.50) | - | 0.251 (3.72)$^{***}$ | - | -0.002 (-0.19) |
| Liquidity Position | $\Delta WCR_t$ | - | 0.001 (6.92)$^{***}$ | - | -0.002 (-1.94)$^{**}$ | - | 0.001 (0.25) |
| | $\Delta CashR_t$ | -0.145 (-1.81)$^{*}$ | - | -0.023 (-0.71) | - | -0.001 (-0.13) | - |
| | $\Delta CR_t$ | - | 0.074 (1.78)$^{*}$ | - | -0.071 (-3.78)$^{***}$ | - | 0.001 (10.95)$^{***}$ |
| Interest Rate | $IR_t$ | -0.76 (-0.63)$^{***}$ | 6.32 (1.76)$^{*}$ | 0.903 (0.85) | -2.87 (-1.06) | 0.96 (1.81)$^{*}$ | 1.22 (1.17) |
| Industry Type | Textiles, Garments & Consumers Goods | 0.034 (2.86)$^{***}$ | - | 0.019 (1.58) | - | -0.001 (-0.34) | - |
| | Paper, Packaging & Plastics | - | - | - | 0.008 (0.75) | - | 0.003 (0.47) |
| | Housing & Real Estate | -0.014 (-2.22)$^{**}$ | - | 0.011 (0.69) | - | 0.003 (1.40) | - |
| | Tourism & Leisure | -0.007 (-1.19) | 0.009 (0.87) | 0.001 (0.01) | -0.002 (-0.28) | - | - |
| | Utilities & Other Services | 0.076 (3.15)$^{***}$ | - | - | - | 0.011 (2.54)$^{***}$ | - |
| Corporate Size | Small Size | -0.008 (-1.54) | - | 0.001 (0.23) | - | -0.001 (-0.44) | - |
| | Medium Size | -0.015 (-2.19)$^{**}$ | - | -0.001 (-0.36) | - | 0.001 (0.24) | - |
| Time Effect | Time Dummy | - | -0.012 (-2.25)$^{**}$ | - | 0.001 (0.28) | - | -0.001 (-0.67) |
| *N* | | 99 | 100 | 157 | 159 | 148 | 138 |
| F statistics | | 5.49$^{***}$ | 99.89$^{***}$ | 2.69$^{***}$ | 10.77$^{***}$ | 3.02$^{***}$ | 8.97$^{***}$ |
| $\overline{R}^2$ | | 0.438 | 0.91 | 0.15 | 0.41 | 0.18 | 0.36 |
| D-W test | | 1.95 | 2.37 | 2.29 | 1.68 | 1.65 | 1.80 |
| Theil Inequality Coefficient | | | | | | | |

**Note:** Regression coefficients (partial adjustment) for the three levels of debt; high medium and low debt ratio. The dependent variables are the long-term debt ratio (t LTDR Δ) and short-term debt ratio (t STDR Δ). The *t*-statistics are shown between brackets. The six regression equations are free from multicollinearity (VIF<5). The heteroskedastic effects are corrected using the White's HCSE, which improves the significance of the OLS estimates.

****D-W test significant at 2% two-sided level of significance
*** Significant at the level 1%
** Significant at the level 5%
* Significant at the level 10%

### Third: The Extent of Debtholders-Stockholders Association of Interests in Egypt

This section discusses the extent to which the debt structure, outlined in the previous section and table (3), is relevant to corporate performance. The relevancy is to be considered it terms of the association between debt structure and corporate performance. At this point, the hypothesis to be tested is "the higher the association between debt structure and corporate performance in the stock market, the higher the association of interests between debtholders and stockholders." In addition, within the context of corporate governance mechanisms, the relevant debt structure is to be considered as a debt governance structure since it refers to a driver of corporate performance. Table (4) reports the results of the association between debt structure (short-term and long-term debt and cross sectional for three classes; high, medium and low debt) and corporate performance in the stock market. The latter is measured by three measures; Market-to-Book Ratio (t MB),Percentage of Market Value Added (t MVA%), and Price/Earnings Ratio (t PE Δ).

**Table 4.** Corporate Debt Governance Structure and Performance

| Corporate Market-based Measures | Relevancy of Debt Governance Structure | Corporate Debt Structure | | | | | |
|---|---|---|---|---|---|---|---|
| | | High Debt Ratio | | Medium Debt Ratio | | Low Debt Ratio | |
| | | Short-Term Debt | Long-term Debt | Short-Term Debt | Long-term Debt | Short-Term Debt | Long-term Debt |
| Market-to-Book Ratio $MB_t$ | Speed of Adjustment $MB_{t-1}$ | 0.71 (10.39)*** | 0.63 (9.56)*** | 0.76 (19.87)*** | 0.76 (20.09)*** | 0.73 (19.26)*** | 0.73 (19.18)*** |
| | Short-term Debt $\Delta STDR_t$ | -1.54 (-1.1) | - | 0.15 (0.31) | - | 0.07 (0.24) | - |
| | Long-term Debt $\Delta LTDR_t$ | - | -1.92 (-1.61) | - | -0.81 (-2.19)** | - | -0.83 (-1.57) |
| | Capital Structure Determinants | Tax Effects (-) Growth (+) Profitability (+) Liquidity (-) Industry Type (+) | Target Debt (+) Industry Leverage (-) Growth (+) Profitability (-) | Profitability (+) Financial Flexibility (-) Industry Type (-) | Long-term Debt (-) Industry Leverage (+) Growth (+) Profitability (+) Interest Rate (+) Industry Type (-) Medium Size (+) | Growth (-) Liquidity (-) Interest Rate (+) | Growth (-) Interest Rate (+) Industry Type (+) Small Size (-) |
| | $\bar{R}^2$ | 0.76 | 0.82 | 0.84 | 0.86 | 0.78 | 0.81 |
| | F statistics | 30.17*** | 25.17*** | 72.8*** | 60.7*** | 56.41*** | 45.15*** |
| Percentage of Market Value Added $MVA\%_t$ | Speed of Adjustment $MVA\%_{t-1}$ | 0.98 (3240)*** | 0.98 (2661.2)*** | 1.08 (677)*** | 1.09 (147)*** | 0.92 (19.78)*** | 0.9 (18.14)*** |
| | Short-term Debt $\Delta STDR_t$ | -0.74 (0.18) | - | 1.86 (2.52)*** | - | 0.24 (0.92) | - |
| | Long-term Debt $\Delta LTDR_t$ | - | -1.51 (-1.73)* | - | -1.94 (-2.51)*** | - | 0.31 (0.68) |
| | Capital Structure Determinants | Tax Effects (-) Profitability (-) Liquidity (+) Time Effect (+) | Long-term Debt (-) Industry Leverage (-) Tax Effects (-) Growth (-) Industry Type (+) | Short-term Debt (+) Tax Effect (+) Growth (+) Profitability (+) Time Effect (+) | Long-term Debt (-) Industry Type (-) | Profitability (-) Interest Rate (+) | Growth (-) Interest rate (+) Small Size (-) Medium Size (+) |
| | $\bar{R}^2$ | 0.99 | 0.99 | 0.99 | 0.98 | 0.91 | 0.90 |
| | F statistics | 715940*** | 149663*** | 38848*** | 716.1*** | 2.04*** | 87.71*** |
| Price/Earnings Ratio $\Delta PE_t$ | Speed of Adjustment $\Delta PE_{t-1}$ | -1.00 (-209)*** | -1.01 (-184)*** | -0.33 (-1.76)*** | -0.008 (-0.88) | -0.77 (-12.4)*** | -0.31 (-5.3)*** |
| | Short-term Debt $\Delta STDR_t$ | -71.04 (-1.93)** | - | 3.06 (0.11) | - | -7.22 (-1.70)* | - |
| | Long-term Debt $\Delta LTDR_t$ | - | -12.59 (-0.68) | - | -5.85 (-1.48) | - | -2.28 (-0.64) |
| | Capital Structure Determinants | Short-term Debt (-) Profitability (-) Liquidity (+) | Target Debt Ratio (-) Growth (+) Profitability (+) Liquidity (-) Interest Rates (+) Industry Type (+) | Liquidity (-) | Industry Leverage (+) Industry Type (+) | Short-term Debt (-) Tax Effects (-) Growth (-) Interest Rate (-) Time Effect (+) | Target Debt (-) Tangibility (-) Growth (mixed) Industry Type (mixed) Small Size (-) |
| | $\bar{R}^2$ | 0.99 | 0.99 | 0.16 | 0.12 | 0.80 | 0.68 |
| | F statistics | 2336*** | 1183.2*** | 3.38*** | 2.15*** | 55.92*** | 20.02*** |

Table (4) summarizes the results of the debt relevancy and firm's stock market performance. The detailed results are reported in tables (A, B, and C) in the appendix. A correlation matrix was carried out for the three stock market-based measures. The correlation coefficients are quite small which ensure that there is not overlap between and among the results of each measure. Table (4) shows that for each performance measure, the estimate of the speed of adjustment shows the extent to which either short-term debt or long-term debt (indigenous) and the associated determinants of capital structure (exogenous) help adjust the firm's stock market performance measure to a target level. The results show that all coefficients of the speed of adjustment are statistically significant. This indicates that either the shortterm or the long-term debt and the associated determinates have a substantial influence of the firm's three stock market-based performance measures. As for the high debt firms, the results show that the long-term debt and shortterm debt have negative and statistically significant relationship with market value added and PE ratio (-1.51 and -71.04 respectively). The combined effects of each one and its associated speed of adjustment add insights from this debt structure. As for the market value added, the negative coefficient of long-term debt and the positive speed of adjustment indicate that the less long-term debt, the higher the market value added in a next period. As for the PE ratio, the negative coefficient of short-term debt and the negative speed of adjustment indicate a positive relationship, that is the less the short-term debt, the less the price-earnings in a next period. In this case, the short-term debt could have been used to improve the PE ratio.

As for the medium debt firms, the results show that both types of debt help adjust the market value added to a target level since the coefficient of the speed of adjustment of each type of debt (1.08 and 1.09 respectively) is positive and statistically significant. It is clear that the positive coefficient of short-term debt (1.86) indicates that this type of debt helps improve the firm's market value added, while the negative coefficient of long-term debt (-1.94) affects the market value added negatively. This shows that the long-term debt is perceived negatively by the stockholders which means that an agency problem exists here between the debtholders and stockholders. As for the low debt firms, short-term debt only has a negative and significant coefficients (-7.22) with the PE ratio. As in the case of high debt levels, the negative coefficient of short-term debt and the negative speed of adjustment (-0.77) indicate a positive relationship, that is the less the short-term debt, the less the price-earnings in a next period. In this case, the short-term debt could be used to improve the PE ratio.

It is worth to note that, with the exception of medium debt in the PE equation, the explanatory power ( $R^2$ ) for the other performance measures are relatively high which indicates a relatively high degree of association between both types of debt with the MB and MVA respectively. That is, the changes in either types of debt and the associated determinants of debt (exogenous variables) have a substantial effects on firms' stock market performance. As for the effects of determinants of capital structure, the results in table (4) show that certain determinants are common among three performance measures. These determinants are firm's growth, profitability, liquidity, interest rate, industry type and size. The coefficients of each present mixed results which indicate that the stock market participants have divergent attitudes toward these determinants. For example, growth and profitability are expected to have a positive relationship while the results show few negative coefficients. In most of the cases, the coefficient of interest rate is positive indicating the firm's do not time the borrowing decisions.

The results also show that the firm specifics (industry type and size) have significant effects. Size has a persisting effect especially in the low debt firms in which small size firms have a significant effects on the three stock market-based performance measures. The negative coefficients show that the small size firms are associated with low levels of the stock market measures. That is, the stock market participants appreciate negatively small firms.

## VI. Conclusion

This study examines one dimension of the agency relationship between debtholders and stockholders. The focus is on the extent to which the debt governance structure is associated with firm's performance in the stock market. The results indicate that in the high debt firms, the less long-term debt, the higher the market value added and the less the short-term debt, the less the PE ratio. This means that the short-term debt can be used to improve the PE ratio. As for the medium debt firms, the results show also that the short-term debt helps improve the market value added. The results of the low debt firms are similar to those of the high debt firms indicating that the shortterm debt can be used to improve the PE ratio. The regression characteristics show that with the exception of medium debt in the PE equation, the explanatory power ( $R^2$ ) for the other performance measures are relatively high which indicates a relatively high degree of association between both types of debt with the MB and MVA respectively.

The overall conclusion is that (1) debt governance structure in Egypt is characterized by the dominance of short-term debt, (2) the latter can be used to improve the firm's performance in the stock market, which shows that the association of interests between debtholders and stockholders is highly likely, and (3) the negative relationships of long-term debt indicate to the presence of an agency problems between debtholders and stockholders. A further

research on this path using measures of debtholders' interests can be pursued to examine the extent to which the use of short-term debt can mitigate the agency problems between debtholders and stockholders.

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**Appendix**

Table (A)

Debt Governance Structure and Performance for the High Debt Firms

| *Dependents*: Long-term Debt Ratio | | Short-term Debt | | | Long-term Debt | | |
|---|---|---|---|---|---|---|---|
| | | $MB_t$ | $MVA\%_t$ | $\Delta PE_t$ | $MB_t$ | $MVA\%_t$ | $\Delta PE_t$ |
| *Independents*: Constant | | 2.32 | -1.15 | -190.3 | -3.59 | 3.83 | -321.2 |
| Market-to-book | Speed of adjustment $MB_{t-1}$ | 0.71 (10.39)*** | - | - | 0.63 (9.56)*** | - | - |
| Market Value Added (%) | Speed of adjustment $MVA\%_{t-1}$ | - | 0.98 (3240)*** | - | - | 0.98 (2661.2)*** | - |
| Price-Earnings Ratio | Speed of adjustment $\Delta PE_{t-1}$ | - | - | -1.00 (-209)*** | - | - | -1.01 (-184)*** |
| Short-term Debt Ratio | $\Delta STDR_t$ | -1.54 (-1.1) | -0.74 (0.18) | -71.04 (-1.93)** | - | - | - |
| Long-term Debt Ratio | $\Delta LTDR_t$ | - | - | - | -1.92 (-1.61) | -1.51 (-1.73)* | -12.59 (-0.68) |
| Target Debt Ratio | $DE_{t+1}$ | - | - | - | 0.03 (1.99)** | -0.004 (-0.26) | -1.12 (-2.6)*** |
| Average Industry Leverage | $\Delta DR_{AVGt}$ | - | - | - | -4.81 (-2.31)** | -4.44 (-1.69)* | 104.9 (1.55) |
| Structure of Tangible Assets | $FATA_t$ | - | - | - | 0.22 (0.81) | 0.33 (0.86) | -4.69 (-0.39) |
| Relative Tax Effects | $\Delta NDTAX_t$ | -3.80 (-2.08)** | -9.56 (-2.38)*** | 25.96 (0.30) | - | - | - |
| Relative Tax Effects | $\Delta NDTA_t$ | - | - | - | -0.48 (-0.34) | -8.88 (-1.80)* | -28.7 (-0.65) |
| Growth | $CETA_t$ | - | - | - | 0.01 (1.18) | -0.001 (-0.18) | 0.005 (0.01) |
| | $GTA_t$ | - | - | - | 0.3 (1.66)* | -2.4 (-9.56)*** | 32.1 (1.67)* |
| | $SG_t$ | 0.18 (2.13)** | 0.04 (0.71) | -2.66 (-0.97) | 0.18 (2.18)** | 0.09 (1.03) | -3.31 (-1.37) |
| Profitability | $\Delta EBITDA_t$ | - | - | - | -3.79 (-2.02)** | -1.68 (-1.27) | 84.01 (1.90)* |
| | $\Delta PM_t$ | 0.03 (1.96)** | -0.08 (-11.51)*** | -0.61 (-2.22)** | - | - | - |
| Financial Flexibility | $\Delta REA_t$ | -1.79 (-1.59) | -0.08 (-0.30) | 5.13 (0.52) | - | - | - |
| Liquidity Position | $\Delta WCR_t$ | -0.004 (-1.95)** | 0.01 (21.27)*** | 0.09 (2.62)*** | - | - | - |
| | $\Delta CashR_t$ | - | - | - | 3.56 (1.42) | -0.60 (-0.34) | -109.2 (-1.82)* |
| | $\Delta CR_t$ | -0.44 (-0.85) | 0.66 (2.46)*** | 26.1 (1.89)** | - | - | - |

*Table A continued*

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Interest Rate | $IR_t$ | -16.33 (-0.34) | 6.61 (0.22) | 1438 (1.29) | 26.36 (0.91) | -30.73 (-0.93) | 2440.3 (1.96)* |
| Industry Type | Textiles, Garments & Consumers Goods | - | - | - | -0.44 (-0.53) | -0.57 (-1.21) | -7.12 (-0.44) |
| | Housing & Real Estate | - | - | - | -0.11 (-0.4) | 0.4 (1.67)* | 12.5 (2.01)** |
| | Tourism & Leisure | 0.13 (0.66)*** | -0.001 (-0.01) | -1.22 (-0.34) | 0.24 (1.11) | 0.27 (1.36) | 3.60 (0.49) |
| | Utilities & Other Services | - | - | - | 0.10 (0.31) | -0.11 (-0.36) | 8.55 (0.46) |
| Corporate Size | Small Size | - | - | - | 0.12 (0.72) | 0.16 (1.04) | -2.86 (-0.56) |
| | Medium Size | - | - | - | -0.23 (-1.26) | 0.01 (0.07) | 1.92 (0.32) |
| Time Effect | Time Dummy | -0.001 (-0.01) | 0.06 (1.71)* | -0.13 (-0.09) | - | - | - |
| *N* | | 98 | 82 | 92 | 96 | 84 | 96 |
| F statistics | | 30.17*** | 715940*** | 2336*** | 25.17*** | 149663*** | 1183.2*** |
| $\overline{R}^2$ | | 0.76 | 0.99 | 0.99 | 0.82 | 0.99 | 0.99 |
| D-W test | | 1.51**** | 2.51**** | 1.83**** | 1.71**** | 1.79**** | 2.55**** |

**Note:** Regression coefficients (partial adjustment) for Corporate stock market performance. The dependent variables are measures of Corporate stock market. The *t*-statistics are shown between brackets. The six regression equations are free from multicollinearity (VIF<5). The heteroskedastic effects are corrected using the White's HCSE, which improves the significance of the OLS estimates.

****D-W test significant at 2% two-sided level of significance

*** Significant at the level 1%

** Significant at the level 5%

* Significant at the level 10%

Table (B)

The Debt Governance Structure and Performance for the Medium Debt Firms

| *Dependents*: Long-term Debt Ratio | | Short-term Debt | | | Long-term Debt | | |
|---|---|---|---|---|---|---|---|
| | | $MB_t$ | $MVA\%_t$ | $\Delta PE_t$ | $MB_t$ | $MVA\%_t$ | $\Delta PE_t$ |
| ***Independents*:** Constant | | -1.45 | -3.79 | 383.4 | -4.81 | -39.9 | -16.7 |
| Market-to-book | Speed of adjustment $MB_{t-1}$ | 0.76 (19.87)*** | - | - | 0.76 (20.09)*** | - | - |
| Market Value Added (%) | Speed of adjustment $MVA\%_{t-1}$ | - | 1.08 (677)*** | - | - | 1.09 (147)*** | - |
| Price-Earnings Ratio | Speed of adjustment $\Delta PE_{t-1}$ | - | - | -0.33 (-1.76)* | - | - | -0.008 (-0.88) |
| Short-term Debt Ratio | $\Delta STDR_t$ | 0.15 (0.31) | 1.86 (2.52)*** | 3.06 (0.11) | - | - | - |
| Long-term Debt Ratio | $\Delta LTDR_t$ | - | - | - | -0.81 (-2.19)** | -1.94 (-2.51)*** | -5.85 (-1.48) |
| Target Debt Ratio | $DE_{t+1}$ | - | - | - | 0.008 (0.38) | 0.09 (0.64) | -0.24 (-1.53) |
| Average Industry Leverage | $\Delta DR_{AVGt}$ | - | - | - | 1.87 (2.09)** | 0.98 (0.36) | 15.98 (2.53)*** |
| Structure of Tangible Assets | $FATA_t$ | - | - | - | 0.14 (0.85) | -0.88 (-0.84) | 2.53 (1.6) |
| Relative Tax Effects | $\Delta NDTAX_t$ | 2.45 (0.81) | 1.09 (0.47)*** | 95.53 (0.5) | - | - | - |
| Relative Tax Effects | $\Delta NDTA_t$ | - | - | - | 0.27 (0.14) | -4.35 (-0.76) | 6.62 (0.55) |
| Growth | $CETA_t$ | - | - | - | 0.001 (0.31) | -0.001 (-0.18) | 0.02 (1.14) |
| | $GTA_t$ | - | - | - | 0.11 (0.66) | 1.07 (1.46) | -1.47 (-1.28) |
| | $SG_t$ | 0.03 (0.81) | 0.06 (1.68)* | -7.14 (-1.33) | -0.02 (-1.28) | 0.01 (0.16) | -0.45 (-1.17) |
| Profitability | $\Delta EBITDA_t$ | - | - | - | 3.22 (4.20)*** | 2.4 (1.46) | -1.10 (-0.2) |
| | $\Delta PM_t$ | 0.69 (5.44)*** | 0.89 (2.15)** | -11.71 (-1.09) | - | - | - |
| Financial Flexibility | $\Delta REA_t$ | -1.01 (-2.12)** | -1.06 (-1.35) | 18.34 (0.42) | - | - | - |
| Liquidity Position | $\Delta WCR_t$ | 0.002 (0.06) | -0.001 (-0.04) | -0.69 (-0.33) | - | - | - |
| | $\Delta CashR_t$ | - | - | - | 0.23 (0.46) | 0.15 (0.12) | -5.68 (-1.6) |
| | $\Delta CR_t$ | -0.01 (-0.11) | 0.03 (0.28) | -12.43 (-1.74)* | - | - | - |
| Interest Rate | $IR_t$ | - | - | - | 37.1 (2.72)*** | 290.2 (1.23) | 124 (1.16) |

*Table B continued*

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Industry Type | Textiles, Garments & Consumers Goods | - | - | - | -0.04 (-0.32) | -0.41 (-0.60) | 4.22 (3.44)*** |
| | Paper, Packaging & Plastics | -0.08 (-1.43) | -0.18 (-0.8) | 10.59 (0.93) | - | - | - |
| | Housing & Real Estate | - | - | - | -0.11 (-0.61) | -1.48 (-3.8)*** | 2.84 (1.51) |
| | Tourism & Leisure | -0.18 (-2.92)*** | 0.08 (0.49) | 2.46 (0.58) | -0.16 (-1.87)* | 0.02 (0.06) | 1.23 (1.51) |
| Corporate Size | Small Size | - | - | - | 0.01 (0.21) | 1.46 (0.98) | -0.72 (-0.89) |
| | Medium Size | - | - | - | 0.01 (0.26)*** | 1.29 (0.91) | -0.69 (-1.18) |
| Time Effect | Time Dummy X45 | 0.02 (1.01) | 0.09 (2.11)** | -0.94 (-0.53) | - | - | - |
| *N* | | 159 | 140 | 151 | 160 | 135 | 140 |
| F statistics | | 72.8*** | 38848*** | 3.38*** | 60.7*** | 716.1*** | 2.15*** |
| $\overline{R}^2$ | | 0.84 | 0.99 | 0.16 | 0.86 | 0.98 | 0.12 |
| D-W test | | 2.12**** | 1.89**** | 2.41**** | 2.15**** | 2.05**** | 2.17**** |

**Note:** Regression coefficients (partial adjustment) for corporate stock market performance. The dependent variables are measures of corporate stock market. The *t*-statistics are shown between brackets. The six regression equations are free from multicollinearity (VIF<5). The heteroskedastic effects are corrected using the White's HCSE, which improves the significance of the OLS estimates.

****D-W test significant at 2% two-sided level of significance

*** Significant at the level 1%

** Significant at the level 5%

* Significant at the level 10%

Table (C)

Debt Governance Structure and Corporate Performance for the Low Debt Firms

| *Dependents*: Long-term Debt Ratio | | Short-term Debt | | | Long-term Debt | | |
|---|---|---|---|---|---|---|---|
| | | $MB_t$ | $MVA\%_t$ | $\Delta PE_t$ | $MB_t$ | $MVA\%_t$ | $\Delta PE_t$ |
| ***Independents*:** Constant | | -8.02 | -7.52 | 74.09 | -8.85 | -5.74 | 14.73 |
| Market-to-book | Speed of adjustment $MB_{t-1}$ | 0.73 (19.26)*** | - | - | 0.73 (19.18)*** | - | - |
| Market Value Added (%) | Speed of adjustment $MVA\%_{t-1}$ | - | 0.92 (19.78)*** | - | - | 0.9 (18.41)*** | - |
| Price-Earnings Ratio | Speed of adjustment $\Delta PE_{t-1}$ | - | - | -0.77 (-12.4)*** | - | - | -0.31 (-5.3)*** |
| Short-term Debt Ratio | $\Delta STDR_t$ | 0.07 (0.24) | 0.24 (0.92) | -7.22 (-1.70)* | - | - | - |
| Long-term Debt Ratio | $\Delta LTDR_t$ | - | - | - | -0.83 (-1.57) | 0.31 (0.68) | -2.28 (-0.64) |
| Target Debt Ratio | $DE_{t+1}$ | - | - | - | -0.007 (-0.21) | -0.05 (-1.32) | -1.27 (-3.1)*** |
| Average Industry Leverage | $\Delta DR_{AVGt}$ | - | - | - | -0.31 (-0.40) | -0.57 (-0.72) | -10.89 (-1.24) |
| Structure of Tangible Assets | $FATA_t$ | - | - | - | 0.09 (0.68) | -0.21 (-1.39) | -4.55 (-2.9)*** |
| Relative Tax Effects | $\Delta NDTAX_t$ | 0.49 (0.27) | 0.20 (0.21) | -16.52 (-2.04)** | - | - | - |
| Relative Tax Effect | $\Delta NDTA_t$ | - | - | - | -1.85 (-0.85) | -0.95 (-0.47) | 11.53 (0.24) |
| Growth | $CETA_t$ | - | - | - | -0.008 (-2.26)** | 0.001 (0.38) | -0.01 (-0.43) |
| | $GTA_t$ | - | - | - | -0.33 (-2.24)** | -0.36 (-3.3)*** | 3.52 (2.5)*** |
| | $SG_t$ | -0.11 (-1.67)* | -0.07 (-1.01) | -4.57 (-3.61)*** | -0.07 (-1.94)** | -0.09 (-2.13)** | -5.44 (-5.13)*** |
| Profitability | $\Delta EBITDA_t$ | - | - | - | -0.03 (-0.82) | -0.01 (-0.38) | 0.15 (0.17) |
| | $\Delta PM_t$ | 0.01 (0.07) | -0.28 (-1.88)* | 1.06 (0.47) | - | - | - |
| Financial Flexibility | $\Delta REA_t$ | -0.53 (-1.57) | -0.31 (-1.46) | -0.96 (-0.36) | - | - | - |
| Liquidity Position | $\Delta WCR_t$ | -0.009 (-0.26) | -0.007 (-0.19) | -0.33 (-0.64) | - | - | - |
| | $\Delta CashR_t$ | - | - | - | -0.04 (-0.12) | -0.54 (-1.34) | -3.66 (-0.96) |
| | $\Delta CR_t$ | -0.001 (-2.19)** | -0.001 (-0.69) | 0.001 (0.27) | - | - | - |
| Interest Rate | $IR_t$ | 60.88 (2.91)*** | 56.09 (2.88)*** | -576.3 (-2.33)** | 67.55 (5.1)*** | 42.93 (2.72)*** | -103.1 (-0.69) |

*Table C continued*

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Industry Type | Textiles, Garments & Consumers Goods | - | - | - | -0.07 (-0.71) | 0.17 (0.95) | 0.79 (0.52) |
| | Paper, Packaging & Plastics | -0.05 (-0.35) | -0.02 (-0.18) | -0.55 (-0.68) | - | - | - |
| | Housing & Real Estate | - | - | - | 0.01 (0.15) | -0.02 (-0.13) | -2.95 (-2.08)** |
| | Utilities & Other Services | - | - | - | 0.21 (1.81)* | 0.06 (0.89) | 2.47 (2.22)** |
| Corporate Size | Small Size | - | - | - | -0.24 (-2.77)*** | -0.16 (-1.93)** | -1.42 (-1.71)* |
| | Medium Size | - | - | - | 0.01 (0.14) | 0.12 (1.69)* | 0.71 (0.98) |
| Time Effect | Time Dummy | 0.01 (0.51) | -0.01 (-0.63) | 0.77 (2.65)*** | - | - | - |
| $N$ | | 169 | 159 | 152 | 167 | 154 | 147 |
| F statistics | | 56.41*** | 152.48*** | 55.92*** | 45.15*** | 87.71*** | 20.02*** |
| $\overline{R}^2$ | | 0.78 | 0.91 | 0.80 | 0.81 | 0.90 | 0.68 |
| D-W test | | 1.7**** | 2.04**** | 1.82**** | 1.91**** | 2.31**** | 1.91**** |

**Note:** Regression coefficients (partial adjustment) for corporate stock market performance. The dependent variables are measures of corporate stock market performance. The *t*-statistics are shown between brackets. The six regression equations are free from multicollinearity (VIF<5). The heteroskedastic effects are corrected using the White's HCSE, which improves the significance of the OLS estimates.

****D-W test significant at 2% two-sided level of significance

*** Significant at the level 1%

** Significant at the level 5%

* Significant at the level 10%

# ECONOMIC AND CORPORATE GOVERNANCE

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## Introduction

"Governance" has emerged in the social sciences and public policies only in the last two decades, although, according to Webster's Collegiate Dictionary, the word is rooted in Middle English. There, however, it was identified with government, i.e. with state authorities. Nevertheless, it was hardly used until recently.

With its re-invention, governance is no longer confined to public government but it now reflects renewed interest in diversity and comparative structures, processes and performance of allocation mechanisms, (economic) systems, or organisational forms through which economic agents interact and get coordinated. The shift is indicative of the fact that the ideal, competitive "market", largely viewed as the optimal system and measuring-rod by mainstream economics and economic policies, is far from being the problem-solving device in a complex world and, therefore, has to be complemented, (re-) embedded or substituted by competing forms of coordination. Hierarchy (bureaucracy, private and public), network forms of cooperation and their hybrid forms are at stake. "Governance" now pertains to diverse forms of coordination of agents beyond the ideal "market".

The issue of "allocation" and distribution of resources, information, power, rights and duties, as well as income and wealth, has become more open with the recognition that forms of coordination can be quite diverse. Moreover, each coordination mechanism may have a number of sub-versions. The problem of economic coordination and performance, thus, can no longer be fruitfully dealt with in the axiomatic world of the "pure" logic of (general) "market" equilibrium models.

The new relevance of governance expresses the fact that we face complex economic conditions that call for more adequate forms of coordination beyond (1) the "market", (2) the "black box" of the (isolated) firm and (3) a largely non-reflexive state. In a genuinely complex world, only forms of coordination which can deal with this increased complexity are capable of maintaining and improving economic performance. Starting from a simple "baseline" for any coordination mechanism, i.e. structure + governance = performance, the economic problem, basically, is to work through a potentially great number of combinations of structural forms of these mechanisms, procedural rules, and resulting levels of economic efficacy.

Here, the rules that shape the processes which may lead to coordination, given a certain structure, and in order to generate high economic performance, are at the core of governance. In other words, governance is about "governing", "policing" and "managing" problem-solving processes through certain rules and principles. "The challenge is less that of building capacity to compete, but capacity to evolve in order to compete" (Amin, Hausner 1997, 28).

"Governance" has experienced proliferating, and increasingly vague meanings. At present, a general definition is not at hand. Any debate on economic development, from LDCs to local communities, from "governance" of the global system to the corporation, from "transitional" economies to "structural reforms" of the welfare state, is increasingly anchored around "governance", where its vague content is prone to be used or misused in many ways. Against this background, it seems reasonable to anchor its meaning to some basic theoretical framework. So we will try to reduce the "complexity" of its use and to focus on a basic explanation.

## Definitions

The Commission on Global Governance, in a 1995 report, defined governance as "the sum of the many ways (…) [agents] manage their common affairs. It

is a continuing process (…) It includes formal (…) as well as informal arrangements (…)" (Commission on Global Governance 1995, 3). The understanding here seems to be that governance reflects (1) the existence of many agents involved who have (2) common problems to be solved, which in turn requires (3) continuing processes rather than a single "rational" calculus, and which lead to the (4) emergence of informal institutional arrangements together with the deliberate installation of formal institutions. In 1997, the United Nations Development Program (UNDP) took a step further by connecting governance with the (continuing) interaction among diverse agents (public, private, commercial and societal) which will lead to a form of lasting cooperation, i.e., that was termed a network (United Nations Development Program 1997). Schmitter has defined governance as "a method/mechanism for dealing with a broad range of problems/conflicts in which actors regularly arrive at mutually (..) binding decisions by (…) cooperating in the implementation of these decisions" (Schmitter 2002, 53; also, e.g., Prakash, Hart 1999, 2).

Governance seems to make sense only if understood in the framework of a genuinely socio-economic and societal conception where more than one agent are involved who are directly interdependent with each other, i.e., beyond arm's length relations defined by "markets", and recurrently interacting, in this way entering open-ended processes that may result in collectively learned and self-sustaining coordination, through institutionalised cooperation, in order to solve problems that are common, but nevertheless involve incentive structures that render individual interests mixed, i.e. both partly converging and conflicting.

We can easily agree, therefore, that a definition of "governance as the art of complexity" (Jessop 1997, 101), is in contrast to ideal "markets" and hierarchies. Governance can be defined as the set of principles and rules that determine the interaction processes (i.e., exchange, collective learning) among individual agents in specific allocation mechanisms (i.e., hierarchy, network, "market", and hybrids), with specific structures, in order to obtain high and increasing levels of performance (i.e., production, innovation). We will not delve deeper into specific variants and applications of governance such as "global", "local" and "multilevel" governance (for overviews of such applications, s., e.g., Pierre 2000; Wolf 2002). In the following we will stick to a more basic view.

## Economic "Mainstream" Governance Agenda

The objective of neoclassical approaches, and "neo-liberal" political postulates, is the avoidance of the full implications of complexity. This applies to the "general market" theory, i.e., GET, to Hayek, and to Coase's understanding of man-nature interactions, as well as man-to-man bargaining in his theory of social costs. This avoidance saves isolated individualist rationality and, thus, the ideal "market" form of coordination. It even downplays the conception of transaction costs, which can be infinitely high in situations involving strong uncertainty.

From the "neo-liberal" policy perspective, governance is primarily an instrument to increase "market efficiency". A major application is public administration efficiency, which rationalizes the reduction of welfare state activity. The mainstream's political programme, therefore, is about ideal, unrestricted property rights, privatisation of any commons, and about generating, by de-regulation, a maximum of liberties in the exercise of such property rights.

## Hidden Governance of the (Ideal) "Market Economy"

Ideal "markets" can not cope with complexity originating in direct interdependencies among individual agents, as they are systems of isolated individual agents who have only man-good relationships. These relations are determined, in the general equilibrium of a "market economy", through a price vector that depends on the aggregated supply and demand decisions of all isolated sellers and buyers in the different "markets". Agents are indirectly interdependent in that the equilibrium price vector depends on the all other agents taken together. However, as no decentralised, direct man-to-man interactions (i.e., exchange bargaining) can be accommodated in the GET, mere existence of a general equilibrium of the "market economy" is feasible only by accepting the fiction that any decentralised exchange cannot be allowed before the equilibrium price vector is determined. This, in turn, implies that the "market economy" is governed by a central, authoritarian entity, i.e., the auctioneer. The hidden governance of the general equilibrium and optimality conception, with its specific structure, thus, turns out to pervert its initial governance postulates of individualism, perfect liberties and rights into the most centralised and dictatorial governance comprehensible (for a critical discussion of the neoclassical research programme, s., e.g., Mirowski 1989; Potts 2000; Wellhoener 2002). The "market economy" cannot be comprehended in any sense as an institution-free construct in a pure physical-mechanical analogy. Its governance implications have drastically reduced its applicability and scientific attractiveness and have lead to different approaches within the framework of "free markets".

## Hayekian Evolutionary "Market"

The Hayekian approach relaxes the informational assumptions for the individual agent and, in this way, permits roles for uncertainty, search and adaptation,



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which, in turn, comprise an evolutionary approach to the "market" mechanism. However, other basic assumptions remain unchanged so that the consideration of complexity, and of different allocation mechanisms, is avoided. In the Hayekian world, "market" prices still contain and diffuse enough information to enable individual agents to effectively search, behave and adapt as isolated and individualistically rational units. Direct interdependencies are avoided, and the decentralised "market" remains the optimal mechanism, in some "evolutionary" sense, though. Under informational restriction, individuals may search and learn, even from each other, but they behave in their isolated, optimal way.

Jessop is right to qualify this as an a priori reduction of complexity to save the "market" ideal: "Such incrementalism is sub-optimal from a governance viewpoint because it is based on short-run, localised, ad hoc responses" (Jessop 1997, 101). In contrast, mutual direct interdependencies and related "socially complex orders defy both centralized and spontaneous forms of governance" (Amin, Hausner 1997, 27), specifically, they defy isolated individualist forms of spontaneous self-governance that ignore the full implications of complexity.

## Transaction Cost Economics: the "Market" and Corporate Governance

The transaction cost analysis of governance takes place in the framework of the theory of the firm, that is, between the twin forms of "market" versus "hierarchy" (Zingales 1997). Economising transaction costs and their influential conditions form the basis of the attempt to delimit these two basic governance regimes against each other (Williamson 1996, 93ff.). The "organisational theory" branch of transaction cost economics pertains to the relative efficiencies of the two mechanisms. The corporate governance branch, being closer to real-world problems, proceeds from informational limits of some kind (namely bounded rationality) and from the incompleteness of contracts. This gives way to opportunism and moral hazard in principal-agent relations. The latter apply to owner/shareholder-management relations, being extended to capital market issues, and to management-employee relations, including labour market issues.

Governance then is defined as "(serving) to mitigate hazards related directly to bounded rationality and opportunism" (Williamson 1996, 12; s. also Zingales 1997, 500f.). According to Williamson, contracting gives rise to "bilateral dependency" (not the other way round!), out of a "large numbers-supply condition" (in the "market" as well as in the commons). Mutual dependency, in turn, specifically when combined with asymmetric information, gives rise to the problem of moral hazard (Williamson 1996, 13ff.). Governance, then, involves the set of mechanisms that shape the ex-post bargaining over the distribution of the economic effects generated in the course of an incomplete contract (also Zingales 1997).

Utilising the theoretical conceptions and ideas of the transaction as the basic unit of analysis, limited rationality and asymmetric information, incomplete property and contracts, institutions, mutual dependency (beyond the price relation), (strong) uncertainty, adaptation and evolution, Williamson's organisational approach to governance contrasts with mainstream analysis and aligns itself with institutional(ist) and evolutionary approaches (Williamson 1996, 3ff., 93).

Nevertheless, with respect to spontaneous, self-governing arrangements, Williamson favours a spontaneous competitive "market" which presumably produces arrangements that minimize opportunism/moral hazard in and between companies/employees. This approach clearly supports a neoclassical "'nearly' hands-off" political view (Williamson 1996, 145ff.).

## Institutional(ist) Governance Agenda

In the Original Institutional Economics, governance is viewed as a participatory, inclusive and discursive form of management to cope with complex economic problems that have a genuinely socio-economic, i.e. societal, character.

In the Twenties and Thirties, Commons developed an elaborate system of governance for a society that is characterised by ubiquitous conflicts of interest over the bundles of rights and duties connected with transactions. Physical exchange of a "good" consists of a variety of transactions involving different rights and duties, liberties and exposures. The allocation of rights and duties to different agents constitutes direct interdependencies beyond price-determined and arm's length "market" relations. Consequently, it is social institutions which determine these allocations, bargaining processes, relative prices, and the distribution of income, wealth and power. The institutions may be changed in manifold ways to better serve future negotiations of interest conflicts. Resulting prices and distributions must be transparent and reasonable for the different social groups. Thus, the structure of values that may minimise the level of conflict has the character of a collective good. These, in turn, can be generated only through all agents taking their common future into account (futurity). Effective collective action, not at least public action, is needed to shape the institutional conditions for the generation of an overall reasonable structure of values.

This is the idea behind the negotiated economy concept, which is connected to an institutional reform policy agenda (Commons 1934/1990). It is a participative policy conception. At its basis are transactions involving direct man-to-man relations.

As institutions determine the allocation of rights and duties, they are restrictions as well as enablers of individual action. They restrict, and free, individual action. Without institutions, action could easily be blocked, misled, reduced or distracted in a complex, turbulent and highly uncertain environment.

Obviously, governance is a non-trivial issue that requires “processuality”, futurity, institutionalisation and continuous institutional reform in order to solve complex collective problems with mixed interests, through societal coordination and coherence. So, for instance, the institutionalist analysis of corporate governance that was established by Berle and Means in the early thirties involved the relative power of organisation both within and outside of contracts, and inside and outside of hierarchy (for example, vis-à-vis households and the general public), and its distributional effects (Berle, Means 1932).

Other institutional economists like Polanyi (1957) and Boulding (1970) have dealt with the real-world diversity of coordination mechanisms and their hybrids that realise relative efficacies in evolving processes. The processes involve collective learning of forms of coordination in complex environments, where the common future is important to the agents and where the emergence of trust, commitment and institutional behaviour are supportive.

This institutional analysis of governance is far from assuming any kind of “optimality”, “efficiency” or “teleology” of interactions and processes. Rather, it is about ubiquitous potential blockage of action and of forms of “wrong”, “outmoded”, or “petrified” forms of coordination where institutions that once helped coordinating agents have become “sclerotic” and rigid (institutional hysteresis), prematurely age, and coordinated behaviours become locked-in (also, e.g., Arthur et al. 1985; David 1985; Schoenig 2001, 313-330; Javary 2001). Whether and in which ways this may happen is analysed using path dependence. Blocked or locked-in processes call for continuing examination of institutionalised governance to renew collective action capacity in order to leave an “old” path and a locked-in situation when their efficacy has decreased to non-acceptable levels.

## Real World Governance Problems Today: Interdependence, Complexity, Uncertainty, and Networks

The economy is a socio-economy in the sense that its agents are directly interdependent in manifold ways. Particularly, the modern economy has assumed a more de-regulated, net-based, and clustered character through continuing intensification of direct interdependencies, where the outcome for A directly depends on the behaviour of B, and vice versa.

Direct interdependencies are genuinely complex, and complex situations, in turn, cause non-trivial coordination problems. They involve direct interactions of agents, which can neither be effectively conceptualised nor performed by the ideal “market”. Prices do not account for direct interdependencies and, therefore, are incapable of generating and diffusing information and the formation of future expectations required to effectively coordinate agents. They cannot stimulate the collective action capacity required in complex situations.

"Neo-liberal" globalisation is a political and administrative project, regulated by highly selective strategies of de-regulation and empowerment of capital and corporate concerns (e.g., Elsner 2003). The global layer of exclusive activities has become dis-embedded from the social institutions that used to exist in the nation-states and in national, regional, and local cultures. The "neo-liberal" construction of the global space has deliberately reduced collective action and social control capacities. It has, thus, become a system of social fragmentation (in addition to spatial fragmentation) and can be called a system in "institutional disequilibrium" (Padoan 2001). Being "under-socialized", it does not provide enough "structure". This is true even for the most powerful individual corporate agents. Hence, the corporate economy, being insufficiently co-ordinated, faces increased uncertainty and turbulence. As a result, instability and transaction costs (especially, information costs) have increased. Consequently, powerful corporate organizations find it necessary to increase their power even more to keep control over their socio-economic environment and, thus, the global system has increasingly become a power-based, and re-distributive, mechanism, generating ubiquitous negative external effects on third parties, the social commons and the natural environment, rather than a mechanism for comprehensive, sustainable and deliberate innovation and capacity enhancement. Increased uncertainty, instability and turbulence generally have assumed levels that are counterproductive for problem-solving.

Note that we are discussing true uncertainty which is "strategic" in the sense that, with ever more fragmentation, the individual agent can neither know at the outset nor calculate with a certain probability, the strategic choices of other agents (e.g., Dequech 2001, 919f.).

Globalisation has also increased the momentum of vertical disintegration in value-added chains and the redefinition of the boundaries of corporate organization in an effort to reduce labour costs and to control an enhanced labour force world-wide. Value-added chains not only have been spatially fragmented by selecting labour and suppliers at optimal locations around the globe, they have also become functionally fragmented.

Functional fragmentation involves securing technological compatibility and complementarity in the chain in an effort to create coordination and quasi-reintegration of production and innovation (on a fragmented basis). Again, it has involved

individualistic, power-led solutions on a hierarchical basis, e.g., the transnational corporation and its centralized hub&spoke supplier networks.

In addition, the "new" economy is characterised by net-based technologies. As such, no decision can be made without a technical dimension, and no technically influenced decision can be made without technical complementarity and compatibility with others. In this way, each decision, piece of information, and innovation possesses positive or negative externalities. Every decision is relevant for effective communication and interaction among agents.

This is but one aspect of the fact that information today increasingly displays the features of a collective good. Information has always been characterized by non-rivalry in consumption. Regardless of the fact that generating and exploiting asymmetric information is a dominant and "rational" opportunistic strategy in an individualist environment, joint use (joint consumption) of information is welfare-enhancing and increasingly becomes a basic necessity for social coordination. It is well known in economic theory that the total societal benefit of information, as with collective goods in general, increases with the number of its users. Basic information, thus, is systemic - and it is generated collectively from billions of acts of behaviour and learning. Against this background, production and innovation have become systemic as well. Digital microelectronic technologies have added another characteristic to the collective-good property of information: the (re-)production of most information takes place at near-to-zero marginal costs. Further, microelectronic information has virtually become subject to non-exclusion, rendering information a full-fledged collective good (e.g., Gallaway, Kinnear 2002).

Finally, information and technological knowledge are increasingly user- and context-specific and tacit, and must be developed and learned in a dense, common interactive process.

With accelerating innovation and competing (initially, non-standardized) technologies, uncertain, reluctant and passive, or even completely blocked agents have become an ubiquitous latent feature of the economy (e.g., Tirole 1995, chp. 10.6). The introduction of color TV, video-systems, high-definition TV and computer operating systems are examples from the recent industrial history that demonstrate the ubiquity of latent collective blockages and impeded dissemination of innovation.

It has become more difficult under these circumstances to collect profit in the conventionally commercial way, i.e. through "markets". The recent political and administrative efforts to secure and increase profits through ever more protected “intellectual property rights”, in turn, endanger a continued process of rapid generation and diffusion of new information, knowledge, and cultural material. This agrees with the artificial "construction of scarcity" of information which could easily be provided as a public good and largely be available for free. The enforced power structure, thus, "is increasingly at odds with technological reality" (Gallaway, Kinnear 2002, 446).

Besides huge global private power-led (“hub&spoke”) networks, international private-public bureaucracies have been established to assist the development of technological standard-setting, interface definitions and transfer protocols in order to prevent potential blockages from becoming effective (e.g., Weitzel, Westarp 2002).

All production, exchange, and innovation increasingly include the dimension of a collective good or a social dilemma. Here, individual agents have to actively cooperate (i.e., to give some sacrifice of immediate self-interest) to generate an effective outcome, but at the same time have individualistic incentives not to do so, and even to gain an extra one-shot profit by exploiting others, if these contribute to the collective outcome. This is a complex situation where coordination is non-trivial.

The corporate economy, including SMEs, has developed new spatial forms of organisation such as local clustering in order to establish solutions to compensate for the coordination failures of the markets. Here, agents may enter into processes of collective learning of correlated behaviour that coordinates them in a non-"market" way and helps them solve the collective dilemma problems in the background. And clusters may be an effective basis for a more consciously developed kind of coordination, i.e. networks, normally established by some subset of firms in the cluster, and on the basis of the trust that has emerged (e.g., Elsner 2000, 413).

## Self-Governing Network Coordination in a Complex Environment?

However, can “progressive”, i.e., problem-solving networks spontaneously evolve, and be self-sustaining and self-governing?

Real worlds of collective-goods and social dilemmas are complex with their multiple relations among agents (e.g., Delorme 2001). As every decision/action even in any real "market" has to contribute to some collective framework good, i.e., the (re-)production of the environment of social rules (e.g., Callon 1998; MacEwan 2000, chp. 4), this also reflects the fact that the economy inevitably is a socio-economy and that production, exchange and innovation have a collective and dilemma-prone dimension. Effective action becomes feasible only by way of complexity reduction. Decreasing the number of potential multiple relations down to some effective coordinated way of behaviour is feasible only through collectively learned institutions of cooperation.

There are many approaches and models to formalize cultural-evolutionary processes which employ mechanisms of "selection", "crossing",

"mutation" and individual adaptation through learning (from one's own experience, through imitation, etc.). They formally show that cultural evolution in dilemma-prone settings may result in the emergence of an institution of cooperation, where reciprocal cooperation may be self-sustaining, specifically through the built-in sanction mechanism (e.g., Axelrod 1984; Hirshleifer 1997; Dixit 2001; s. Elsner 2004, for an overview of the argument).

The behaviour which results habitually excludes or restricts the strive for short-run maximization, i.e., a social institution of cooperation emerges in spite of continuing incentives to defect. Individuals, then, can reasonably be expected to act effectively, i.e., to manage the now reduced level of uncertainty. In this way, they become capable and inclined to innovate, that is, to develop more comprehensive and continuous solutions through future-bound collective-action capacity.

## "Network Failure", and Network Lifecycles

Networks can be viewed as real-world forms of such emergent cooperation. Progressive networks are structures and governance regimes that solve problems and are innovative in a wide sense, but do not generate and protect invidious power.

However, the reality of power-centered de-regulated "market" economies imply that networks become dominated by powerful corporate agents. Being private solutions, unregulated networks, in the reality of power-based economies, display tendencies towards exclusion and collusion, and, thus, also may hamper comprehensive and sustainable innovation (see for instance, the recent attack of the Microsoft-Intel "Trusted Computing Platform Alliance" (TCPA) on open source networks, namely Linux; s., e.g., Anderson 2003). And even highly innovative networks may petrify and become locked-in forms of coordination in the course of their life-cycle. Therefore, to make an operational distinction between progressive and regressive networks one may also refer to a set of properties that define the position of the corporate agents affected in the life cycle of their products, technologies, industries and regions.

## "Good" Network Governance

Progressive networks have inspired, with their structures and governance regimes, contentions about the possibility of self-governing cooperation.

One form of progressive network is what we call the Linux paradigm. It is based upon a radical open source strategy. Its structure is largely characterized by decentralization, where hubs do not exert much power, but, rather, assume the role of organizers and moderators (e.g., Cohendet et al. 2001; McKelvey 2001; Raymond 2001). This form of network is largely public and highly communicative, nearly anarchic, and is one of the biggest success stories of the "new" economy. Linux, itself, possesses unprecedented and sustainable high speed and high quality of innovation, exceeding that of the system built by one of the most powerful hierarchical structures, Microsoft, i.e., the MS-DOS/Windows operating system.

Interestingly, a core finding of "hackerdom" is that structures of low power and flat hierarchy and governance regimes, intended to open information flows and non-exclusion, are network properties that favour cultures of effective learning of cooperation and, subsequently, enhance the speed and sustainability of innovation in a broad sense (also, e.g., Foray 1998). If the "network equation" holds

*structure + governance = performance*

(Elsner 2004) then we may conclude that the principles developed and applied in this case may be highly relevant as a model of sustainingly innovative networks.

"Good governance" principles and rules aim to promote effective collective action and to avoid the restrictive/collusive character of networks, which makes them vulnerable to sharp external changes and premature aging. These principles include informational openness, guaranteed and continuous entry and exchange with the environment, parallel and even "redundant" processes among network participants, the exertion of the voice mechanism irrespective of differences of size and power of participants, learned reciprocity, and others (e.g., de Bruijn, ten Heuvelhof 1995, 168ff.; Maggioni 1997, 238-49; Jessop 1997, 103ff.; Elsner 2004). Sustainably effective networks of this kind could well be ineffective in the short-run, especially, for powerful individual agents.

## The Case for Hybrid Governance

A problem that cannot be solved through private rationality in an individualistic culture is the continuing existence of the basic social dilemma. This is reflected by the fact that the spontaneous evolutionary process may be highly time-consuming and fragile. The more individualistic the culture is, i.e., the stronger the dilemma-structure, the greater the incentive will be to defect, and, especially, to deviate even from an established institution. Both lab experiments and model simulations have illustrated that hundreds, even thousands, of interactions may be necessary to establish cooperation and that, even then, cooperation may be unstable and occasionally collapse because of small external changes or internal dynamics. The "cooperation vs. competition dilemma" (Jessop) remains.

Further, economies of scale and sunk costs of investments in collective learning, building trust and institutionalised cooperation may lead members to close the network in order to maintain high effectiveness at the expense of future flexibility. Therefore, basic dilemmas about "openness vs.



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closure" or "effectiveness vs. flexibility" also exist (e.g., Jessop 1997, 118ff.).

Finally, there is no guarantee that the collective goods are confined to the limits of these networks, even those that are well-governed. The most effective networks generate considerable positive external effects not only among their members but also beyond their limits. And the collective goods relevant here normally are functionally, personally and/or spatially more far-reaching than the boundaries of any private-agents networks.

It seems necessary, therefore, to introduce a more comprehensive and deliberate supra-individual(istic) rationality into spontaneous evolutionary processes, and even into "well-governed" networks. Specifically, a public-policy framework is needed either to initiate (i.e., de-block, un-lock) or to accelerate and stabilize the institutionalisation of cooperation. Generally speaking, the societal character of any production and innovation requires an integration even of "well-governed" networks in a larger, i.e., public environment (e.g., Maggioni 1997; Elsner 2000, 435ff.). Social problem-solving can be promoted by gradually weakening the social dilemma structure and, in this way, supports a more cooperative behaviour. This allows for a leaner policy approach which already proved to be useful in fields of industrial policy and regional and local development. Relatively small rewards for cooperation may be effective here and define a 'leaner' policy. And it could be demonstrated that with gradual relative changes in the incentive structure or in futurity, cooperation is more likely to emerge and increase speed and stability (also Elsner 2001).

A leaner policy approach constitutes an increasingly established form of governance which of course needs to be managed carefully. Its design includes the definition of aims and the use of (pecuniary and non-pecuniary) promises and rewards, threats and punishments (de Bruijn, ten Heuvelhof 1995, 173ff.; Elsner 2001, 76).

Additionally one may increase the "discount parameter" by increasing the probability for the agents to meet again. As Axelrod (1984) already has pointed out, the public agent can increase the importance of future interaction, for instance, through more frequent meetings, dividing projects into several sub-interactions, connecting different projects, etc. so that the same agents will meet in different arenas and become more aware of their interdependence and common future.

Thus, a leaner policy becomes feasible because the cooperation/network mechanism permits a clearer allocation of the relative interests, or benefits, as well as of the relative responsibilities, or costs, of the private and public agents. The fuzzy "public-private partnerships" in fashion today, in contrast, lack clear designation of responsibility and run the risk of "privatising politics" or "statization" (Jessop) of the private, though collective, sphere.

Obviously, there is opportunity for the public agent to deliberately shape the conditions of private interaction to promote collective learning and institutionalisation of cooperation, that is, to shape the private governance. Thus, this policy approach works by affecting the interaction process of the private agents (e.g., Amin, Hausner 1997, 18ff.). Operational policy conceptions have already appeared for this approach (e.g., Lindberg, Campbell 1991; Mizrahi 1998; Yu 2000; Elsner 2001).

## Meritorisation

We assume that the potential outcome of the private interaction process can be related to a policy objective in such a way that it is subject to social valuation or "meritorisation". The private agents are assumed to be capable of collective production of a "good" that has a potential public value in addition to its private values. The merit good concept been developed into one that is substantiated on the basis of "community preferences" that have evolved from processes of interaction outside the "market" (Musgrave 1987, 452). This implies an evaluation of the "market" outcome using a form of social valuation which is broader than, independent of, and superior to the "market".

For our purpose we will define a merit good as one which was originally a collective good but can basically be produced by the spontaneous interaction process described (i.e., a "private good"). This is evaluated with respect to its quantity, quality, relative price, and the probability, speed and stability of providing it through private interaction.

Specifically, the conception of the negotiated economy has been developed to emphasize the "market" must be embedded in a wider socio-political process (above and, e.g., Commons 1934/1990, 612ff., 649ff.; Ramstad 1991; Nielsen 1992; Jessop 1997, 113ff.). We will assume here the existence of an economic policy agent who is legitimised through a process of participatory democratic decision-making. In this decision-making process, public policy objectives can be created which provide the criteria for "meritorisation".

Other branches of hybrid governance approaches view the state as an endogenous factor in a "second-order public good" game-theoretic argument, hence extending the Folk Theorem approach (e.g., Hirshleifer 1997, 500f.).

## Potentials and Limitations of Governance Regimes – An Outlook

A "hybrid" system of coordination, a "New New Deal" for enhanced collective-action competence, with well-defined "good" (self-)governance of well-structured cooperative network-arrangements together with a new public policy approach has been outlined here. The policy approach relates specific policy measures to the private interaction system. It

also permits the combination of strengths, rather than weaknesses, through a clear-cut allocation of responsibilities and benefits of private and public agents. As such, it is specified through a general interactive and institutionally oriented governance.

The conception of governance is relatively unexplored vis-à-vis the traditional political, state and democracy model that is constituted by national sovereignty, free, equal and secret elections, majority rules etc. Can any governance system provide similar formal legitimacy and collective responsibility compared to that model? Is governance a "political" conception in this sense? Can it become one? And should it become one? Presently, it seems to be capable of preparing, rather than substituting, official political decisions.

The conception of "interactive policy" clearly distinguishes between private coordination regimes, namely, "well-governed" networks, and the official public realm and state policy arena, however participative and transparently negotiated.

Nevertheless, "governance" has become a central notion of any socio-economics. It has the potential to deal with complex relations among different and diverse agents who may act, each at different portions, in different environments and allocation mechanisms, including "markets".

Governance suggests the vision of "re-embedding" (e.g., Ruggie 1997), i.e., the understanding that "thin" and lean coordination forms can, in a complex world, not be "pure" ones. Inclusive and participatory coordination forms "would help to improve the chance of a sustainable outcome by associating all the relevant actors (…)" (Gbikpi, Grote 2002, 18). Its potential, thus, includes high requirements, and high legitimacy, both on its input and output sides.

Finally, governance points to "mid-sized" platforms, such as "mid-size" groups, sectors, clusters, networks and regions, as the arenas where complex interactions and coordination problems can be solved and (coordinated) action capacity be gained. It thus also is a cornerstone in what is to become a new, interactive, meso-economics (e.g., Elsner 2000, 440ff.).

**See Also:** Accountability; bureaucracy; civil and common law; collective action; complexity theory and governance; constitution; corporate governance 1&2; corporatism; disembedded economy; economics and law; environmental governance: global/local/national ®ional; financial system regulation and deregulation; game theory analysis of governance; global and regional alliances, agreements and protocols; global and regional systems of production and distribution; global justice and solidarity movements; globalisation; governance 2; governance: global/local/ national; industrial relations in a global age; institutionalist policies; journals of governance and policy; justice, morality and ethics; legal foundations of capitalism; modes of regulation; moral hazard and adverse selection; multiculturalism; neoliberalism and globalisation: opposition; non-profit enterprise governance; organisational capital; policy ineffectiveness proposition; policy networks; property rights laws and institutions; public goods, externalities and governance; public goods: global; social and cultural capital; state and market; theories of the state; uncertainty and risk; urban and regional policy issues; welfare state; worker control and participation; workplace agreements.

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# GOVERNMENT AND MARKET: A CRITIQUE OF PROFESSOR JAMES BUCHANAN'S "WHAT SHOULD ECONOMISTS DO?"

***Walter Block****

**Abstract**

**For Professor James Buchanan, government is just one more player in the market, along with all others, such as consumers, landlords, farmers, etc. This view is subjected to sharp criticism by the present author, who makes the case that the government differs from all other participants in society in that it and it alone enjoys a legal monopoly over initiatory aggression against person and property. No individual presumes to take on the role accorded the state (e.g., to "tax" anyone, or prevent businesses from merging under threat of fine or jail); the government does this every day.**

**Keywords:** Government, monopoly, public choice, anarchism, libertarianism, aggression, public goods, free rider, market failure

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## Introduction

Political science may be defined as the systematic thorough and rational analysis of politics. In order to approach this field in a scientific manner, the analyst must avail himself of the relevant empirical insights as well as normative considerations, since political science straddles, or is composed of, or touches upon, endeavors such as economics, ethics, sociology, history, etc., in addition to politics itself.

To the extent that political science is interdisciplinary, economics is its first cousin. A sub field of the dismal science, public choice, has perhaps made the greatest strides, from within economics, to bridge the gap in the direction of political science. The public choice school of economic thought is dedicated to the notion that political choices and decision making may be profitably studied using the tools of economic analysis. If there is a father of public choice, it is James Buchanan.[1] His Nobel Prize in economics[2] was awarded to him, in large part, because of his path breaking work in the analysis of political institutions from an economic perspective.

Such a research agenda is sometimes characterized as "social science imperialism," the attempt of one field within this broad calling to take over the "turf" of another, or as "economic imperialism," the endeavor to establish a beachhead of dismal science on to what had been traditionally counted as the territory of a different discipline. Public choice is an attempt, par excellance, on the part of economists to seize the intellectual property of political scientists.[3] It is one of the main purposes of the present paper to assess whether or not, and if so to what extent, have economists of the public choice school succeeded in wresting away realms traditionally the preserve of political scientists.

## A Contradiction

What was the thesis of Buchanan and Tullock (BT) in their 1971 book, Calculus of Consent (CC)? They put forth the view that government is really just another sort of market; that the political marketplace and the political marketplace are just two sides of the same coin; that dollar votes and ballot box votes follow the same rules (e.g., downward sloping demand curves); that, at the very least, there is a strong analogy between the two.

[1] Gordon Tullock deserves, also, to be mentioned in this context, since he co authored with James Buchanan several of the tomes which have set up the foundations of public choice. As well, Tullock has contributed mightily to this field on his own and with others besides Buchanan. See for example Tullock (1980a,b, 1985, 1967).

[2] In justice, this Nobel Prize should have been given to both Buchanan and Tullock.

[3] In the interests of full disclosure, I am an economist, not a political scientist. My Ph.D. is in the former field not the latter. True confession: my natural predilection is to support forays of this sort.

But Buchanan (1979, pp. 30,31) contradicts this thesis. Here, he maintains that there arc two ways of viewing human economic organization. The first, a means-ends perspective, sees the "wealth of nations" as the goal, and economic allocation as a problem to be solved. In this conception, the market, as a mechanism, is appropriately compared with government, as an alternative mechanism for accomplishing similar tasks."

However, continues Buchanan, "The second ... is wholly different, although subtly so, and it is this second conception that I am trying to stress in this paper. And what is this second view of human economic organization? It specifically rejects the idea of macro level goals, such as maximizing the "wealth of nations," or the challenges of overall economic allocation. Rather, it takes on a more individualistic or micro stance. "It is, instead, the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities." It is not that there are no purposes in this second concept. There are. It is just that these are held by private individuals, with no thought as to how this impacts the entire society. Here, Buchanan (p. 31) observe(s) men attempting to accomplish their own purposes, whatever these maw he." Buchanan can only have it both ways, that is, can remain true to CC, if he accepts the first of these two visions. If, and to the degree he embraces the second, as he says he does in this later work, then he must, upon pain of contradiction, renounce the thesis of CC.

## Public Goods

His further comments in this context would appear to buttress the claim that he had abandoned the CC thesis. For next lie discusses the "local swamp (which) requires draining to eliminate or reduce mosquito breading" (p. 32). One would expect the Buchanan of CC to wax eloquent about externalities, free riders, and the need for government to make good this "market failure." Instead, we are treated to an outright rejection of this typical view: "Defined in the orthodox, narrow way, the 'market' fails; bilateral behavior of buyers and sellers does not remove the nuisance.... This is, however, surely an overly restricted conception of market behavior."

How then will the market work? How can people, without the aid of the state[4], work together to solve the problems of the swamp?

Here he continues in a vein perfectly consistent with that of a libertarian: "Individual citizens will be led, because of the same propensity, to search voluntarily for more inclusive trading or exchange relationships." Were he to continue in this vein, one can almost hear Buchanan maintaining at this point, Rothbard-like[5], that the entire swamp, and much of the surrounding area, will be owned by one corporation; then, the negative externalities of the mosquitoes will he internalised by this land company. Unless they solve this swamp problem, the surrounding land values will not increase; they will not be able to sell fishing, boating, swimming, housing rights. That prospective golf course will remain on the drawing boards forever.

In the event, Buchanan says none of this, unfortunately. But he does do the next best thing: he discusses the internalization of externalities, albeit in a completely different context, He states (p.32):

*"How is the 'free rider' problem to be handled? This specter of the free rider, found in many shapes and forms in the literature of modern public finance theory, must be carefully examined. In the first place, there has been some confusion between total and marginal effects here. If a pretty woman strolls through the hotel lobby, many tired convention delegates may get some external benefits, hut, presumably, she finds it to her own advantage to stroll, and few delegates would pay her to stroll more than she already does."*

Not so good. Had Buchanan remained perfectly true to the free market vision, had he more closely tied the strolling woman case to that of the mosquito-laden swamp, he would have speculated about the possibility that there was too little strolling compared to the optimal amount[6]. Then, this would have led him, as if by "an invisible hand" to enquire as to the identity of the person with a financial interest in seeing to it that the incidence of strolling increased. Obviously, this would be the hotel owner, the analog to the land arid water company of the previous example.

## Market Failure

Unhappily, this author then completely drops the ball. He resorts to the same tired old traditional "market failure" analysis he just finished excoriating (pp. 32, 33):

*"there may be eases where the expected benefits from draining are not sufficiently high to warrant the emergence of some voluntary cooperative arrangement. And, in addition, the known or predicted presence of free riders may inhibit the cooperation of individuals who would otherwise . In such situations, voluntary cooperation may never produce an 'efficient' outcome for the individual members of the*

[4] Nowadays, the government is the least likely source of the solution to the mosquito challenge. It is not part of the problem, not the solution. For under the aegis of the Environmental Protection Agency, swamp draining, or interfering with practically any body of water, or "wetlands," will likely be prohibited outright. And if not prohibited, then postponed, and made far more expensive than before.

[5]See on this Rothbard (1962, 1973, 10\982, 1990). See also Hummel (1990), Hoppe (1993), Block (1983, 1990).

[6]E.g., "market failure." Not to be sure, of the external diseconomy mosquito type, but of the mirror image failure to promote an external economy of the stroller sort.

*group. Hence, the 'market,' even in its most extended sense, maybe said to 'fail."*

All he is saying, here, is that even with a full private property free enterprise system, there may still he some swamps which remain undrained, This might well be true. But Buchanan has no warrant for claiming that if this occurred, it would be a "failure." On which stone tablets is it written that all undrained swamps are an affront to the Almighty? Who says that the optimal number of mosquito infested swamps is zero? The neoclassical economists live and die by empirical considerations, but what evidence could he adduced in behalf of this claim? On the contrary, if the market "fails" in this manner, it is prima facie evidence that for those few swamps which remain in the pristine form, it is a success to leave them exactly as they were[7]. The "market failure-ists" never put forth their own independent criterion of the optimal number of undrained swamps. They rely on the claim that there are externalities to assume, a forteriori, that the optimal level will not he reached through voluntary economic action. Consider the possibility of swamp ownership by a group such as Ducks Unlimited, or the Sierra Club, or some such other environmental group. Suppose they owned a large holding with a swamp located in the middle of it, such that the mosquitoes never strayed onto the property of other ææ1 people. That is, this "harm"[8] never reaches out to those who view it negatively. Why isn't this a case of economically rational swamping?

## Voluntarism?

However, Buchanan does redeem himself at least partially. He poses the challenge, "What recourse is left to the individual in this ease (of market failure)?" Arid his answer (p 33):

*"It is surely that of transferring, again voluntarily, at least at some ultimate constitutional level, activities of the swamp-clearing sort to the community as a collective unit, with decisions delegated to specifically designated rules for making choices, and these decisions coercively enforced once they are made."*

This is all well and good, if interpreted sympathetically enough. The constitutional state would he directly analogous to the "big land company" that would own both the swamp and the surrounding effected area. Of course it would be legitimate for it to enforce its decisions "coercively," because they would be no more coercive than would be those of the business firm in demanding its ight to evict trespassers. The government would be like a private club, where everyone had agreed to pay dues, to be bound by the rules created by the majority, subject perhaps to a bill of rights agreed upon at the outset, etc. But all this soon comes unglued when we realize that Buchanan is not talking about some ideal situation, some model he has concocted entirely from his imagination. Rather, he is offering this as an analysis of real world governments such as that of the United States. And here, Spooner's (1966)[9] insights render nonsensical all such claims. There simply is no such agreement, signed by all citizens at any given time, in all of U.S. history. The closest we come to this model is when a scant few men signed the Declaration of Independence. Buchanan's is an attempt to analyze not merely theoretical governments, but extant ones. He may have succeeded in the former case, in coming up with some very interesting fairy tales, but with regard to the latter his effort must be judged a dismal failure.

As it happens, Buchanan comes very close to admitting his whole scheme is self-contradictory; that the voluntary elements of the free enterprise system cannot be reconciled with the essentially coercive elements of the state. He states (p. 34):

*"Insofar as individuals meet one another in a relationship of superior-inferior, leader to follower, principal to agent, the predominant characteristic in their behavior is 'political,'... Economics is the study of the whole system of exchange relationships. Polities is the study of the whole system of coercive or potentially coercive relationships."* But it is not true that hierarchy is per se exploitative. The orchestra conductor leads the musicians, not the other way around; the employer, within limits, controls the behavior of the employee; it is the principal, not the agent, who exerts the commands. But all of this occurs in the market, where all relationships are reciprocal and voluntary. How, then, to explain how someone can "boss" someone else around, and yet not coerce him? The answer is simple. As long as the "inferior" person has agreed to be bound by the dictates of the "superior" (usually but not always because of monetary payments), the relationship is a legitimate, voluntary one. Take away this essential prior agreement, and a legitimate hierarchical one is rendered coercive.

## Visions

It is just barely possible that we have been too hard on Buchanan. Maybe his model is merely an imaginary one, in which ease we have no serious objections; perhaps he does not really mean to apply it to the real world. Evidence for the former hypothesis abounds. He tells us (p.144):

*"In my vision of social order, individual person are the basic component units, and 'government' is simply that complex of institutions through which individuals make collective decisions, and through which they carry out*

[7]This would merely show that in the view of the economic actors who stand ready to lose money by making poor decisions, the benefits of clearing of the marginal swamp are more than offset by the costs. Or, that the costs of internalizing the externalities, whether through restrictive covenants, or single ownership, are lower than the benefits of these activities.

[8]Remember, one man's meat is sometimes another man's poison.

[9]See also Rothbard (1973, 1982) and Hoppe (1993).

*collective as opposed to private activities... In my vision or my model, individual persons are the ultimate decision-makers" (emphasis added).* The word "vision" clearly, is compatible with the idea that Buchanan is dealing with a theoretical construct, not the real world. But then he takes it all back. He asserts (p. 144): "if we want to discuss governmental decision processes we must analyze the behavior of individuals as they participate in these processes." Now it is just barely possible that people could take part in political processes in a purely theoretical manner; then, the fact that there is no evidence that they have agreed to be bound by the constitution would not count against Buchanan. So far, we have been arguing not that if the constitution is like a private contract, but w actually was a private contract, that we have no serious reservations with the Public Choice Model of constitutional economies. This is because if the state really is akin to the market, then any force excited by it on "unwilling" participants is really justified, for these persons agreed beforehand to be bound by the view of the majority[10].

## Tyranny of the majority

Buchanan (1979, p. 150) criticizes Arrow (1951) not for the latter's analysis, with which he agrees in any case, but for the latter's wishes about that analysis. Specifically, Arrow proved that given simple majority voting, no unique and consistent social ordering of the social welfare function would emerge. Arrow was unhappy with this result, yearning for stability, while in Buchanan's view. "If we had a majority voting rule that would, in fact, produce internally consistent choices in the Arrow sense, we should, indeed, have a tyranny of the majority."

But this is highly problematic. BT have all along been asserting their constitutional thesis, namely, that the populace has agreed to be bound by the dictates of the majority. How can Buchanan, then, turn around and castigate any determination of the majority at all as "tyrannical"? That is, even if a majority of Nazis, for example, were to vote to eliminate all Jews, this would still not be tyrannical, at least according to the thesis put forth by BT. This is because the Jews, initially, made a decision to be bound by the will of the majority. If they feared animosity emanating toward them from the Nazis, they never should have constitutionally agreed to be bound by majority decision[11]. Since they have, by stipulation, they should calmly accept their fate, and not denigrate their fellow citizens with such a harsh and unjustified a characterization as "tyrannical."

## Unanimity

Buchanan (1979, p. 153) states:

> *"If we reject the notion that there must exist a public or general interest apart from that of the participants, we are necessarily led to the conclusion that only upon unanimous consent of all parties can we be absolutely sure that the total welfare of the group is improved."*

In this, he is totally correct. First of all there is no general or public interest over and above that of the citizenry. There are only separate people. All groups, nations, collectives, etc.. are merely gatherings of unique individuals. Even a marriage, perhaps the closest collective of all, is still composed of two non identical people. There is no third party in the marriage, over and above the two of them. "Two's company, three's a crowd."

The only problem is that BT talk about a near or "relative" or "conceptual" unanimity[12]. In their view, this can also justify state activity. Put this as highly problematic. Suppose that the near unanimity consists of 98% of the populace. But this still leaves the other 2% which can be victimized by them. Now it might pay for the 2% to agree to be bound by political voting of the 98%; perhaps this will be better for their, under certain circumstances, than a situation where the state is nonexistent. Maybe the 98% could more heavily, or efficiently, brutalize the 2% under anarchy[13] than under archy[14]. But that is for them (e.g., the minority) to say. There is no warrant for maintaining that the 2% must have agreed with this assessment. Perhaps, in some eases (e.g., Nazi Germany, for the Jews) they may prefer

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[10]Some people might take from this line of thought that it is always illegitimate to impose one's will on people who have not agreed to be bound by it, beforehand. This is only roughly correct, and it may be worthwhile to explore why such a line of reasoning is not entirely valid.
So we ask, what is the case for supposing that it is legitimate to use force even against people who have not agreed to be bound by it? Let us return to the Hobbesian state of nature for this exercise. According to the libertarian perspective, Public Choice's main competitor within the broadly based free enterprise camp, each individual has a right to be free from aggression in his person, and in his legitimately held property. This in turn, is based on either original homesteading, or trades based on such title. Therefore, if someone attempts to inflict damage on a person or his property, he has a right to defend himself and what is his through use of violence if need be. This means that it is legitimate to use force against a would be aggressor, even if this latter person has not agreed to be bound by anything at all, as would be true in a state of nature.

[11]Not that they could have done anything about it, given that for Buchanan, their signatures on the dotted line is not needed.

[12]For the view that we all accept government "implicitly," and thus no explicit unanimity is needed to justify it, see Buchanan (1971, p. 254).

[13]The overwhelming majority of brutality and mass murder occurs within or between governments (Conquest, 1986, 1990); thus it might appear that anarchy has had a bad press, since the opposite view is perhaps more prevalent.

[14]For critiques of anarchy, see Buchanan (1977), Nozick (1974). For defenses, see Spooner (1966), Hoppe (1993), Barnett, (1977), Childs (1977); Evers (1977); Rothbard (1977); Sanders (1977).

to go it alone, unprotected by the niceties of the political process.

## Bureaucracy

Buchanan (1979, p. 162) states: *"The administrative hierarchy of a modern corporate giant differs less from the federal bureaucracy than from the freely contracting tradesmen envisaged by Adam Smith."*

Now this is undoubtedly true–but only superficially. For example, it is surely the case that the employees of Big Government and Big Business are housed in similar office buildings; that the memos they pass along to each other are parallel in many specifics; that there are as many levels in the chain of command in the one case as in the other. Moreover, it cannot be denied that in this same regard both of these are as far apart as it is possible to imagine from the small firm with one or two employees. The latter has no chain of command worthy of that name at all, The boss usually initiates, but typically depends on trusted workers to contribute; there are no memos; they work in a basement or in a garage or in a small shop or office. Not for them the trappings of Bigness.

But Buchanan's point is just like saying that a big man and a seal are more alike (since they weigh about as much) than is a big man and a small baby. It is akin to asserting that Pope Paul II's kinship with his replica in Madame Taussaud's Wax Museum is greater than that which exists between him and someone else, say Professor Buchanan. It amounts to concentrating on superficial similarities, and ignoring important, but underlying differences. Big Business and Big Government may look alike to an ignorant outside observer (or even to an insider, a participant), but they are very different as pertains to the voluntariness of each institution. Business no matter how Big, cannot compel customers to make purchases; they must attain consent. Government, no matter how Small, may legally do so.

They also differ as far as survivability is concerned. Business, no matter how Big, must satisfy customers; if it fails to do so, it are forced into bankruptcy. Government, in contrast, particularly the bureaucracy[15], boasts of no such automatic feedback mechanism. If you don't like how they run things at the Post Office, or at the Motor Vehicle Registry, you cannot take your "business" elsewhere. If many people boycott these institutions, and they lose money hand over fist, there is still no tendency toward dissolution. Instead, the government merely hands over additional funds mulcted from the long-suffering taxpayer.

## Value Free Policy Prescriptions

Buchanan (1979, p. 180) holds the following view:

*"In a sense, public-choice analysts can take on a normative role in advocating some matching of policy proposals with the institutional realities of modern politics. We can talk meaningfully about the 'best' rules, or the 'nth best' arrangements, often quite independently of the ultimate policy targets. In other words, we can talk normatively about 'process' or 'procedure,' while staying clear of normative discussions of 'end-states.'* This sounds altogether too much like the "value free" chemist being asked by the Nazis about the most efficient way to attain their goals. Yes, to be sure, the words offered by the scientist under such a condition would be indistinguishable from those uttered in an entirely different context, But context is all. Sentences indicating that water is composed of two parts oxygen and one part hydrogen, or the poison gas can best be produced in such and such a way, or that the most efficient oven will be composed of this metal not that, are non normative sentences. But uttering them, an act may or may not he value free. Contrary to Buchanan, the usual presumption is that speech acts are normative exercises. Why would the speaker have spoken them did he not prefer a world which included these statements to one which did not? And is this preference not to he considered a value? And is the attainment of a value not to be considered normative?

## A Contradiction?

Buchanan (1979, p. 181) holds the following view, which we shall call A:

*"We should care, and we should think about, what the fiscal constitution for political democracy should look like, what sort of institutions should he most efficient in the working of democratic politics."*

Let us contrast this with another statement, call it B, which reads as follows (Buchanan, 19?9.p. 186):

*"I found myself less interested in the old question, How should tax shares be allocated? and at the same time more interested in the new question, How are tax shares allocated in a democracy?"*

While it might be too harsh to claim that A and B are explicit contradictions of each other, one must acknowledge that they, at the very least, lead the reader in rather different directions. According to B, we should eschew old normative questions. But A is a normative issue. Now let us bring into the analysis opinion C (Buchanan,1979, p. 188):

*"Individuals do not pay 'prices' for partitionable units of (public) goods, They pay 'taxes' which arc coercively imposed through a political process and this coercion is, in turn, made necessary by the free rider motivation inherent in*

[15]Governments come and go, according to elections. Here, there is at least an analog between the dollar vote and the ballot box variety, however weak is the latter in comparison to the former (it takes four years to be consummated; only a "package deal" of candidate A vs. B is offered – the voter cannot pick and choose as he wishes). But in the case of bureaucracy, not even a Buchanan can seriously maintain that there is a process where consumer or citizen dissatisfaction automatically translates into termination.

*general collective action. Few persons will voluntarily pay taxes if they expect to receive the benefits from generally available public goods."* One problem with C is that it is logically incompatible with BT's oft-made claim to the effect that the polity is a voluntary one at the outset. If we all agree to be part of the government (e.g., citizens) how can it be "coercive" to compel us to pay our fair share of taxes, as determined democratically? After all, in joining up, we have agreed to be bound by the will of the majority, and the vote was, presumably, in favor of leveling taxes. Another difficulty is that coercion is by no means "made necessary" by the free rider motivation. It is not at all logically "necessary" that the government force people to contribute to programs it is pleased to think provide for the betterment of non contributors, One man's meat is another man's poison[16]. There is not a single solitary act, from defense to mosquito eradication, which benefits all people. Pacifists, and members of the fifth column of the beleaguered country, are harmed by its attempt to defend itself. They would actually prefer that the nation not be militarily secure. Members of Earth First!, who believe that there are altogether too many human beings inhabiting the planet, and that they are "excessive protoplasm" which should be destroyed would actually welcome disease bearing mosquito infestation. But suppose, just for the sake of argument, that all people had the same evaluations of all of these goods and services; that there were no pacifists, internal enemies, nor misanthropes. Would it then be "necessary" for the government to force people to contribute for these "good" ends? Not a bit of it! For we would still have to weigh the good to he clone as a result of compulsion against the bad inherent in using this fiduciary device. Also problematic is the fact that C and B are somewhat incompatible. B claimed an interest ii positive economics. A is nothing if not normative, While we are on the subject of internal contradictions in the public choice philosophy, let us consider (Buchanan, 1979, pp. 189-190):

*"In ordinary markets, the presumption that all persons choose rationally does little to distort empirical reality because the rationality of only a few participants who can affect results at the appropriate margins of adjustment guarantees the equivalence of outcomes as between what we might call the full rationality and the partial rationality models. The situation in "public markets" is not at all analogous. Solutions do not emerge as the outcome of the mutual interactions of many participants who make private and independent decisions. Instead, public-market solutions are the result of the interactions of many persons who are necessarily involved in the unique public or collective decision. The result reflects the choice of the median voter, or his representative, who may or may not he fully rational in the sense that informs traditional price theory. The presumption of fully informed rationality here is much more severely restrictive than in any other market setting (emphasis added)."* Where is the contradiction? The constitutional argument of BT, the claim that there are really two kinds of "markets," the political and the economic, the view that the polity is really a contract between all citizens, is predicated on the vision that there is a strong analogy between the political and economic realms. And vet in this quote Buchanan concedes that the situation between the two "is not at all analogous." In so doing, however. he strives valiantly to maintain that this analogy is valid. He does so by calling the political realm a "public market" and by referring to politics as an "other market setting." But this is clearly not the case, as even Buchanan (partially) admits. The point is, we can infer rationality in the market because there is a weeding out process which occurs every minute. Those who act rationally in ferreting out future consumer desires, and in ministering to them in an expeditious manner, earn profits; those who fail in this regard, and instead produce Edsels, suffer losses. Rut people who acquire profits, other things equal, tend to make more and more decisions and have greater and greater control over resources than those who bear losses. And the same goes for consumers and investors. Those who make wise choices prosper; those who do not see their wealth reduced. Over time, such a process ensures that market activity at least tends toward rationality.

In the political sphere, no such occurrence takes place. Those who vote for the eventual winner do not receive additional ballots for the next election. Those who vote for the loser do not suffer any diminution in their treasure. Nor can this sort of analysis be applied to any aspect of politics. The analogous "weeding out" process is completely missing. As a result, there is no case for supposing a move toward rationality, ceteris paribus.

## Conclusion

We began this paper by posing the question of whether economists of the public choice stripe have succeeded in claiming for their own (in behalf of the entire profession) areas of study traditionally under the sway of political scientists. That is, do the tools of traditional economic analysis succeed in explaining, characterizing, pigeon holing, or in any other way accounting for intellectual realms which lie squarely in the province of political science, or even in territory lying somewhere in between these two disciplines? Clearly, given the foregoing, I find no warrant for any such claim, at least in this case. While the lines of demarcation between the various social sciences cannot be impenetrable unshakeable inviolable barriers, while forays from one onto the territory of another are thus in principle acceptable[17],

[16] On this see Buchanan (1969), Buchanan and Thirlby (1981), Mises (1966), Rothbard (1962, 1973, 1977, 1989).

[17] And highly so, since intellectual pursuits are all but impossible when frozen in concrete.

success in this regard cannot be claimed in the present case.

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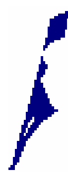
# РАЗДЕЛ 2
# ОРГАНИЗАЦИЯ РАБОТЫ СОВЕТОВ ДИРЕКТОРОВ



# SECTION 2
# BOARD PRACTICES

## STOCK OPTION PLANS FOR CEO COMPENSATION

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**Abstract**

**Stock options plans (SOPs) can be used as a CEO remuneration instrument. Our study examines the dimensions of SOPs, the types of SOP used by Spanish firms to reward the CEO, and the effect of different SOP types on CEOs' behavior. The results show that traditional options "at the money" are the most used by Spanish firms. Although this SOP type is not the most appropriate from the optimum contract theory approach, it offers high potential gains to the CEO. It may therefore increase the capacity of companies to attract and retain competent executives.**

**Keywords:** Stock option plans, CEO compensation, Incentives

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### 1. Introduction

The remuneration of the chief executive officer is considered to be a strategic management tool available to the Board of Directors. For Lawler (1990,1991), the remuneration system of top managers permits the company: 1) to attract and retain competent executives, 2) to influence their behaviour, incentivising them to develop strategies that create value and 3) to modify or reinforce the corporate culture. The remuneration system of top management integrates decisions regarding the level of remuneration, its mix between fixed and variable, and the mix of variable remuneration between short and long term. Two types of plans can be differentiated in long term variable remuneration: 1) those that link management reward to accounting measurements of the firm's internal performance, and 2) those that relate executives' remuneration to the price of the shares. Within this second category are the stock option plans (SOPs) which, for Murphy (1999), constitute an important theme for research in the area of top managers' remuneration.

Our study focuses on an area unexplored in Spain: the SOPs subscribed by firms to reward the CEO. Our objectives are: 1) to analyse the types of options used and 2) to reflect upon the possible effects of the different types of SOPs on the behaviour of their beneficiaries. The conclusions of the study contribute to the development of knowledge in a subject that has been little studied in Spain due, on the one hand, to the lack of

transparency regarding the remuneration of top management and, on the other, to its newness as a remuneration tool, given that SOPs began to be used as systems of remuneration of top management in the late 1990s.

The paper is structured as follows. In the first part we examine the pros and cons of SOPs, their dimensions and types, and their influence on the behaviour of managers. Then we analyse the SOPs subscribed by the 115 listed firms most representative of the General Index of the Madrid Stock Exchange, during the period from 1998 to 2001. To finish we discuss the results.

## 2. Pros and Cons of Stock Option Plans

According to the theory of agency, the manager's risk aversion and his pursuit of his own interest leads him to direct his actions towards achieving his own interests, which do not always coincide with those of the shareholders. Jensen and Meckling (1976) show that the manager who owns a fraction of a firm will expend resources to the point where the marginal utility derived from the firm's expenditure equals the marginal cost of his own portion of the firm. As the manager's ownership claim falls, his incentive to contribute significant effort to increase the value of the firm falls. The mission of the Board of Directors is to monitor the top managers so that they act in accordance with the interests of the shareholders. One mechanism of control available to the Board is to implant SOPs. Since SOPs give the recipient the right to purchase shares of company for a pre-specified term at a pre-specified strike price, which is usually at money, it only awards the manager the appreciation part of the stock price. The manager would try to take more creative activities to increase the value of his option and the expected share price would rise due to the manager's effort. SOPs have advantages over annual incentive plans based on accounting measures, and also over other types of incentives based on market measurement.

Against annual incentive plans based on accounting measurements, SOPs stand out: a) for their ability to harmonise the interests of the top management with those of the shareholders and b) because the share price is a more objective measurement than those of an accounting nature.

Although financial accountancy measures such as profit, profit per share, return on investments, etc., are much used in the design of incentive plans for top management because of their influence on the market value, some studies (Beaver, Clarke and Wright, 1979) showed a low or medium correlation between these indicators and returns to shareholders. This result may be because:

1. Annual profits do not show the future impact of present decisions. For example, even though a substantial investment in research and development may have a depressive effect on profits in the short term, it can have a positive effect in the long term. The implementation of measurements of yield such as ROI may motivate managers to reduce expenditure on R&D, marketing, etc. which are necessary to improve long term competitiveness. The results of the study by Hoskisson, Hitt and Hill (1993) revealed that, when the intensity of R&D of the industry, the size and diversification of firms is monitored, incentives based on accounting measurements were negatively related to the intensity of firms' R&D.
2. The growth of profits adds value only if the return on investments exceeds the return required by the investors (Buchman, 1991). Accounting profits do not reflect the changes in the cost of capital needed to finance the investments of the firm. Inflation and the higher risks taken by the investor may increase the cost of capital. Hence, unless the additional profits are sufficient to counteract the increase in the cost of capital, the value of the firm descends, even if profits increase. The low correlation between annual profits and the share price obtained by Rappaport (1986) was attributed in large part to the cost of capital. Therefore, rewarding managers for profits without "charging" them for the capital used may generate distortions in investment.

The second advantage of SOPs over plans based on accounting profits derives from the fact that the latter can easily be manipulated by managers, as they can be inflated or reduced by accounting procedures (stock valuation, methods of depreciation etc.) or by policies of deferment of income or expenditure (Gomez-Mejia and Balkin, 1992). Smith (1992) describes twelve practices of "creative accounting", all of them legal, used by British firms to massage their profits and returns. Also, Healy (1985) revealed that managers modify spending policies and accounting procedures in order to achieve the annual bonus.

Against other types of incentives based on market measurements, e.g. the granting of restricted shares, SOPs have the advantage of their lower cost, as the firm only refunds the appreciation over the exercise price. "For a company with an average dividend yield and a stock price that exhibits average volatility, a single stock option is worth only about one-third of the value of a share" (Hall, 2000, p. 124). This occurs because the holder of the option receives only the marginal appreciation over the exercise price, while the shareholder gets all the value plus the dividends. For this reason the firm, for the same cost, can offer the manager three times as many options as shares. In view of their advantages, SOPs have been recommended, by both the academic and professional sectors, as an effective means of aligning the interests of top management with those of shareholders.

The recommendations of specialists, together with the tax advantages, the accounting norms[1] and the constant increase of environmental turbulence, which promotes greater management discretion[2] and makes monitoring more difficult, have favoured the growing use of SOPs to reward top managers in the U.S.. Several studies reveal their use in the Anglo-Saxon environment. For example, Yermack (1995) points out that the percentage of the CEO's remuneration paid in stock options rose from 20% in 1984 to 30% in 1991, and Murphy (2002) underlines that, between 1992 and 2000, this percentage rose from 25% to 40% for S&P 500. In Spain, though their use is not as widespread as in the United States and the United Kingdom, SOPs are becoming more and more popular. Some studies confirm the effectiveness of SOPs, showing their positive impact on: a) the performance of the firm, measured by financial returns and the growth of earnings per share (Kumar and Sopariwala, 1992, Ferris *et. al*, 1997), b) the growth of investments congruent with the interests of the shareholders (Agrawal and Mandelker, 1987, Lacker, 1983), c) the development of a long term vision (Hagerty, Ofer, and Siegel, 1991), and d) the share price (Masson, 1971; Lacker, 1983). But other more recent ones question their positive effect on results. For example, Ofek and Yermack (2000), observing that top managers tend to exercise their SOPs as soon as they are able to, and sell practically immediately all the shares acquired, conclude that stock option exercise has little substantive impact on managerial ownership. Other studies associate the stock option plans with: 1) reductions in R&D (Henderson and Fredrickson, 2001), 2) cutback in the level of dividends paid (Bartov, Krinsky and Lee, 1998; Lambert, Lanen and Lacker, 1989, Fenn and Liang, 2001), and 3) increase in the levels of repurchase of shares (Bartov, Krinsky and Lee, 1998). Altogether, these studies support the criticisms made by outside observers who maintain that SOPs "confer greater riches on top executives, with little connection to corporate performance and motivate corporate leaders to pursue short-term moves that provide immediate boosts to stock values rather than build companies that will thrive over the long run" (Hall, 2000, p. 121-122). Also, authors like Bebchuk *et al.* (2002) maintain that SOPs do not solve the problem of agency and that top managers use them to obtain a higher remuneration than they would achieve with other types of remuneration.

## 3. Dimensions and Types of Share Option Plans

In order to reduce the conflict of agency, SOPs have to be well designed, which is not frequently the case. According to Hall (2000, p. 126), "most of the companies I´ve studied don't pay a whole lot of attention to the way the grant options work... assume that the important thing is just to have a plan in place, the details are trivial". This may lead to the implementation of plans in which the incentive effect does not compensate the costs to shareholders (Aboody, 1996). Therefore, the effectiveness of SOPs can be increased by appropriate design.

SOPs are complex systems of remuneration because their design involves many decisions. The most important are: beneficiary group, basis of allocation, exercise price, establishment of conditions and duration of the plan (see table 1).

### *Beneficiary Group*

The first decision when designing a SOP is to determine which group of members of the firm it is aimed at. Currently, both in continental Europe and in the Anglo-Saxon countries, SOPs, traditionally considered to be systems of remuneration for key managers and personnel, are being extended to all staff (Conyon and Freeman, 2001, Murphy, 2002).

The most critical maintain that this generalisation is due more to tax and accounting norms in force in the UK and USA than to strategic considerations. On the basis of the theory of expectations, they argue that stock options can only motivate top management, because the rest of the employees find it difficult to see the connection between their efforts and the price of the shares (Huddart, 1994). They also maintain that this expansion dilutes shareholders' earnings, reduces the cash flows necessary to be able to make investments, and reduces liquidity if firms establish buy-back programmes to prevent dilution of capital (Bens *et. al.*, 2000). However, other authors (Pinder, 1997, Newman and Krzystofiak, 1998) maintain that the extension of SOPs to all the staff should increase the performance of the firm because it improves the employees' morale and job satisfaction, and incentivises greater cooperation and greater commitment among its employees. These arguments are supported by some empirical studies (Blasi, Conte, Kruse, 1996; Conyon and Freedman, 2001)

[1] Under US regulations, the expenditure caused by the remuneration of managers based on share options with pre-fixed exercise price and maturity has to be charged to the profit and loss account for the differential margin at the time of delivery between the share price in the stock market and the exercise price fixed. Options whose exercise price coincides with the share price at the time of the grant of the plan are therefore considered by the firm as free of charge in the short term because they are not computed as expenditure. ]

[2] Various research studies (Gaver and Gaver, 1995; Yermack, 1995; Rajagopalan and Finkelstein, 1992) reveal that firms whose contexts provide their CEOs with a high level of discretion use SOPs more frequently because these contexts make monitoring difficult, and the Board of Directors seeks to align managers' and shareholders' interests by implementing systems of incentives, such as stock options. ]

which show that granting share options to all the staff has a positive influence on performance. For Conyon and Freedman (2001), the granting of options to all the staff is effective, even when the number of options granted is small, because it encourages the feeling that we're all in the project together. Moreover, this system of remuneration offers firms the possibility of rewarding the staff while preserving liquidity to be able to finance new investments. Since the need for liquidity to finance investments can prevent payment of competitive salaries to attract and retain qualified staff, SOPs free firms from this pressure, as well as offering a stimulus to attract and retain managers and employees with the possibility of sharing in the firm's future earnings (Core and Guay, 2001).

**Table 1.** Dimensions and alternatives in the design of SOPs

| Dimension | Alternatives |
|---|---|
| Beneficiary Group | • CEO, top management and other key staff<br>• All the staff |
| Basis of Allocation | • Fixed value plans<br>• Fixed number plans<br>• Mega-grant plans |
| Exercise price | ♦ Price at which the beneficiary can exercise the purchase of the shares:<br>• Fixed price:<br>- With possibility of review.<br>- Without possibility of review.<br>• Price adjusted to a predefined index<br>♦ In relation to the share price at the start of the plan:<br>• Grant of options " at the money".<br>• Grant of options "in the money".<br>• Grant of options "out of the money". |
| Establishment of conditions | • Restrict exercise of the option.<br>• Prohibit sale of the shares acquired for a certain period of time.<br>• Limit amount of reward.<br>• Slow vesting. |
| Duration of plan | Exclusion period + exercise period. |

### *Basis of Allocation*

The Board may choose among three types of SOPs: 1) fixed value –the beneficiaries receive options of a predetermined value every year over the life of the plan, 2) fixed number -each year of the life of the plan the beneficiaries are granted a fixed number of options and the exercise price is determined on the basis of the share price of the corresponding year, and 3) megagrants –the beneficiaries are granted a fixed number of options at an exercise price determined at the start of the plan.

Fixed value plans, which control the percentage of remuneration taking the form of options, have the advantage of allowing remuneration of executives to be determined in accordance with wage surveys. The disadvantage of these plans, however, is that they weaken the connection between remuneration and performance, because in the years when the shares are worth more, the managers receive fewer options (Hall, 2000). This problem does not exist in fixed number plans and in megagrants because these types determine a number of options and not a monetary value. The value of the options therefore changes with the quotation of the shares.

Megagrant plans permit managers to obtain greater gains than fixed number plans if the share price increases during the period of the plan. However, if the share price falls, the options can be so devalued that the manager may lose all hope of obtaining gains with the plan, thus disincentivising him to strive to increase the share price or incentivising him to seek another firm and obtain new options. Furthermore, he will not receive new options that will enable him to offset those that have lost value as occurs in a multi-annual plan.

### *Exercise Price and Establishment of Conditions*

The price at which the beneficiary can exercise the purchase of the shares can be: 1) a fixed price, with or without the possibility of review in the event of significant falls in the share price, and 2) a price adjusted to a predefined index, such as the general stock market index, or one for the industry or a group of shares (*benchmark).* Relative to the price of the shares at the start of the plan, the following alternatives exist: 1) options " at the money" -exercise price equal to starting price, 2) options in the money -exercise price lower than the starting price, and 3) options out of the money -exercise price higher than starting price. When designing SOPs different conditions can be established to limit the right of exercise, the amount of the remuneration or to stipulate the manner of exercising the options.

From the combination of these dimensions arise different types of options (Table 2).

**Table 2.** Types of options

| | |
|---|---|
| Traditional options | These establish a fixed exercise price and the only condition required of the beneficiary to exercise the purchase of shares is to remain in the firm. |
| Repriceable options | These are traditional options that have the possibility of modifying the exercise price in the event of a substantial fall in the quoted share price. |
| Indexed options | These are options that establish an exercise price linked to a predefined index, such as the general stock market index, or one for an industry or a certain group of shares (*benchmark*). |
| Conditioned options | These are options that establish a fixed price, conditioning the exercise of the right to purchase to remaining in the firm, but with further conditions, such as the achievement of objectives *(performance vested options)* and participation in capital. |

### - *Duration of the Plan*

The duration of the plan is determined by the sum of the exclusion period – from the approval of the plan to the exercise period - and the exercise period – the period within which the manager can exercise the option right.

## 4. Types of SOPs and their Influence on Managers' Behaviour

Traditional options have been questioned because they link the manager's compensation to the absolute share price, a variable that does not always correlate with the creation of value. Although in the long term the performance of the company is what drives changes in the share price, factors external to the firm cause fluctuations which in some cases can be very large. Patterson and Smits (1998) found that 70% of share price variations of U.S. firms were due to such factors. If the impact of these factors is so great, it calls into question the incentivising capacity of the plans, because they may allow the manager to obtain a reward without having made any effort, simply taking advantage of a "lucky break" propitiated by external factors, or deprive him of it even though he deserves it (Bebchuck et. al., 2002).

The positive influence of external factors in the quoted price of shares leads the executive rewarded by conventional options to obtain a higher reward than he deserves. Thus, the manager can obtain a high reward even though the returns of his company do not exceed the average for the sector (Johnson, 1999). A negative influence of external factors on the share price, however, means that the manager obtains no reward even though by his management the firm has achieved higher returns than its competitors. The implantation of conventional options therefore especially favours mediocre managers who, as a consequence of the positive impact of external factors on the share price, will receive higher compensation than they deserve, and will suffer no disadvantage in unfavourable situations. Consequently, this type of options wastes shareholders' money and at the same time sends inappropriate messages to managers. It also helps to increase the scepticism of employees, customers, and the general public about this compensation mechanism, which tends to look more like a lottery than a performance-dependent compensation system.

Repriceable options are even more questionable. As well as suffering the same defects as the above, they foment even more the decoupling of managerial reward from shareholder return, by establishing clauses that permit changing the exercise price if the share price falls significantly. The lack of linkage between managerial reward and shareholder return that exists in conventional options and in repriceable options can be overcome by two different designs. The first consists of indexing the exercise price of the option to the performance of the sector or market to filter out changes in the stock price that are not due to the manager's efforts. The second conditions vesting to the achievement of certain objectives linked to the creation of value.

Indexed options reward the differential between the value of the company's shares and the named index. Thus, the manager will only obtain the reward if the share price of his company exceeds the index. This type of options encourages the manager to concentrate his efforts on exceeding the return of the index – return of certain competitors, average return of the industry, etc.. Consequently, indexed options create a more powerful incentive per dollar value than conventional options (Johnson and Tian, 2000) and reward the manager for his efforts by isolating the part of share value arising from external factors beyond the manager's control (Kerr and Bettis, 1987). Performance vested options, like indexed options, prevent the manager obtaining a reward thanks to a "lucky break" due to the influence of external factors on the share price. On the other hand, restricted stock options, conditioned to a participation in capital, i.e. those options that require the possession of a certain number of shares to be able to exercise the option right, increase the manager's personal commitment to the firm. The best guarantee for improving the future performance of managers is to link the beneficiary to the fate of the firm even before receiving the incentive. The literature indicates that the CEO, to reduce his risk, tends to sell the shares as soon as he has exercised

the option (Carpenter and Remmers, 2001; Heath et al, 1999; Ofek and Yermack, 2000; McGuire and Matta, 2003). Therefore, the requirement that managers possess a certain number of shares in order to exercise the options will encourage them to keep at least some of the shares acquired.

Indexed options and performance vested options are easier to justify to shareholders. However, they are the least valued by managers because they provide them with a lower potential gain than conventional options and repriceable options. According to Murphy (2002), the probability of obtaining a reward with an indexed option is 50%, whereas a conventional "at money" option allows gains in 80% of cases. Consequently, the implantation of conventional option plans and repriceable options may play an important role in attracting and retaining top managers.

Independently of the type of option used, the way the exercise price is determined affects both the cost of the plan and the managers' motivation. The lower the exercise price in relation to the initial price, the higher the cost for the company. Regarding the motivational impact, some authors (Bebchuk, Fried and Walker, 2002) consider that the grant of in-the-money options rewards the beneficiary unduly, as instead of giving him an incentive to strive, it lulls him to sleep. Nevertheless, the granting of in-the-money options can be used to attract and retain talented managers, as they offer the beneficiary greater potential gains than "at the money" or "out of the money" options. According to Hall and Murphy (2000), executives prefer a small number of options at a low price to a greater number at a higher price. The attraction and retention of managers, and their decisions can be affected by decisions on: a) the duration of the plan and the exclusion and vesting periods, and b) clauses that slow vesting, limit the amount of reward and restrict the sale for a certain time of acquired shares.

The duration of the plan is determined by the sum of the period of exclusion (from the approval of the plan until the exercise period) and the exercise period, during which the manager can exercise the option right. Establishing a period of exclusion encourages retention of the manager and motivates him to focus on long-term decision making because during this period he cannot exercise the right to buy. Likewise, the establishment of clauses that slow vesting, or restrict the sale of shares for a certain period of time after exercising the right, will have repercussions for long term orientation, as it de-stimulates initiatives developed to artificially increase the share price in the short term: the price of the shares will decrease when the market discovers these manoeuvres. The CEO can manipulate the value of the stock when the exercise date approaches by controlling the publication of news about the firm, using privileged information or by re-purchasing the firm's own shares in the market. Finally, slow vesting also encourages retention, because the manager would lose the outstanding option rights if he left the firm before the end of the exercise period. Aiming to recruit high prestige managers in tight labour markets, some companies may be obliged to offer option plans with very short exclusion periods and no slow vesting clause, so that the option to buy can be exercised quickly. This action is very frequent when the managers whom it is desired to hire lose the options granted when they leave the company.

## 5. Empirical Analysis

### 5.1. Data

The data used in this study correspond to the types of SOPs used in the 115 most representative firms of the General Index of the Madrid Stock Exchange, during the period between 1999 and 2001, both inclusive. The data are from Comisión Nacional de Mercado de Valores (National Commission of the Stock Market).

### 5.2. Results

The data gathered indicate that only 32 of the 115 firms analysed (27,8%) use some type of SOP as a mechanism of remuneration.

### Beneficiary Group

The 32 firms that have implemented SOPs limit this incentive to the top manager group. In 23 firms, the plans include the CEO, while 9 firms exclude the CEO given his participation in the capital of the firm (table 3).

**Table 3.** Stock option plans

| Stock option plans (SOPs) | Freq. | % |
|---|---|---|
| CEO included in the group "top management rewarded with options" | 23 | 20% |
| CEO excluded from the group "top management rewarded with options" | 9 | 7,8% |
| ▪ Total " top management remunerated with options" group | 32 | 27,8% |
| ▪ Not used | 83 | 72,2% |
| Total | 115 | 100 |

### Base of Allocation

In the 23 firms that reward their CEOs by means of SOPs, we identified 39 plans, distributed between megagrant plans and fixed number multi-year plans. Of the two alternatives, the first type is more frequent (table 4). In the case of multi-year plans,

30.4% were of two and three years and 69.6% concentrated the grant of options at a particular time, though not all these plans establish the same conditions for the totality of the grant. Specifically, there are four plans in which the grant is divided into groups and different exercise prices are set for each group of options.

**Table 4.** Type of plans by base of allocation

| | | % | Frequency |
|---|---|---|---|
| Base of allocation | Mega-Grants: | | |
| | - Identical conditions | 52.1% | 12 |
| | - Different conditions | 17.5% | 4 |
| | Total | 69.6% | 16 |
| | Multi-year | | |
| | - Two years | 21.7 % | 5 |
| | - Three years | 8.3% | 2 |
| | Total | 30.4 % | 7 |
| Total firms | | 100% | 23 |
| Total of plans: 39 | | | |

## Duration of the Plan, Exclusion Period and Restrictions During the Exercise Period

The duration of incentive plans, determined by the sum of the exclusion period and exercise period, varies from 2 to 10 years; their average duration is 5.2 years. The exclusion period, during which the CEO cannot exercise the right of purchase, varies between 1 and 5 years; the average is 2.2 years (see table 5). Also, as can be seen in table 6, in 59% of the plans the exclusion period is less than three years.

**Table 5.** Duration of the plan and of exclusion period

| | Mean | S.D. | Max. | Min. |
|---|---|---|---|---|
| Duration of the plan | 5.2 | 0.26 | 10 | 2 |
| Exclusion period | 2.2 | 0.14 | 5 | 1 |

**Table 6.** Exclusion period

| | | Frequency | % |
|---|---|---|---|
| Exclusion period | Less than three years | 23 | 59% |
| | More than three years | 16 | 41% |
| | Total | 39 | 100 |

## Exercise Price

The exercise price of the 39 SOPs identified in Spanish firms is a fixed value. The way it is established varies, however (see table 7):
- In 46.2% of the plans, the exercise price coincides with the starting price. These are options granted "at the money".
- In 28.2% of cases, the exercise price is lower than the starting price. Therefore, the options are granted "in the money". The average discount represents 21.55% of the starting price and varies between 3% and 79.6%. - In 25.6% of the plans, the exercise price is higher than the starting price of the shares. These are options granted "out of the money". The average premium is equivalent to 35.3% of the starting price and varies between 0.6% and 135% of this price.

**Table 7.** Determination of the exercise price

| Exercise price | | % | Freq. | Mean | Max. | Min. |
|---|---|---|---|---|---|---|
| Subject to review | | 0 | 0 | | | |
| Adjusted to an index | | 0 | 0 | | | |
| Fixed | Equal to starting price (Grant "at the money") | 46.2% | 18 | | | |
| | Lower than starting price (Grant in the money) | 28.2% | 11 | 21.55% | 79.6% | 3% |
| | Higher than starting price (Grant out of the money) | 25.6 % | 10 | 35.3% | 135% | 0.6% |
| Total options based incentive plans | | 100% | 39 | | | |

Therefore, in none of the SOPs implemented by Spanish firms to reward their CEOs did we identify provision for review of the exercise price in the event of significant falls in the share price, or plans that establish exercise prices adjusted to an index.



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## Establishment of Conditions

In all the plans, the exercise of the right to buy shares is subject to the CEO remaining with the firm; labour loyalty is therefore required (table 8). In some cases, performance and patrimonial loyalty clauses are added to this condition. As shown in table 8, the right of exercise is conditioned:

- In 20.5 % of the plans to the achievement of objectives such as ROE, ordinary results, revaluation of the share, or profits per share, established in all cases in absolute terms.

- In 10.3% of the plans to the possession of a certain number of shares and to their preservation throughout the period of the plan (patrimonial loyalty).

Other noteworthy aspects are (table 8):

- Only one of the plans limits the amount of the reward that the CEO can obtain. Furthermore, in this plan the right of exercise of the options is conditional to the achievement of objectives.

- In 28.2% of the cases clauses are established that slow the vesting of the right of purchase during the exercise period; i.e. the plans specify both the dates and the maximum number of options to be exercised on each date.

- 20.5% of the plans establish clauses that restrict the sale of the shares acquired during a period that varies between 1 and 2 years.

**Table 8.** Establishment of conditions

| Conditions | | % | Freq. |
|---|---|---|---|
| Labour loyalty | Required | 100% | 39 |
| Performance | Required<br>Not required | 20.5%<br>9.5% | 8<br>31 |
| Patrimonial loyalty | Required<br>Not required | 10.3%<br>89.7% | 4<br>35 |
| Limitation of the amount of the reward | Required<br>Not required | 2.5%<br>97.5% | 1<br>38 |
| Slowed vesting | Required<br>Not required | 28.2%<br>71.8% | 11<br>28 |
| Restriction on sale of shares | Required<br>Not required | 20.5%<br>79.5% | 8<br>31 |

## Types of Options

Analysing jointly the exercise price and the existence of conditions that limit the right of exercise, we observe that, to reward the CEO, Spanish firms (see graph 1):

- Do not use indexed options, nor repriceable options.

- Traditional options are used more than conditioned options. Of the total, 69,2% of the plans are traditional options and 30,8% are conditioned, of which 20,5% condition the right of exercise to prior achievement of certain objectives: ROE, ordinary results and profits per share; and the remaining 10,3% to the possession of a certain number of shares.

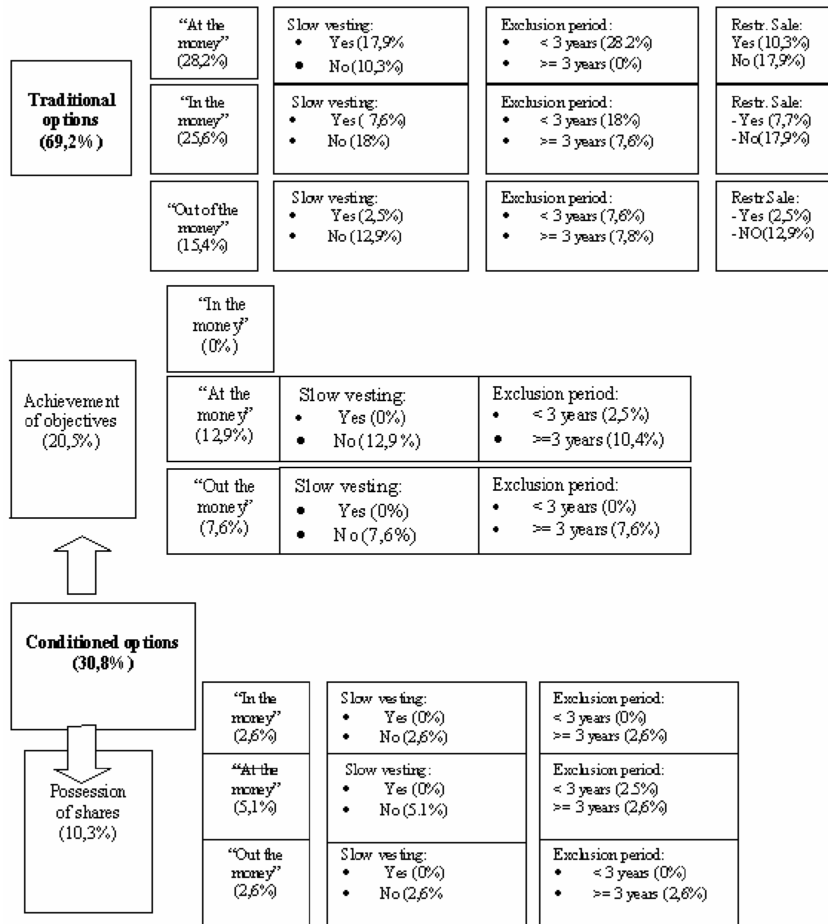
If the exercise price is compared with the price of the shares at the start of the plan we observe that:

- Of the 69,2% of the plans that we have counted as traditional options, 28,2% are granted at the money, 25,6% in the money and 15,4% out of the money.

- Of the 30,8% of plans computed as conditioned options, 2,6% are granted in the money, 18% at the money, and 10,2% out of the money.

So, of the total of traditional options, 41% are granted at the money, 37% in the money and 22% out of the money, and of the total of conditioned options, 59% are granted at the money, 8% in the money and 33% out of the money. These results allow us to conclude that: 1) the grant at the money is the most frequent in both groups, 2) the grant in the money has more weight in the traditional options and 3) the grant out of the money is more frequent in the conditioned options.

Analysing the amplitude of the exclusion period, we observe that in 59% of the plans it is less than three years (table 7), which raises doubts as to the capacity of these plans to retain managers and to encourage a long term orientation. However, as we have shown earlier, this incapacity can be made good by slowing the vesting during the exercise period and restricting the sale of the shares acquired for a certain time. In order to examine this possibility, we have analysed these three dimensions jointly, crossing two variables: 1) the existence of slow vesting; and 2) sum of the exclusion period and restriction of the sale of shares acquired (table 9). We observe that there are 8 plans (20,5%) which do not slow the vesting, and the sum of the exclusion period and the period of restriction on the sale of the shares acquired is less than three years. Nevertheless, taking into account the existence of other multi-year plans, or even mega-grant plans that do not establish the same conditions for all the options, only three plans can encourage the manager to start manoeuvres to artificially increase the share price. These are traditional options, two granted at the money and one in the money.




**Graphic 1.** Types of Share Option Plans

**Table 9.** Crossed Table of the variable "sum of exclusion period and period of restriction of sale of shares"

| | | | Slow vesting | | Total |
|---|---|---|---|---|---|
| | | | No | Yes | |
| Sum of exclusion period and sale restriction period | Less than three years | No other plan | 3 (7,7%) | 1 (2,5%) | 4 (10,2%) |
| | | Other plan | 5(12,8%) | 6 (15,4%) | 11 (28,2%) |
| | | Sum | 8 (20,5%) | 7 (17,9%) | 15 (38,4%) |
| | More than three years | | 20 (51,3%) | 4 (10,3%) | 24 (61,6%) |
| | Total | | 28 (71,8%) | 11 ( 28,2%) | 39 (100%) |

## 6. Discussion and Conclusions

Stock options can be used as an instrument of CEO remuneration. Their implementation requires decisions to be made about several dimensions: beneficiary group, base of allocation, exercise price, establishment of conditions, duration of the plan, exclusion period, and exercise period. From the combination of these dimensions different types of SOPs are obtained.

In this study, we have identified the types of SOPs used by Spanish firms to reward their CEOs. The results of this analysis confirm that:

1.- SOPs do not have the importance that they have acquired in the Anglo-Saxon countries, only 20% of the 115 listed firms most representative of the General Index of the Madrid Stock exchange using them to remunerate their CEO. The difference in the use of SOPs between Spanish firms and, specifically, those of the USA to reward their CEOs may be due to the different structure of ownership. Whereas in the USA the wide dispersal of ownership may compel the Board to use stock options as a mechanism of alignment of interests between owners and the management, the concentration of ownership existing in Spain permits direct control of the management.

2.- SOPs are limited exclusively to the group of top managers. This practice of allocation again differentiates Spanish firms from those of the Anglo-Saxon countries, where it is increasingly common to make SOPs extensive to all the staff (Conyon and Freeman, 2001, Murphy, 2002). From this we can deduce that Spanish firms do not use SOPs as a

mechanism to strengthen or create a culture of cooperation and an organisational commitment in all the members of the firm.

3.- The base of allocation most used is the mega-grant, i.e. the grant of the options is concentrated in one specific financial year. When the price of the shares increases, this form of allocation offers more potential profit to managers than multi-year plans. However, when the share price goes down, mega-grants favour demotivation and the flight of the beneficiaries to competing firms, above all when the fall in the share price is caused by outside forces.

4.- Traditional options are the most used, in 69,2% of cases. Of the remaining plans, 20,5% are options conditioned to the achievement of objectives (performance-vested options) and 10,3% are conditioned to the possession of shares. No plans use indexed options or repriceable options.

5.- The grant of options "at the money" is the most frequent, both in the case of traditional options and in that of conditioned options. Comparing the importance of grants in the money and out of the money, we observe that the first is more frequent among traditional options, while the second has more weight among conditioned options.

So, the types of SOPs used to reward Spanish CEOs are fairly similar to those used to reward US CEOs, in that: 1) indexed options are not common (Murphy 1985), 2) the use of "performance vested options" is rare, being implemented by only 5% of the 250 largest American listed firms (Levinshon, 2001), and 3) the grant of traditional options "at the money" is the most frequent type (Murphy, 2002, Bebchuk et al, 2002). The fact that traditional options are the most used type and most of those are granted at the money and in the money, and that even, in some cases, the exclusion period is shorter than three years and there are no clauses that compel slow vesting or limit the sale of the shares acquired, permit us to conclude that the majority of SOPs designed by Spanish firms offer high potential gains, with implications for the attraction, retention and motivation of executives. This expectation of gains may increase the attraction and retention of competent executives, but decrease the motivation to seek new investment opportunities that result in the achievement of a profitability higher than the industry average. These plans encourage the CEO to perceive that, to obtain profits, it is not necessary to strive to increase the share price, but it is sufficient to take advantage of the upward trend of the market.

On the basis of these conclusions we can ask the question: What is the reason for the non-existence of indexed options and the proliferation of traditional option plans, especially granted at the money?

Although there are several arguments in the literature that allow this result to be explained, some of them are disputable. For example, authors such as Janakiraman et al, (1992) maintain that indexed options are not used because they are not an incentive to CEOs to disinvest from unattractive business and reinvest in industries with greater opportunities (Janakiraman et al, 1992). This type of options will reward the CEO of a firm whose shares are falling more slowly than those of its industry, even though the correct decision would be to disinvest from that sector and reinvest in other more attractive ones. However it is not clear that reinvestment in other industries is a desirable option for shareholders, due to their capacity to diversify their portfolio and to their choice – to invest in a particular industry, accepting the risk specific to it (Bebchuk et. al., 2002). But, even accepting the argument of Janakiraman et al (1992), the options could be linked to a broader index (the stock exchange index rather than the industry index), which would solve the problem indicated by the authors.

Levmore (2001) maintains that indexed options are not used because this type incentivises the choice of highly risky strategies. Indexed options, by rewarding the differential between the value of the shares and that of the selected index, could encourage CEOs to forgo projects of higher value in favour of those that present greater volatility relative to the said index. However, even assuming that indexing reduces the quality of the projects selected, this negative effect could be offset by the potential profits deriving from the indexing – greater incentives to create value in any project selected (Bebchuk et. al. ,2002).

Other arguments, in our opinion more convincing, which allow us to explain the designs of option plans, arise from the perceived value/cost approach (Murphy, 2002) and from the Management Power theory (Bebchuk et al, 2002,).

## Perceived Value/Cost

According to the perceived value/cost view, risk-averse and undiversified executives perceive that stock option compensation is highly risky and give the option a lower value than would be given to it by an investor (Hall and Murphy, 2002). Unlike the latter, who is only exposed to systematic risk, the manager is affected by the total risk. Hence the return expected by the manager is too low to compensate him adequately for the risk that he runs. Meulbroek (2001) maintains that the value of a traditional option for a manager is reduced by the volatility of the firm. For example, the value of traditional stock options for a manager of an Internet firm is 53% of their market value, while for a manager of a NYSE firm it is 70%. This value may be even more reduced in the case of indexed or conditioned options, or those granted out of the money, because with these designs the probability that the option plan will end in a positive result is reduced. Murphy (2002) maintains that the probability of obtaining a reward with indexed options is less than 50%, while that of a traditional

stock option, granted at the money and with duration of 10 years, is 80%.

Boards may also perceive, wrongly, that traditional option plans granted at the money are a low-cost form of compensation, because they are granted without paying out any money and without registering them as expenditure. Both in the USA and in Europe there is no obligation to make a charge to the firm's Profit and Loss account when the exercise price is the price of the share at the time of handing over the options.[3] Therefore, unlike the other types of options (traditional options in the money or out of the money, indexed options and restricted options), traditional options granted at the money may be perceived as gratis because, as they are not entered in the accounts, they do not reduce the firm's profits.

Thus, the fact that for the manager the most valued type of options is the traditional option granted in the money and at the money, together with the Board's perception that the least costly is the traditional option granted at the money, may explain the proliferation of the latter type ( Murphy, 2002).

## Theory of Managerial Power

The use of options that offer high potential gains and low risk of loss may be due to managerial power, defined by Lambert, Larcker and Weiglt (1993:441) as "the capacity of the manager to influence or impose upon the board or compensation committee that his wishes regarding compensation be fulfilled".

Managerial power may arise from different sources: weak governance structures, expertise in a critical area (expert power) and prestige (prestige power ) (see Finkelstein, 1992).

The power of top management to influence the design of its system of compensation increases with weak governance structures (dispersion of ownership, and deficient structure and working of the board).

There is evidence to support the hypothesis that the CEO takes advantage of the weakness of the firm's governance to achieve a system of compensation in accord with his interests: high reward and low risk (Gomez Mejía and Balkin, 1992). Studies such as that by Tosi and Gomez Mejia (1989) conclude that, in firms with dispersed ownership, the influence exercised by the CEO and external consultants on the process of CEO compensation is greater than in firms with ownership concentrated, and consequently the level of risk of the CEO's compensation package is also lower in firms with dispersed ownership. This result is coherent with those obtained by earlier studies (Gomez Mejia, Tosi and Hinkin, 1987) which reveal that, in owner-controlled firms (concentrated ownership), the most important determinant of the CEO's level of compensation is performance, while in management-controlled firms (with dispersed ownership), the most important determinant is size. Other studies (Boyd, 1994, Mangel and Singh, 1993, Conyon and Peck, 1998) also found a negative relation among different aspects that enhance the effectiveness of the Board, such as non-duality of President/ CEO office, the Board's participation in the capital of the firm, the presence of independent directors, the existence of compensation committee and the CEO's level of compensation.

The CEO's capacity to influence Boards that function deficiently in firms with dispersed ownership may therefore explain the non-existence of indexed options and the use of traditional options granted in the money and at the money and with short exclusion periods. This type of options may be used with the intention of camouflaging high compensation and thus to avoid possible scandals and outside criticism (Bebchuk et al 2002).

The power of the top management may also derive from the possession of leadership and management skills, as well as the prestige achieved.

According to the theory of resources and capacities, a firm can deliver a sustainable competitive advantage if it possesses resources that are valuable, rare, and difficult for competitors to imitate or acquire. Superior managerial skills meet these criteria, so they can constitute a critical resource (Castanias and Helfat, 1991). The notion that managerial skills are valuable is traditional in strategy research. Given the complexity of managerial work, the many leadership skills that must be developed, and the need to develop industry and firm specific knowledge to guide decision making, superior managerial capabilities also appear to be rare (Combs and Skill, 2003). Finally, superior managerial skills are difficult to imitate because they are generally learned through experience and are thus difficult to codify and teach (Castanias and Helfat, 1991). Superior managers can be hired away from their current employers, but doing so is costly (Harris and Helfat, 1997)

For all these reasons, their skills, knowledge and prestige give managers great power when negotiating their compensation contract. Furthermore, the competition among firms for talented executives has intensified in the last two decades as a consequence of the increased level of uncertainty in the business environment. In unstable environments, Boards may be forced to design option plans that offer a high potential profit and little risk of loss (e.g. traditional options in the money) in order to attract or retain talented top managers.

To sum up, the design of option plans can be explained by the power of top management derived both from weak governance structures and from the manager's possession of superior skills and prestige. However, the two influences can have different consequences that should also be investigated in the

[3] However, from 2005 onwards, internacional accounting normas establish that stock options must be accounted for as expenditure.

future. Probably the effect on the firm's performance of options with high potential gains, such as traditional options, will be different according to the source of the manager's power. It is to be expected that when the SOP is determined by managerial power derived from weak structures of governance, the implementation of traditional option plans will have a negative influence on the firm's results, whereas when it is influenced by expert power or prestige, the relationship between the implantation of the plan and the results of the firm will be positive. For this reason we consider that the effect of traditional options on performance may be contingent upon the source of the manager's power. This would explain the divergent findings of different studies that analyse the influence of the implantation of options on the firm's results.

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# TARGET BOARD STRUCTURE AND TAKEOVER-INDUCED ABNORMAL RETURNS IN THE UK

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**Abstract**

**We examine the link between board structure and bid-induced abnormal returns for a sample of 198 UK-based firms that became takeover targets between 1989 and 1998. As expected, takeover targets experience significant gains during the takeover announcement period. In line with a disciplinary explanation for takeovers, we find that target boards that are larger, with fewer independent directors, and a managing director chairman, experience more favorable announcement-period returns. Targets with more reputable directors and directors with greater ownership incentives, also experience more favorable announcement-period returns.**

**Keywords:** Board of directors; takeovers; bidders

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## 1. Introduction

Corporate takeovers involve considerable discretion on management's part. Because of this, takeovers present a useful setting for observing the effectiveness of alternative corporate governance structures in guiding managerial discretion and in protecting shareholder interests. In particular, prior research has suggested that the structure of a corporate board, a mechanism that is at the apex of corporate governance, is a major determinant of a takeover's success. The first such evidence came from Byrd and Hickman (1992) who report that bidders in the US experience more positive announcement-period returns when their boards are independent of management's influence. In a related vein, Cotter et al. (1997) report an analogous result for US takeover targets. The presumption in both studies is that independent boards help to protect shareholder interests in takeover transactions, and that such benefits are reflected on share prices (the effective board explanation). We posit a competing possibility, suggesting that takeovers are most beneficial for shareholders when targeting poorly governed firms. In this view, firms with less independent, and otherwise less effective, boards stand to gain more from a takeover because the potential improvement in governance resulting from the change in control is greater for poorly governed firms (the disciplinary explanation).

In this study, we address these competing explanations empirically by studying the importance of board structures in explaining shareholder returns for a sample of UK firms becoming takeover targets between 1989 and 1998. Our study adds to existing knowledge in two additional ways: First, it is staged in a UK, rather than in a US, setting. Although in both countries ownership in public corporations is dispersed and shareholders receive significant legal protection in the common law tradition, there are important differences in the way corporate boards are structured and operate: In marked contrast to US-based firms, in the vast majority of UK firms there is a separation in the roles of board chairperson and CEO, executives and non-executives are roughly evenly represented on boards, boards are generally small, executive compensation packages are leaner and simpler, and little work is delegated to board committees. (See Conyon (1994) for descriptive statistics on UK boards, and Yermack (1996) for descriptive statistics on US boards.) The impact of these differences on the shareholder wealth effects of takeovers is not a priori clear.

Second, exploiting these differences and building on prior work, this study employs a wide set of proxies for board structure in addition to board independence, such as board size, leadership structure, director ownership, director incentives, and director reputation. This approach draws on a growing body of research that suggests that several features beyond independence may be important in

measuring successful boards, and tests the importance of these features in enhancing target shareholder wealth. Our findings are mostly in line with a disciplinary explanation for the market reaction to takeovers. Importantly, we find that target boards that are larger, with fewer independent directors, and a managing director chairman, experience more favorable announcement-period returns. Firms with smaller, less independent boards that are led by a CEO-chair are likely to be firms with more corporate governance problems and would, presumably, benefit more from a change in control. In contrast, we also report evidence that targets with more reputable directors and directors with greater ownership incentives, experience more favorable announcement-period returns, suggesting that director incentives may increase the wealth of target shareholders. The study is organised as follows. The literature review and hypotheses are presented in section two. Our data collection procedure, variable selection, sample description, and methodology comprise section three. A discussion of the results obtained from multivariate analysis is reported in section four. Section five summarises and concludes.

## 2. Literature Review and Testable Hypotheses

### 2.1 Background

In this study we address the following question: 'how does a takeover target's board structure affect its shareholders' wealth during a takeover?' This pursuit draws on agency theory[1] that highlights the conflicts of interest that usually appear in public corporations. Jensen and Meckling (1976) and Fama and Jensen (1983) argue that agency costs can be minimised by using a variety of governance mechanisms that reduce the scope of managerial discretion. Such mechanisms include the corporate board, ownership structure, and compensation incentives. In cases where internal structures are not working properly, the market for corporate control acts as a monitoring mechanism of last resort, since it corrects for managerial failure by displacing under-performing managers (e.g., Weir, 1997). Thus, firms with inadequate internal controls are expected to have poor financial performance and a higher likelihood of becoming takeover targets; poorer financial performance will attract outside bidders who can potentially manage the firm's resources better than existing management.

This assertion is empirically supported by Limmack (1994) who finds evidence that acquisitions are undertaken not only for synergistic reasons but also to acquire previously under-utilised assets, suggesting that the market for corporate control acts as one of the disciplinary mechanisms aiming to improve corporate profitability. In a related vein, Cotter, Shivdasani, and Zenner (1997) find that when the target's board is independent, the initial tender offer premium, the bid premium revision, and the target shareholder gains over the entire tender offer period are higher. They conclude that independent outside directors enhance the target shareholders' wealth and that independent target boards are more likely to use resistance strategies.

Shivdasani (1993) compares a sample of hostile US targets to a sample of non-targets and concludes that the likelihood of hostile takeovers is negatively related to stock ownership, and the number of additional directorships held by non-executive directors, in line with firms with poorer governance structures being more likely to resist a takeover. Furthermore, Brickley and James (1987) find that the presence of non-executive directors serves to reduce consumption of perquisites in the absence of an effective takeover market, consistent with independent boards and the corporate control market being substitute mechanisms in disciplining management. Finally, Stulz (1988) argues that higher managerial stock ownership can reduce the likelihood of a successful takeover, since a higher equity stake might prevent the efficient operation of the market for corporate control. In such a case, managers can block an offer or set a high premium that may be unprofitable for the bidding company.

Focusing on a sample of UK firms, Weir (1997) studied the relationship between the probability of being acquired, firm performance, and governance structure. He finds that board independence and leadership structure can differentiate between acquired and non-acquired firms. Weir also finds that targets are poor performers, a fact that supports the view that their internal governance is ineffective. Finally, O'Sullivan and Wong (1998) find that executive stock ownership decreases the likelihood of a hostile takeover in the UK, but increases the likelihood of a successful takeover.

### 2.2 Testable Propositions

The preceding discussion leaves open the possibility for two competing effects of board effectiveness on the target shareholders' wealth: First, the most widely held view is that effective boards elicit more attractive bids, and make better decisions for their shareholders, resulting in higher returns in the presence of good governance (an effective board explanation). In contrast, a disciplinary explanation predicts lower returns for targets that are properly governed because such firms have less to gain from a change in control.

Below, we present a series of governance mechanisms and argue their potential importance in corporate governance. Because of the competing

[1] Agency problems are the conflicts that arise when the interests of shareholders and managers diverge. More formally, agency problems occur because the control and management functions are separated from risk bearing.



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nature of the "effective board" and "disciplinary" explanations, we do not express directional expectations in stating our hypotheses. Instead, we simply illuminate each mechanism as potentially important in explaining the target shareholder's returns and outline the arguments supporting each explanation for the market reaction to takeovers.

#### 2.2.1 Pct. Outside Directors

The board of directors is responsible for supervising the actions of senior management to protect shareholder interests (Fama, 1980). This objective has been closely linked to the composition of the board, i.e., executive and non-executive director representation.[2] Specifically, it is recommended that non-executive directors assume an active monitoring role in the boardroom (Fama, 1980; Fama and Jensen, 1983; and Cadbury, 1992). The oversight provided by outside directors when a firm has to respond to a tender offer is of great importance for shareholders, since tender offers can have a very significant effect on shareholder wealth. Although target shareholder gains are usually large in successful tender offers, managers may suffer (e.g., by losing their jobs), and thus may try to reject such offers. Thus, according to the effective board explanation, independent boards will make better decisions for the target firm's shareholders, consistent with shareholder wealth maximisation.

Alternatively, in line with the disciplinary explanation, firms with more independent boards have less to gain form a takeover because these firms are, on average, well-governed. Shareholders will respond with greater relief to news of a change in control in firms where managers have control of the board, and who compromise the board's monitoring effectiveness. Thus,

*Hypothesis 1: Shareholder gains during tender offers are related to the fraction of outside directors serving on the board.*

#### 2.2.2 CEO-Chairman

A second important characteristic of the board, highlighting its independence, is its leadership structure or concentration. Some argue that no individual director should hold the CEO and board chair jobs together (e.g., Cadbury, 1992). Having a unitary leadership structure by combining the roles of chairman and CEO can yield excessive power to one person, thus reducing the board's ability to exercise effective, independent control over management. (For mixed empirical evidence on the value-relevance of leadership structure see Brickley, Coles, and Jarrell, 1997.) Separating the two roles allows the CEO to run every-day business while allowing the chairman to focus on different strategies and evaluate the performance of the firm and its directors independently. In line with the earlier discussion, if more independent board chairpersons make better takeover decisions, targets that have separated the CEO chairman roles would experience greater returns. In the disciplinary view of takeovers, the removal of a CEO chairman from a target's board would result in a greater reduction in agency costs, and would thus elicit greater announcement-period returns for the target.

*Hypothesis 2: Shareholder gains during tender offers are related to the presence of a CEO-chairman on the board.*

#### 2.2.3 Pct. Interlocking Directors

Third, probing further into the independence of boards, we identify all target firms with directors also serving on the bidder's board (termed interlocking directors). We examine how such directorships can affect the target shareholders' wealth given that these directors have a fiduciary obligation to both firms, and face a conflict of interests. Further, interlocking directorships can reduce the information asymmetry between the target and bidder, so other bidders may be discouraged from making a bid, also reducing the potential benefits of shareholders. Alternatively, the presence of interlocking directors is likely to cause conflicts in the board because of conflicting interests among directors. Bringing the entire board under the bidder's control will increase the board's operating efficiency.

*Hypothesis 3: Shareholder gains during tender offers are related to the fraction of interlocking directors serving on the target firm's board.*

#### 2.2.4 Directorships Held by Outside Directors

Fourth, the reputation of independent directors is another relevant director attribute. A proxy of how reputable independent directors are in the labour market is their value in the market for directorships. Fama (1980) and Fama and Jensen (1983) underline the importance of reputation capital as a measure of director effectiveness. One proxy for director reputation, and thus for director ability and willingness to protect shareholder interests, is the number of additional directorships held by outside directors. According to the effective board explanation, companies whose board includes more

[2] Executive, dependent, or inside directors are appointed to the board because of their experience and industry-specific knowledge of the business. Inside directors are full-time employees of the firm. Non-executive, independent, or outside directors are those directors who are not current or past employees of the corporation. In this study independent directors might include directors that have some affiliation with the firm, or have substantial business or family ties with the firm. The duties of a non-executive director are to encourage senior management to improve corporate performance, to offer specialised assistance when required, and to monitor managerial actions.

reputable non-executive directors (those holding more additional board seats) make better decisions during takeover contests, and are thus able to elicit higher returns for the target firm's shareholders. According to the disciplinary explanation, targets stand to benefit more when the directors to be replaced are less reputable, and thus less effective in overseeing management.

*Hypothesis 4: Shareholder gains during tender offers are related to the number of directorships held by the target firm's outside directors.*

### 2.2.5 Director Incentive Shares

A fifth characteristic that is critical in testing the role of the board of directors in takeover bids is the amount of incentive shares held by the target firm's directors, both executive and non-executive. It is a widely-held belief that agency problems between corporate directors and shareholders can be reduced through appropriate incentives by which shareholder and director interests are aligned. Two possibilities exist: a) better motivated directors make better takeover decisions or b) replacing poorly motivated directors creates additional wealth for takeover targets.

*Hypothesis 5: Shareholder gains during tender offers are related to the amount of incentive shares held by the target's directors.*

### 2.2.6 Director Stock Ownership

Related to director incentives, a sixth key characteristic of the board is the amount of stock owned by directors. It is expected that in firms with high director stock ownership, directors are more inclined to act in line with shareholder interests. First, non-executive director shareholdings contribute to a large extent to the minimisation of the asymmetry of information between the managers and the rest of the shareholders since non-executives have an incentive to monitor the managers' behaviour while simultaneously protecting their own interests. On the other hand, stock ownership by management can reduce the agency problem stemming from the separation of ownership and control. According to the effective board explanation, the more stock managers own, the stronger their motivation to raise the value of the firm's stock (e.g., McConnell and Servaes, 1990).[3] According to the disciplinary explanation, the removal of directors with low equity-holdings (in anticipation of new directors with greater equity-holdings) is positively received by the market.

*Hypothesis 6: Shareholder gains during tender offers are related to the amount of director stock ownership.*

### 2.2.7 Board Size

Finally, the size of the board is also an essential part of board structure. Up to a point, there are essential benefits to large boards because an increased number of board members may bring a wider perspective to the board. However, process losses and operational inefficiencies may render boards that are larger than a critical level to be less functional (e.g., Yermack, 1996). Often a board of directors faces co-ordination problems, which increase as the size of the board increases.[4] Given that small boards are unusual in public firms, we expect the effect of board size on bid-induced returns to be monotonic, i.e., the effective board explanation would predict a negative relation between board size and shareholder gains; the disciplinary explanation would predict a positive relation.

*Hypothesis 7: Shareholder gains during tender offers are related to the target firm's board size.*

In addition to these variables, we control for other factors that can potentially explain the market reaction to takeover bids. First, a binary variable distinguishes all-cash transactions from those that are financed partly with equity (see Travlos, 1987). Second, the market-to-book ratio reflecting the target's growth opportunities, is used to capture the bidder's incentives for a disciplinary takeover to eliminate over-investment by the target. Third, an industry affiliation dummy separates synergistic acquisitions from diversifying acquisitions. Finally, the tests control for the target's size relative to the bidder, the target's leverage, and its pre-bid equity capitalisation.

## 3. Data and Methodology

### 3.1 Data

Data on the bidding and target firms and the characteristics of the bid were collected from Acquisitions Monthly, and span the period from December 1989 to April 1998. For a firm to be included in the sample, both the bidder and target had to be based in the UK. To measure the wealth effect of the bid, we collected data on daily security returns from Datastream. Our corporate governance data, covering each firm's board and ownership characteristics, come from the Price Waterhouse Corporate Register. Specifically, before 1995 governance data were obtained from the Register's bi-annual books, and after 1995 from the Register's

[3] At the extreme, excessive managerial stock ownership might work the other way around and increase agency problems, as in the case of many family-controlled firms where directors may put the interests of the family above the interests of shareholders.

[4] Theoretically, the optimal size of the board is determined by increasing the number of directors until the benefits from additional perspectives are offset by the costs of greater difficulties in co-ordination and decision making.

quarterly books. Firms that were not listed in either Datastream or the Price Waterhouse Corporate Register were excluded from the sample. The final sample of takeover targets used in this study comprises 198 tender offers. The sample is then divided into hostile bids (bids that were contested by the target firm's management) and friendly bids. Hostile bids are in turn divided into successful and unsuccessful bids. Specifically, we consider a bid to be hostile if Acquisitions Monthly reports that the target firm resisted the offer. A bid is considered to be friendly if Acquisitions Monthly reports that it was accepted by the target firm's management. If the bid was hostile, but at last was completed, it is considered to be hostile and successful; otherwise, it is considered to be hostile and unsuccessful. Data concerning whether the bidder and target firms were in the same industry, and whether or not the bid settlement was made entirely in cash, were also collected from Acquisitions Monthly. To evaluate the impact of the bid on the target shareholders' wealth we use standard event-study methodology and estimate the cumulative average abnormal returns (CARs) around the bid's announcement date. Further, we employ two groups of variables to explain the shareholder wealth effects. The first group includes our governance variables, proxying for board and ownership structures. The second group comprises control variables for firm size, growth opportunities, leverage, the method of payment, an industry dummy, and a hostile offer dummy. The definition of all governance and control variables is provided in the Appendix.

[insert table 1]

Table 1 provides a brief description of our sample by year. The total number of announcements is 198, of which most occur between 1995-97. The number of resisted (hostile) offers is 58 (about 29%);[5] contested offers are distributed rather evenly between successfully completed offers and unsuccessful offers. The overall sample contains 50 cash offers and 148 offers that were paid in full or in part through the issuance of other securities. Last, in 90 cases (45%) the bidder and the target were in the same industry, and in 108 cases they were not.

### 3.2 Methodology

In order to evaluate the influence of board composition on shareholder wealth, we estimate abnormal stock performance around the takeover announcement as the difference between the expected and actual return. For each company we estimate a single-factor market model and compute the excess return for each day t as

Abnormal Return ($AR_{it}$) = $R_{it} - (a_i + b_i R_{mt})$

where $R_{it}$ is the return on time t for the shares of company I, and $R_{mt}$ is the rate of return for period t on the FTSE all share index. The estimation period is 260 days, spanning from –300 to –41 trading days prior the announcement of the initial bid. Following Dodd and Warner (1983), we standardise each abnormal return by the estimate of its standard error, with the standardised abnormal return computed as:

$$SAR_{it} = \frac{AR_{it}}{\sqrt{Var(AR_{it})}},$$

$Var(AR_{it})$ is the variance of the abnormal returns, defined as

$$Var(AR_{it}) = \sigma_i^2 \left( 1 + \frac{1}{N} + \frac{(R_{mt} - \overline{R}_m)}{(N-1)Var(R_{mt})} \right),$$

where $\sigma_i^2$ is the residual variance from the market model regression, N is the number of observations, $R_{mt}$ is market return on day t, and $\overline{R}_{mt}$ is average daily market return over the estimation period. To measure the abnormal returns over a specific interval for firm i, the abnormal returns (AR) are summed to give the cumulative abnormal returns as:

$$CAR_i(T_1, T_2) = \sum_{t=T1i}^{T2i} AR_{it}$$

To form the interval test statistic, we first standardise the individual t-statistic for company i for a number of ($T_2 - T_1$) days in the interval as:

$$SCAR_i(T_1, T_2) = \sum_{t=T1i}^{T2i} \frac{SAR}{\sqrt{T_{2i} - T_{1i} + 1}}$$

For the overall sample the interval test statistic is given by:

$$Z = \sum_{i=1}^{N} \frac{SCAR_i}{\sqrt{N}}$$

Since the individual $SAR_{it}$ are assumed to be unit-normal and independent under the null hypothesis of no abnormal returns, both $SCAR_i$, and Z will be approximately unit normal.

## 4. Results

### 4.1 Descriptive Results

[insert table 2]

Table 2 presents daily average abnormal returns (AR) from forty days prior to the bid announcement to 40 days after the announcement, and cumulative average abnormal returns (CAR) for selected windows during this period. The related test statistics

[5] In our sample, 29% of takeovers are classified as hostile, a figure that is in line with those reported by prior studies. Franks and Mayer (1996) study a sample of 325 UK bids during 1985-86 and find that 23% are hostile; Cosh and Guest, (2000) study a sample of 204 UK takeovers taking place between 1985-96 and similarly find that 23% are hostile. Schwert, (2000) studies a sample of 2346 takeovers taking place between 1975-96 and finds that 21% were hostile.

for the hypothesis that these returns are different from zero are reported in the last column(s). The results suggest that there are small positive pre-bid (cumulative) returns that become significant as early as 34 trading days prior to the announcement, and steadily increase up to 4% 10 days before the announcement, and to 7.9% two days before the announcement. The event itself (day 0) is associated with a 13.2% unexpected return, in line with prior evidence and consistent with the notion that takeover targets benefit significantly at the bid announcement. This pattern of returns suggests some information leakage prior to the bid and the release of substantial information with the bid announcement. It is interesting to note that returns in the ten days after the bid are near zero, suggesting that the market absorbs and reflects accurately and instantaneously the information released at the bid announcement.

[insert table 3]

In table 3 we present descriptive statistics on the explanatory governance and control variables. Among the governance variables we observe a lower average participation of non-executives than in the US (45%), smaller boards, negligible stockholdings by non-executive directors, and a high incidence of firms exhibiting a separation between the CEO and board chair positions. A quarter of the offers are made for cash only, 45% belong to the same industry, 29% are resisted, and 86% are succesfully completed. The average target firm has an equity capitalization of 238.3 million pounds, a market-to-book ratio of 2.00, and a borroing (leverage-to-assets) ratio of 0.56.

[insert table 4]

Table 4 presents correlations among the explanatory variables. In general, these correlations are not high, indicating a low risk of multicollinearity for the results. Most notably, firms with high inside ownership tend to have less independent boards, in line with the notion that boards and managerial ownership are subtitute monitoring mechanisms; these firms are also smalller, and less likely to resist a takeover; large firms have more reputable directors on their boards and are more likely to receive a hostile offer; and hostile offers are less likley to be successful.

[insert table 5]

Next, we split the sample into firms with an outside-dominated board, where outsiders are at least as many as insiders on the board (n = 82), and firms where board insiders dominate outsiders (n = 116), and proceed to compare the governance and financial characteristics of the two sub-samples. Table 5 provides a brief summary of these sub-sample comparisons, partitioned by board independence. By sub-sample construction, roughly one third of directors are non-executives in insider-dominated firms, while two thirds are non-executives in outside-dominated firms. Contrary to what might be expected, firms with independent boards on average receive a lower initial bid premium than firms with insider-dominated boards, while announcement-period returns are indistinguishable between the two groups. This should not be surprising in view of the fact that in outside-dominated firms non-executives collectively own a lower fraction of target shares, while executives own a higher fraction of their firms' common shares. Consistent with board independence and board quality being correlated, insider-dominated boards are larger, have more interlocking directors, and directors holding fewer board seats, on average. The two groups are not different in terms of size, as measured by equity capitalisation.

## 4.2 Multiple Regression Results

To examine the link between governance structure and takeover-induced wealth effects, we estimate the following relationship:

CAR = f (target's board and ownership characteristics; control variables)

[insert table 6]

To this end, we use OLS regressions. Because of missing data on some of our variables, and the deletion of observations in the upper and lower 1% of their respective variable distributions as outliers, a total of 157 observations remain and are being used. All t-statistics are adjusted for heteroskedasticity using White's (1980) consistent variance-covariance matrix. The results for the target CAR, using various event windows, are presented in Table 6. The results are generally stronger for windows encompassing a longer period around the event. Also, adjusted R-squared values decrease significantly in regressions focusing on narrower event windows.

One interesting result from table 6 is that the coefficient on the percentage of independent directors (hypothesis 1) is negative and highly significant. That is, ceteris paribus, the cumulative abnormal returns (CAR) around the announcement day are lower for targets with an outside-dominated board than they are for insider-dominated targets. This is more pronounced using windows that encompass a longer pre-event period. In a similar vein, the announcement returns are larger in targets with a greater fraction of interlocking directors serving on the board (hypothesis 3). Finally, targets benefit more from a takeover when the managing director (CEO) is also the chairman of the board, contrary to the prescriptions of good governance practices (hypothesis 2). In sum, these results suggest that various measures of board independence do not enhance, and may actually decrease, target shareholder wealth during takeovers for this sample of UK targets. Vafeas and Theodorou (1998) also find that outside directors are not important in explaining firm value in the UK. Further conflicting good governance standards, targets with larger boards elicit larger pay-offs, despite evidence by Yermack (1996) that larger boards are less efficient and are valued less by the market (hypothesis 7).

These non-conventional results appear to be consistent with the disciplinary explanation for the market reaction to takeovers. First, target boards may have limited power over the outcome of a takeover. Also, shareholders may react more favourably to news of a change in control when their firms' boards are sub-optimally structured, because they may perceive larger forthcoming performance improvements as a result of the change in control. Second, if the market for outside directors is thin, the expectation or requirement that firms have many non-executives on their boards may result in a sub-optimal board composition for many small firms that have difficulty in recruiting highly qualified non-executive directors. By contrast, insiders with good decision management skills, or entrenched interests, may have an advantage in guiding the target firm through a takeover.

In contrast, there is strong evidence that more outside directorships held by the target's directors enhance the benefits of a takeover (hypothesis 4), in line with more reputable directors promoting shareholder interests more effectively during takeovers, and with evidence from the US from Shivdasani (1993).

However, as evidenced by the negative coefficient of directorships squared, these benefits are not linear and decline beyond a given level, due to rising drawbacks of holding too many board seats, such as less available time and a lower level of commitment to each board. The result on outside director ownership is also interesting: In targets where outsiders own a high amount of equity, targets benefit more from the takeover as signified by the coefficient on director ownership that is positive and significant (hypothesis 6). (We have re-estimated the model including the square of the executives stock ownership variable to capture potential non-linearities in this relation. That squared term was always statistically insignificant, and is thus not reported). Similarly, the fraction of incentive shares held by executive directors is positively, albeit weakly, related to bid-induced returns (hypothesis 5). This result is in line with the notion that director incentives guide outside directors in making better decisions for shareholders. Other ownership variables are not statistically significant.

Finally, two control variables are found to be significant in explaining the announcement-induced abnormal returns. First, firms with lower growth opportunities, having a low equity capitalisation compared to equity book values and signifying more agency problems, elicit a greater market reaction during takeovers. In firms with greater agency problems, shareholders may welcome the change in control as an opportunity for value enhancement. Similarly, firms with a lower level of borrowing, and thus fewer disciplinary pressures from creditors, also elicit a stronger stock market reaction. This agrees with the notion that takeovers may substitute for leverage in disciplining management. Both results on the control variables are consistent with results on board-related agency problems discussed earlier.

### 4.3 Sensitivity Analysis

To probe further into the reasons our results on board independence counter conventional wisdom, we perform a series of sensitivity checks as follows: First, we created a 2x2 table splitting our sample firms at the median by outside director representation and by CAR, over three different event windows. Comparing the columns with low and high outsider representation we do not find meaningful frequency differences on the basis of low/high CAR.

Second, focusing on the cell (sub-sample) of firms with takeover-induced CAR below the median, and outside director representation above the median (49 firms), we find that 12 firms belong to the financial sector and 7 to communications, providing a weak indication that firms in regulated industries may be weakly responsible for the results. Third, examining the possibility of event clustering in time, we observe that these deals are spread fairly evenly throughout the sample period with a somewhat unusually high occurrence of 14 such deals in 1997.

Fourth, compared to the whole sample of independent boards, executive directors in these firms have higher average stock ownership than the rest, but similar median ownership, while non-executives have less stock ownership. The average salary of directors in these cases is significantly lower than the salary of directors for the remaining sample of firms with independent boards. This finding does not support the notion that high salaries and poor incentives drive managers to destroy shareholder value in takeovers. Other possibilities exist in explaining the results. Perhaps differences in returns would become evident if a long-term horizon was examined. Also, it may be that the likelihood of a bid revision, and thus of higher returns, depends on board structure as well, affecting shareholder wealth. Finally, it is possible that outside directors in the UK play a different role than in the US. We leave these questions to be addressed by future work.

## 5. Summary and Conclusion

In this study we examine whether the structure of the bidder's board of directors influences the wealth effects of a takeover bid to the bidder's shareholders. We statistically show that certain board characteristics are indeed related to the takeover-induced abnormal returns. Specifically, we examine takeover bids for a sample of 198 publicly traded firms based in the UK that became takeover targets between 1989 and 1998. We find that target firms experience significant positive returns (CAR) of nearly 23% in the days surrounding the announcement of a takeover bid. We then proceed to examine the relation between board structure and

bid-induced abnormal returns. We posit two competing explanations for this relation: First, under the "effective board" explanation, takeover targets with more appropriately structured boards elicit higher gains for shareholders, in accordance with a basic premise of agency theory. Alternatively, under a disciplinary explanation, firms with ineffective boards stand to benefit more from a change in control that will presumably improve governance and reduce related agency costs. The empirical results are mostly consistent with the disciplinary explanation. Specifically, we find that independent boards (those with more non-executive directors, fewer interlocking directors, and an independent board chairperson), and larger boards, are associated with lower announcement-period returns compared to inside-dominated boards. Controlling for board composition and size, the incentives of non-executive directors are positively related to bid-induced returns, i.e., higher returns are experienced by targets when non-executives hold more equity, and more outside board seats.

An alternative explanation for the results is that limited availability of competent non-executive directors, and informational advantages of executive directors may lead to a more beneficial role for executives in the case of takeovers. We conclude that firms with larger, management-controlled, boards that potentially face greater agency problems, have more to gain from a takeover and thus experience greater bid-induced returns, consistent with a "disciplinary" explanation for takeovers.

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## Appendices

**Table 1.** Partition of 198 UK takeovers occuring between December 1989 and April 1998 as friendly vs. hostile, cash financed vs. other, and related vs. unrelated

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | Total | % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bid outcome | | | | | | | | | | | | |
| Friendly bids | 2 | 10 | 8 | 9 | 14 | 11 | 27 | 16 | 39 | 4 | 140 | 71% |
| Hostile successful bids | 1 | 5 | 4 | 3 | 4 | 4 | 6 | 3 | 0 | 0 | 30 | 15% |
| Hostile unsuccessful bids | 0 | 1 | 5 | 4 | 2 | 4 | 4 | 5 | 3 | 0 | 28 | 14% |
| Total | 3 | 16 | 17 | 16 | 20 | 19 | 37 | 24 | 42 | 4 | 198 | 100% |
| Method of payment | | | | | | | | | | | | |
| Cash only | 1 | 5 | 2 | 5 | 6 | 6 | 9 | 6 | 9 | 1 | 50 | 25% |
| Mixed payment | 2 | 11 | 15 | 11 | 14 | 13 | 28 | 18 | 33 | 3 | 148 | 75% |
| Total | 3 | 16 | 17 | 16 | 20 | 19 | 37 | 24 | 42 | 4 | 198 | 100% |
| Industry affiliation | | | | | | | | | | | | |
| Same industry | 0 | 9 | 10 | 7 | 14 | 8 | 16 | 9 | 16 | 1 | 90 | 45% |
| Different industry | 3 | 7 | 7 | 9 | 6 | 11 | 21 | 15 | 26 | 3 | 108 | 55% |
| Total | 3 | 16 | 17 | 16 | 20 | 19 | 37 | 24 | 42 | 4 | 198 | 100% |
| Overall | | | | | | | | | | | | |
| # of bids | 3 | 16 | 17 | 16 | 20 | 19 | 37 | 24 | 42 | 4 | 198 | |
| % of sample | 1.5 | 8.1 | 8.6 | 8.1 | 10.1 | 9.6 | 18.7 | 12.1 | 21.2 | 2 | 100 | |

**Table 2.** Daily average abnormal returns (AR) and cumulative abnormal returns (CAR) around the announcement of takeover bids for a sample of UK takeover targets

| Day | AR | t-stat | | Interval | CAR | z-stat | | | Day | AR | t-stat | | Interval | CAR | z-stat | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| -40 | -0.2% | -0.73 | | (-40) | -0.2% | -0.72 | | | 0 | 12.5% | 111.1 | *** | (-40,0) | 22.0% | 29.6 | *** |
| -39 | 0.2% | 0.39 | | (-40,-39) | 0.0% | -0.15 | | | 1 | 0.3% | 8.0 | *** | (-40, 1) | 22.3% | 30.5 | *** |
| -38 | 0.1% | 0.11 | | (-40,-38) | 0.0% | -0.14 | | | 2 | 0.2% | 1.5 | *** | (-40, 2) | 22.6% | 30.4 | *** |
| -37 | 0.2% | 0.95 | | (-40,-37) | 0.2% | 0.23 | | | 3 | 0.0% | 0.2 | | (-40, 3) | 22.5% | 30.1 | *** |
| -36 | 0.3% | 1.59 | * | (-40,-36) | 0.5% | 0.85 | | | 4 | 0.1% | 0.1 | | (-40, 4) | 22.6% | 29.8 | *** |
| -35 | 0.2% | 1.82 | * | (-40,-35) | 0.7% | 1.48 | | | 5 | 0.0% | -1.4 | | (-40, 5) | 22.5% | 29.2 | *** |
| -34 | 0.3% | 1.18 | | (-40,-34) | 1.0% | 1.81 | * | | 6 | 0.2% | 2.4 | ** | (-40, 6) | 22.8% | 29.3 | *** |
| -33 | 0.0% | -0.55 | | (-40,-33) | 1.0% | 1.53 | * | | 7 | -0.1% | -0.5 | | (-40, 7) | 22.7% | 28.9 | *** |
| -32 | 0.1% | 1.43 | | (-40,-32) | 1.1% | 1.98 | ** | | 8 | 0.1% | 0.9 | | (-40, 8) | 22.8% | 28.8 | *** |
| -31 | 0.0% | -0.55 | | (-40,-31) | 1.1% | 1.71 | * | | 9 | 0.1% | 0.8 | | (-40, 9) | 22.9% | 28.6 | *** |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| -30 | -0.1% | 0.89 | | (-40,-30) | 1.0% | 1.91 | * | | 10 | 0.1% | -0.8 | | (-40, 10) | 23.0% | 28.2 | *** |
| -29 | 0.0% | -0.35 | | (-40,-29) | 1.0% | 1.76 | * | | 11 | 0.1% | 0.1 | | (-40,+11) | 23.0% | 27.9 | *** |
| -28 | 0.0% | 0.05 | | (-40,-28) | 0.9% | 1.72 | * | | 12 | -0.1% | -0.1 | | (-40,+12) | 23.0% | 27.7 | *** |
| -27 | 0.0% | 0.91 | | (-40,-27) | 0.9% | 1.90 | * | | 13 | 0.2% | 1.3 | | (-40,+13) | 23.2% | 27.6 | *** |
| -26 | 0.4% | 3.18 | *** | (-40,-26) | 1.3% | 2.63 | *** | | 14 | 0.1% | 0.8 | | (-40,+14) | 23.4% | 27.5 | *** |
| -25 | 0.2% | 0.88 | | (-40,-25) | 1.4% | 2.73 | *** | | 15 | 0.2% | 0.9 | | (-40,+15) | 23.6% | 27.3 | *** |
| -24 | 0.0% | -0.23 | | (-40,-24) | 1.4% | 2.62 | *** | | 16 | 0.1% | 0.7 | | (-40,+16) | 23.7% | 27.2 | *** |
| -23 | -0.3% | 0.79 | | (-40,-23) | 1.2% | 2.73 | *** | | 17 | 0.2% | 1.4 | | (-40,+17) | 23.9% | 27.1 | *** |
| -22 | 0.0% | 1.35 | | (-40,-22) | 1.2% | 3.00 | *** | | 18 | 0.1% | 0.6 | | (-40,+18) | 24.0% | 27.0 | *** |
| -21 | -0.2% | -2.48 | *** | (-40,-21) | 1.1% | 2.43 | ** | | 19 | 0.1% | 0.3 | | (-40,+19) | 24.1% | 26.8 | *** |
| | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | |
| -20 | 0.3% | 2.55 | ** | (-40,-20) | 1.4% | 2.90 | *** | | 20 | 0.0% | -1.0 | | (-40,+20) | 24.1% | 26.4 | *** |
| -19 | -0.1% | 0.43 | | (-40,-19) | 1.4% | 2.98 | *** | | 21 | -0.4% | -0.3 | | (-40,+21) | 23.7% | 26.2 | *** |
| -18 | 0.8% | 5.31 | *** | (-40,-18) | 2.3% | 4.01 | *** | | 22 | 0.2% | 1.0 | | (-40,+22) | 23.9% | 26.1 | *** |
| -17 | 0.0% | -0.29 | | (-40,-17) | 2.2% | 3.87 | *** | | 23 | 0.2% | 0.9 | | (-40,+23) | 24.0% | 26.0 | *** |
| -16 | -0.1% | 0.50 | | (-40,-16) | 2.2% | 3.89 | *** | | 24 | 0.3% | 1.8 | | (-40,+24) | 24.3% | 26.0 | *** |
| -15 | 0.3% | 2.24 | *** | (-40,-15) | 2.5% | 4.27 | *** | | 25 | 0.1% | 0.3 | | (-40,+25) | 24.4% | 25.9 | *** |
| -14 | 0.0% | -0.32 | | (-40,-14) | 2.5% | 4.12 | *** | | 26 | 0.1% | 0.8 | | (-40,+26) | 24.5% | 25.8 | *** |
| -13 | 0.6% | 3.73 | *** | (-40,-13) | 3.1% | 4.74 | *** | | 27 | 0.2% | 1.8 | | (-40,+27) | 24.7% | 25.8 | *** |

| | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| -12 | 0.3% | 2.26 | *** | (-40,-12) | 3.3% | 5.08 | *** | 28 | 0.1% | -0.2 | | (-40,+28) | 24.8% | 25.6 | *** |
| -11 | 0.3% | 3.36 | *** | (-40,-11) | 3.7% | 5.61 | *** | 29 | 0.0% | 0.1 | | (-40,+29) | 24.8% | 25.4 | *** |
| | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | |
| -10 | 0.1% | 1.2 | | (-40,-10) | 3.8% | 5.7 | *** | 30 | 0.0% | -0.1 | | (-40,+30) | 24.9% | 25.3 | *** |
| -9 | 0.3% | 3.4 | *** | (-40,-9) | 4.1% | 6.2 | *** | 31 | 0.1% | 0.3 | | (-40,+31) | 24.9% | 25.1 | *** |
| -8 | 0.3% | 3.0 | *** | (-40,-8) | 4.5% | 6.7 | *** | 32 | 0.1% | 0.8 | | (-40,+32) | 25.0% | 25.0 | *** |
| -7 | 0.3% | 2.0 | ** | (-40,-7) | 4.9% | 6.9 | *** | 33 | 0.2% | 1.2 | | (-40,+33) | 25.1% | 25.0 | *** |
| -6 | 0.1% | 2.1 | ** | (-40,-6) | 5.1% | 7.2 | *** | 34 | 0.1% | 1.5 | | (-40,+34) | 25.2% | 25.0 | *** |
| -5 | 0.7% | 6.8 | *** | (-40,-5) | 5.7% | 8.2 | *** | 35 | 0.2% | 2.0 | | (-40,+35) | 25.5% | 25.1 | *** |
| -4 | 0.4% | 4.9 | *** | (-40,-4) | 6.2% | 8.9 | *** | 36 | 0.4% | 2.6 | | (-40,+36) | 25.8% | 25.2 | *** |
| -3 | 0.9% | 6.9 | *** | (-40,-3) | 7.0% | 9.9 | *** | 37 | 0.2% | 1.8 | | (-40,+37) | 26.0% | 25.3 | *** |
| -2 | 0.3% | 1.1 | | (-40,-2) | 7.4% | 10.0 | *** | 38 | 0.0% | -0.1 | | (-40,+38) | 26.0% | 25.1 | *** |
| -1 | 1.9% | 16.9 | *** | (-40,-1) | 9.2% | 12.5 | *** | 39 | 0.0% | 0.2 | | (-40,+39) | 26.0% | 25.0 | *** |
| | | | | | | | | 40 | 0.1% | -0.4 | | (-40,+40) | 26.1% | 24.8 | *** |

*Other Selected Intervals*

| Interval | CAR | Z-Stat | | Interval | CAR | Z-Stat | |
|---|---|---|---|---|---|---|---|
| (-40,+40) | 26.1% | 24.8 | *** | (-30,+30) | 23.8% | 26.64 | *** |
| (-40,0) | 22.0% | 29.6 | *** | (-20,+20) | 23.0% | 30.40 | *** |
| (-30,0) | 21.0% | 33.0 | *** | (-10,+10) | 19.3% | 36.70 | *** |
| (-20,0) | 20.9% | 38.6 | *** | (-5,+5) | 17.5% | 45.34 | *** |
| (-10,0) | 18.3% | 46.5 | *** | (-4,+4) | 16.8% | 48.01 | *** |
| (-5 , 0) | 16.9% | 56.2 | *** | (-3,+3) | 16.3% | 51.88 | *** |
| (-3 , 0) | 15.9% | 61.3 | *** | (-2,+2) | 15.5% | 62.42 | *** |
| (-2 , 0) | 15.0% | 65.0 | *** | (-1,+1) | 15.0% | 61.29 | *** |
| (-1 , 0) | 14.6% | 74.4 | *** | ( 0 ) | 12.8% | 112.0 | *** |

**Table 3.** Descriptive statistics on governance, deal-related, and other control variables used to explain announcement-induced returns for a sample of 198 UK-based takeover targets

| | | | | Percentiles | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Variable | Mean | S. D. | Min | 1% | 5% | 10% | 50% | 90% | 95% | 99% | Max |
| Corporate Governance Variables | | | | | | | | | | | |
| % outsiders | 0.45 | 0.22 | 0.00 | 0.00 | 0.00 | 0.18 | 0.43 | 0.71 | 1.00 | 1.00 | 1.00 |
| % interlocks | 0.14 | 0.34 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Directorships | 1.42 | 1.33 | 0.00 | 0.00 | 0.00 | 0.00 | 1.10 | 3.33 | 4.00 | 6.67 | 6.67 |
| Ex. Ownership | 0.07 | 0.14 | 0.00 | 0.00 | 0.00 | 0.00 | 0.01 | 0.27 | 0.42 | 0.69 | 0.69 |
| Nex. ownership | 0.02 | 0.06 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.07 | 0.14 | 0.33 | 0.33 |
| Ex. Incentive sh. | 0.01 | 0.02 | 0.00 | 0.00 | 0.00 | 0.00 | 0.01 | 0.03 | 0.04 | 0.11 | 0.11 |
| Nex Incentive sh. | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.01 | 0.01 |
| CEO chairman | 0.19 | 0.39 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Board size | 6.78 | 2.41 | 2.00 | 3.00 | 4.00 | 4.00 | 6.50 | 10.00 | 11.00 | 16.00 | 17.00 |
| Deal Characteristics | | | | | | | | | | | |
| Cash dummy | 0.25 | 0.44 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Industry dummy | 0.45 | 0.50 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Hostile offer | 0.29 | 0.46 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Successful offer | 0.86 | 0.35 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Control Variables | | | | | | | | | | | |
| Equity capitaliz. | 238.82 | 588.1 | 2.66 | 2.77 | 4.75 | 6.38 | 35.20 | 705 | 1184 | 3790 | 5123 |
| Market-to-book | 2.00 | 3.14 | (11.05) | 0.20 | 0.40 | 0.61 | 1.45 | 4.85 | 6.20 | 9.20 | 15.64 |
| Borrowing ratio | 0.56 | 0.75 | 0.00 | 0.00 | 0.00 | 0.02 | 0.37 | 1.23 | 1.97 | 4.47 | 4.47 |

**Table 4.** Pairwise Pearson correlations among the independent variables explaining takeover-induced abnormal returns

Negative correlations are in parentheses. Figures in bold indicate statistical significance at the 0.01 level or better.

| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | % outsiders | 1.00 | | | | | | | | | | | | | | | | |
| 2 | % interlocks | 0.04 | 1.00 | | | | | | | | | | | | | | | |
| 3 | Directorships | 0.06 | 0.09 | 1.00 | | | | | | | | | | | | | | |
| 4 | (directorships)$^2$ | 0.00 | 0.20 | 0.91 | 1.00 | | | | | | | | | | | | | |
| 5 | Ex. Ownership | (0.25) | 0.04 | (0.15) | (0.07) | 1.00 | | | | | | | | | | | | |
| 6 | N-ex. ownership | (0.05) | (0.06) | (0.08) | (0.06) | 0.15 | 1.00 | | | | | | | | | | | |
| 7 | Ex. Incentive sh. | 0.05 | (0.08) | (0.13) | (0.09) | 0.06 | 0.06 | 1.00 | | | | | | | | | | |
| 8 | N-ex. Incentive sh. | 0.08 | (0.04) | (0.09) | (0.09) | 0.07 | (0.04) | 0.07 | 1.00 | | | | | | | | | |
| 9 | Ln (equity capital.) | 0.07 | (0.02) | 0.25 | 0.12 | (0.34) | (0.22) | (0.23) | (0.17) | 1.00 | | | | | | | | |
| 10 | Market-to-book | (0.04) | 0.01 | (0.02) | (0.05) | 0.19 | 0.05 | (0.06) | 0.20 | 0.08 | 1.00 | | | | | | | |
| 11 | Cash financing | 0.08 | (0.10) | 0.04 | 0.00 | (0.03) | 0.11 | 0.19 | 0.17 | (0.01) | 0.07 | 1.00 | | | | | | |
| 12 | Industry dummy | (0.12) | (0.04) | (0.12) | (0.06) | 0.11 | 0.19 | 0.09 | (0.03) | (0.09) | (0.09) | (0.04) | 1.00 | | | | | |
| 13 | Borrowing ratio | 0.00 | 0.04 | (0.02) | (0.07) | (0.05) | (0.09) | 0.15 | 0.01 | 0.03 | 0.16 | 0.12 | (0.07) | 1.00 | | | | |
| 14 | Ln(board size) | 0.13 | 0.04 | 0.18 | 0.10 | (0.28) | (0.15) | (0.07) | (0.00) | 0.55 | 0.11 | 0.09 | 0.04 | 0.10 | 1.00 | | | |
| 15 | CEO-chairman | (0.02) | (0.05) | (0.22) | (0.16) | 0.08 | (0.11) | 0.10 | (0.05) | (0.08) | 0.09 | 0.11 | 0.12 | 0.01 | 0.01 | 1.00 | | |
| 16 | Hostile offer | 0.12 | (0.14) | 0.01 | (0.03) | (0.26) | (0.14) | (0.15) | 0.03 | 0.29 | (0.15) | (0.13) | 0.01 | (0.13) | 0.10 | (0.05) | 1.00 | |
| 17 | Successful offer | (0.09) | 0.17 | 0.00 | 0.03 | 0.13 | 0.09 | 0.04 | 0.02 | (0.20) | 0.12 | 0.13 | 0.09 | 0.11 | 0.08 | 0.03 | (0.64) | 1.00 |

**Table 5.** Profile comparison of 198 UK-based takeover targets partitioned by board composition

Boards with 50% non-executive directors are defined as insider-dominated; boards with more than 50% outside directors are defined as outsider-dominated.

| Variable | | Full sample (198) | Insider-dominated (116) | Outsider-dominated (82) | Diff. | t-statistic Wilcox. z |
|---|---|---|---|---|---|---|
| % of outside directors | Mean | 44.6 | 30.4 | 64.7 | | |
| | Median | 42.9 | 33.3 | 60.0 | | |
| Cumul. abnormal return (-40,+40)) | Mean | 26.9 | 29.4 | 23.2 | 6.2 | 1.5 |
| | Median | 28.6 | 30.8 | 18.7 | | 2.2** |
| Initial bid premium (%) | Mean | 31.0 | 34.8 | 25.6 | 9.2 | 1.91** |
| | Median | 29.5 | 35.0 | 24.0 | | 3.1*** |
| Executive ownership (%) | Mean | 7.25 | 9.7 | 3.8 | 5.9 | 2.9*** |
| | Median | 0.7 | 1.8 | 0.3 | | 3.8*** |
| Non-executive ownership (%) | Mean | 2.2 | 2.3 | 2.1 | 0.2 | 0.3 |
| | Median | 0.1 | 0.1 | 0.1 | | -0.6 |
| Board size | Mean | 6.8 | 7.1 | 6.3 | 0.8 | 2.1** |
| | Median | 6.5 | 7.0 | 6.0 | | 2.8*** |
| % interlocking directorships | Mean | 5.1 | 5.0 | 5.1 | -0.1 | -0.06 |
| | *Median* | 0.0 | 0.0 | 0.0 | | 0.1 |
| Additional directorships per director | Mean | 1.4 | 1.3 | 1.6 | -0.3 | -1.2 |
| | Median | 1.1 | 1.0 | 1.5 | | 0.1 |
| Market value of equity | Mean | 238.8 | 238.3 | 239.5 | -1.2 | -0.01 |
| (in millions of pounds) | Median | 35.2 | 39.6 | 30.3 | | 0.8 |

*, **, ***, significant at the 0.10, 0.05, and 0.01 level, respectively

**Table 6.** OLS regressions of corporate governance and control variables on takeover-induced abnormal returns for a sample of UK targets

This table presents the results of multivariate regressions of the targets' CAR on board composition, board characteristics, stock ownership, incentives, firm and tender offer characteristics. All the data concerning the takeover deals and their characteristics have been collected from Acquisitions Monthly. Our corporate governance data covering each firm's board and ownership characteristics come from the *Price Waterhouse Corporate Register*. The results are based on 157 tender offers after removing the outliers and the companies for which we were unable to obtain share price and accounting data from *Datastream*. The associated p-values of the coefficients are the numbers in parentheses. The variable definitions are provided in the Appendix.

| Explanatory Variables | CAR | | CAR | | CAR | | CAR | | CAR | | CAR | | CAR | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (-40,+40) | | (-40,0) | | (-30,0) | | (-20,0) | | (-5,+5) | | (-30,+30) | | (-20,+20) | |
| Intercept | 0.52 | (0.05) | 0.13 | (0.55) | 0.08 | (0.67) | 0.06 | (0.77) | 0.22 | (0.20) | 0.52 | (0.02) | 0.43 | (0.04) |
| Percentage of outside directors | -0.19 | (0.12) | -0.17 | (0.09) | -0.25 | (0.01) | -0.23 | (0.01) | -0.13 | (0.09) | -0.29 | (0.01) | -0.26 | (0.01) |
| Percentage of interlocking directors | 0.04 | (0.50) | 0.06 | (0.27) | 0.04 | (0.41) | 0.03 | (0.51) | 0.00 | (0.95) | 0.03 | (0.60) | 0.02 | (0.74) |
| Additional directorships per director | 0.10 | (0.02) | 0.08 | (0.02) | 0.06 | (0.06) | 0.05 | (0.13) | -0.01 | (0.75) | 0.06 | (0.11) | 0.04 | (0.24) |
| Additional directorships squared | -0.01 | (0.08) | -0.01 | (0.12) | 0.00 | (0.48) | 0.00 | (0.64) | 0.01 | (0.32) | -0.01 | (0.47) | 0.00 | (0.79) |
| Executive stock ownership | 0.16 | (0.33) | 0.18 | (0.19) | 0.12 | (0.33) | 0.10 | (0.40) | 0.11 | (0.28) | 0.05 | (0.74) | 0.06 | (0.63) |
| Non-executive stock ownership | 0.72 | (0.05) | 0.38 | (0.21) | 0.36 | (0.19) | 0.42 | (0.12) | 0.24 | (0.32) | 0.57 | (0.07) | 0.64 | (0.03) |
| % of executive incentive shares | 1.88 | (0.13) | 1.30 | (0.21) | 2.46 | (0.01) | 1.07 | (0.24) | 0.65 | (0.42) | 2.33 | (0.03) | 0.82 | (0.40) |
| % of non-executive incentive shares | 16.51 | (0.12) | 15.26 | (0.08) | 6.75 | (0.39) | 9.86 | (0.21) | 0.43 | (0.95) | 7.73 | (0.39) | 8.56 | (0.30) |
| Log (equity capitalization) | -0.03 | (0.11) | 0.00 | (0.85) | 0.00 | (0.90) | 0.00 | (0.77) | 0.00 | (0.76) | -0.02 | (0.11) | -0.02 | (0.17) |
| Market- to-book value of equity | -0.02 | (0.03) | -0.01 | (0.02) | -0.01 | (0.28) | -0.01 | (0.28) | -0.01 | (0.06) | -0.01 | (0.19) | -0.01 | (0.28) |
| Cash financing dummy | -0.12 | (0.02) | -0.07 | (0.08) | -0.05 | (0.18) | -0.05 | (0.21) | 0.00 | (0.92) | -0.08 | (0.05) | -0.07 | (0.07) |
| Industry dummy | -0.06 | (0.18) | -0.04 | (0.29) | -0.03 | (0.30) | -0.02 | (0.53) | -0.02 | (0.45) | -0.07 | (0.07) | -0.04 | (0.23) |
| Borrowing ratio | -0.01 | (0.62) | -0.03 | (0.21) | -0.01 | (0.51) | -0.02 | (0.35) | -0.02 | (0.23) | 0.00 | (0.92) | 0.00 | (0.91) |
| Log (Board Size) | 0.12 | (0.13) | 0.09 | (0.18) | 0.07 | (0.23) | 0.08 | (0.17) | 0.00 | (0.95) | 0.11 | (0.13) | 0.11 | (0.09) |
| CEO and chairman dummy | 0.09 | (0.10) | 0.08 | (0.08) | 0.09 | (0.04) | 0.04 | (0.28) | 0.01 | (0.81) | 0.10 | (0.04) | 0.05 | (0.24) |
| Hostile takeover dummy | 0.08 | (0.11) | 0.03 | (0.52) | 0.03 | (0.50) | -0.01 | (0.81) | -0.01 | (0.83) | 0.06 | (0.14) | 0.03 | (0.45) |
| Number of obs. | 157 | | 157 | | 157 | | 157 | | 157 | | 157 | | 157 | |
| Prob > F | 0.03 | | 0.08 | | 0.03 | | 0.14 | | 0.38 | | 0.03 | | 0.10 | |
| Adj R-squared | 0.08 | | 0.06 | | 0.08 | | 0.04 | | 0.01 | | 0.08 | | 0.05 | |

## APPENDIX - Variable definitions

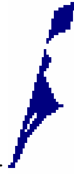
The sample used in this study includes 198 tender offers taking place from December 1989 to April 1998. Companies for which data on board, deal, or firm characteristics were not available have been excluded from the sample. Moreover, deals where either the bidder or the target was not a UK firm were eliminated from the sample.

| Board Characteristics | |
|---|---|
| All data related to board characteristics were collected from the 'Price Waterhouse Corporate Register'. Data were obtained from the bi-annual volumes for the years September 1989 to September 1994 and from the quarterly volumes for the years 1995 onwards. | |
| % outside directors | Measures the proportion of non-executive (outside) directors represented on the board. Alternatively, a dummy variable is set equal to one if the board is independent (greater than 50% outsider representation), and zero otherwise. The 'Price Waterhouse Corporate Register' lists separately the names of executives and non-executives. This variable is constructed by adding the number of non-executives and then dividing by the total number of directors in the board (executives + non executives). |
| % Interlocking directors | Dummy variable equal to one when any of the non-executive directors of the target firm also serves as an executive director in the acquiring firm, and zero otherwise. For every acquisition we find both the target and the bidder firms on the 'Price Waterhouse Corporate Register' (the volume that is closest to the announcement date). Interlocking directorships arise when the name of any executive director of the acquiring firm appears on the targets' board at that time. |
| Additional directorships per director | Average number of additional directorships that are held by non-executive directors. A squared term is also included to examine non-linearities in the relation under consideration. For every acquisition we find the names of the non-executive directors of the acquiring company on the 'Price Waterhouse Corporate Register' (on the volume that is closest to the announcement date). We then use the "Directors and Officers" section of |

| | |
|---|---|
| | the 'Price Waterhouse Corporate Register' that lists the directorships of each director, and we find how many additional directorships are held by the non-executive directors of the acquiring firm. Finally to obtain the average number of additional directorships we add the additional directorships of all non-executives and divide that by the total number of non-executive directors. |
| Executive stock ownership | Measures the percentage of total ordinary shares held by executive directors. A squared term is also included in the model to capture non-linearities in the CAR-ownership relation. To construct this variable for every acquisition we add the ordinary shares held by executives and divide by the number of shares outstanding. |
| Non-executive stock ownership | Measures the percentage of total ordinary shares held by non-executive directors. For every acquisition we sum the ordinary shares held by non executives and divide by the number of shares outstanding. |
| Executive incentive shares | Measures the percentage of incentive shares that are held by executive directors. We sum the incentive shares that are held by executives. The 'Price Waterhouse Corporate Register' lists separately (in brackets next to each director's name) the number of ordinary and incentive shares held by executives and non-executives. We then divide by total shares outstanding. Incentive shares are issued from the company to directors as part of their remuneration to reward more effort. |
| Non-executive incentive shares | Measures the percentage of incentive shares that are held by non executive directors. We sum the incentive shares that are held by non-executives and divide by total shares outstanding. |
| CEO-chairman | Dummy variable set equal to one when the chairman and the CEO is the same person, and zero otherwise. The 'Price Waterhouse Corporate Register' lists separately the chairman's, CEO's and CFO's names. |
| Board size | Measures the total number of directors in the board (log-transformed). For every acquisition we find the acquiring company on the 'Price Waterhouse Corporate Register' (on the volume that is closest to the announcement date) and sum all executives and non-executives to obtain the total number of directors serving on the board. |
| Deal Characteristics | |
| All data related with bid characteristics were collected from the 'Acquisitions Monthly' | |
| Cash financing | Dummy variable equal to one if the bid settlement is entirely made in cash and zero otherwise. 'Acquisitions Monthly' includes a synopsis for every acquisition that describes the general terms of the deal. These terms include the exchange ratio, the price paid for every target share acquired as well as the medium of payment. We consider cash financed acquisitions, those acquisitions in which the acquirer has paid only cash for the acquisition and no shares were issued for this purpose. |
| Industry (related acquisition) dummy | Dummy variable that equals one when the acquirer and the target are in the same industry. 'Acquisitions Monthly' describes separately for the target and the bidder the type of their operations (this industry classification is based on the US SIC classification). Based on this description we define a related acquisition as an acquisition in which both the acquirer and the target have similar operations. Otherwise the deal is classified as unrelated. |
| Hostile offer | A dummy variable equals one when the bid is hostile. A bid is defined as hostile when the initial reaction of the target's board is to recommend their shareholders to reject the offer. We consider a bid to be 'hostile' if 'Acquisitions Monthly' reports that the target firm has resisted the offer. A bid is considered to be 'friendly' if it is reported in the 'Acquisitions Monthly' that the target's board has accepted the offer. |
| Successful offer | Dummy variable that equals one if the offer was successfully completed and zero otherwise. Acquisitions Monthly' lists for every calendar month all new bids, pending bids and completed bids. Completed bids are usually bids that were reported as new bids or pending bids in the previous month's issue. We consider an offer to be successful if we find the deal under the 'Completed Deals' section of 'Acquisitions Monthly'. Otherwise the deal is classified as unsuccessful. |
| Firm Characteristics | |
| Data for share returns and accounting items were collected from DATASTREAM. | |
| Log (equity capitalization) | Measured as the logarithm of market capitalisation, taken as the market price per share times shares outstanding at the end of the year preceding the event year. Data were collected from Datastream using program code 900B and accounting item MV. |
| Market to book value of equity | Measured as the market value of equity divided by the book value of equity of the acquirer at the end of the year preceding the event year. It proxies for growth opportunities of the firm and the quality of management. Data were collected from Datastream using program code 900B and accounting item MTBV. |
| Borrowing ratio | Total loans (total debt), divided by the sum of equity capital plus reserves minus total intangibles at the end of the year preceding the event year. Data were collected from Datastream using program code 900B. |

**РАЗДЕЛ 3**
**УГОЛОК ПРАКТИКА**

**SECTION 3**
**PRACTITIONER'S**
**CORNER**



# BOARD COMMITTEE PRACTICES IN UKRAINE

**Alexander N. Kostyuk***

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International board practice concerning establishing committees on the board is still not spread in the Ukraine. The state obliged Ukrainian joint stock companies to establish an audit commission. But the commission is not on the supervisory board. It is not an integral part of the board. Members of the audit commission are prohibited to be members of the supervisory board at the same time. Although the audit commission reports to the supervisory board, objectives of the audit commission are narrowed only to controlling financial transactions executed by the management board. Therefore, it is worth of establishing an audit committee on the supervisory board with a broader spectrum of functions and equipped with the deepest knowledge on corporate governance mechanisms.

Compensation committees are established on the supervisory boards at 10 percent of researched Ukrainian joint stock companies[1]. These are companies mainly under control of foreign institutional investors. About 58 percent of companies, controlled by foreign institutional shareholders have compensation committees on the supervisory boards. It is worth of mentioning that this number is even higher than an average number for Germany, France and Italy.

Lord Cadbury mentioned that executive directors should play no part in decision making on their own compensation (Cadbury, 1992: para 4.42). Taking into account that executives are not members of the supervisory board in Ukraine, i.e. it is prohibited by legislation, we should broaden a term "executive" to a term "independent". Almost all members of compensation committees (85 percent) at the companies under control of foreign institutional shareholders are independent. That is a strong contribution to performance of the board.

It is interestingly, companies, controlled by employees, have not the compensation committee on the supervisory boards at all. Probably, it is because of very low number of independent directors on the boards and very stable stickiness of employees to

[1] Research was comprised of two stages. At the first stage, we delivered questionnaires to Heads of Supervisory Boards and Deputy-Heads of Supervisory Boards of 240 companies. Feedback on questionnaires was received from 53 companies. They belong to the most developed industries - metallurgy, machine-building, energy generating and energy distributing. Further, we selected the most completed questionnaires (50) to conduct research and process questionnaires. At the second stage of research we used observation. We observed 50 companies whose directors had provided us with questionnaires completed. The following data sources were used to observe corporations:

- annual reports of Ukrainian joint stock companies;
- annual reports of the State Securities and Exchanges Commission in Ukraine;
- annual reports of the First Stock Trade System in Ukraine;
- stock market reports, developed by famous Ukrainian investment companies.

The period of investigation is from 1998 to 2003.

"fixed" compensation contracts to sign with executives that reduces an importance of the compensation committee on the supervisory board. Under such circumstances, executives are free to influence decisions on the size and structure of their compensation through forcing a personnel department that is subordinated to executives and responsible to developing contracts for executives.

Finance committees are on the boards at only 3 percent of researched companies. Motives to establish the finance committee on the supervisory board at companies, controlled by various groups of shareholders are different. Thus, financial-industrial groups want to have the finance committee on the board to control financial expenditures by executives. Foreign institutional shareholders establish the finance committee on the supervisory board to involve directors in strategic financial decision making. Generally, strategic financial decisions are made by executives at the companies, controlled by executives themselves, employees and Ukrainian financial-industrial groups.

Administration committees are not popular on the boards of Ukrainian companies too. About 4 percent of researched companies have an administration committee on the boards. The reason of so low popularity of the administration committee on the supervisory boards in Ukraine is contrasting very much to those conclusions, made previously. Ukrainian companies, whoever controlled them, want to have well-performing administrators on the supervisory boards. But the market for directors in Ukraine has the lack of directors, who may effectively administer the work of the board, from the point of view of its various roles, i.e. strategic, control and advise. A shareholder committee is not popular at Ukrainian joint stock companies. It is quite surprisingly because of frequent cases of violation of the minority shareholders' rights by majority shareholders and executives. This situation can be explained by two reasons. The first is unwillingness of majority shareholders to take into account interests of minority shareholders. The second factor is the very low degree of knowledge of minority shareholders on the major mechanisms of protecting their rights. One of these mechanisms is establishing and participation on the board's shareholder committee.

Only 4 percent of researched Ukrainian joint stock companies have a shareholder committee on the board. It is interesting that all these companies do not experience agent conflicts and are very transparent. About 90 percent of these companies are under control of foreign institutional shareholders. There are no shareholder committees at companies under control of employees and executives. Employees do not establish the shareholder committee on the boards of companies, controlled by them, because they are strongly concerned with responsibility of the company to employees (employment, wages, etc.) and weakly concerned with outside shareholders and institutions (stock market, capital structures, stock price, etc.). Executives do not prefer to establish shareholder committees because an absence of shareholders committee allows executives to absorb a total control of the company and follow their own interests without a threat to be discovered and executed by shareholders.

A policy committee is the most popular committee on the boards at Ukrainian companies. Almost 25 percent of researched companies have the policy committee on the board. Policy committee is the most spread on the boards of the companies under control of foreign institutional investors, Ukrainian financial-industrial groups and Ukrainian investment companies and funds. The higher concentration of ownership structure the higher likelihood of establishing the policy committee on the supervisory board. It is because controlling shareholders want to have a total control over the strategic directions of the companies development through a very simple mechanism to establish - the policy committee. As in the case of the finance committee, only foreign institutional shareholders establish the policy committee mainly to develop strategic directions, and only next to control its execution by executives, i.e. members of the executive board. Companies, controlled by Ukrainian financial-industrial groups, executives and employees, prefer to delegate a function to develop strategic decisions to executive board.

It is interestingly to know a mode of strategic involvement of the policy committee at Ukrainian companies.

**Table 1.** Mode of strategic involvement of the members of supervisory boards in Ukraine

| Involvement in strategy | Frequency |
|---|---|
| Review | 12 |
| Discuss | 12 |
| Approve | 10 |
| Ratify | 9 |
| Decision-taking | 9 |
| Monitor | 9 |
| Define strategic framework | 5 |
| Guide | 4 |
| Help formulate | 4 |

Number of respondents, i.e. members of policy committees - 12

The deepest mode of strategic involvement, i.e. helping formulating strategy, was demonstrated by policy committees of those companies under control of foreign institutional shareholders (3 replies) and with dispersed ownership (1 reply).

The deepest mode of strategic involvement of supervisory boards at companies, controlled by Ukrainian financial-industrial groups is monitoring (4 replies).

Supervisory boards at companies under control of executives are involved in strategic process only from the stage of strategy discussion (1 reply). This proves that shareholder executives are inclined to adsorb corporate control through preventing the establishing the policy committee or through delegating as least as possible involvement in strategy process to the policy committee.

Surprisingly, but we found that directors of those companies, where there are no policy committees are involved in strategy process too. They do this at the ordinary meetings of the supervisory boards or at the general annual meeting of shareholders.

**Table 2.** Roles of the supervisory boards in Ukraine

| Roles | Number of respondents positively answered |
|---|---|
| Involvement in strategy | 44 |
| Hire, appraise and fire executives | 4 |
| Converse with shareholders/stakeholders | 4 |
| Development of corporate vision | 7 |
| Responsibility for ethical framework | 2 |
| Ensure corporate survival | 3 |
| Determine risk position | 2 |
| Lead strategic change | 3 |
| Review social responsibilities | 2 |
| Understand current and forthcoming legislation | 4 |

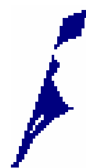
number of respondents - 50

Regrettably, it is worth of mentioning that involvement in strategy is considered by most directors when meeting on the board, only as approving the strategy (38 respondents). 7 respondents consider their involvement in strategy through helping formulating the strategy, and 3 of them are not the policy committee members. Obviously, supervisory boards have a lack of organizational change to let all members apply their knowledge and motivation on committees of the board.

Reviewing social responsibility is the role of members of the board of those companies under control of foreign institutional shareholders. Besides this, reviewing social responsibility is undertaken by members inside of the policy committee. Companies, where there is the policy committee on the board, review social responsibility in general way. Contacts and discussions on the topic of social responsibility with stakeholders, employees, minority shareholders are not undertaken by members of the policy committee. Social responsibility is considered rather as "environmental protection". Obviously, but reviewing social responsibility requires establishing a special committee on the supervisory board. In our sample companies, social responsibility is a role of policy committees, that are not familiar with its role in details.

Generally, we conclude that committees of the supervisory board are demanded more by foreign institutional shareholders. Thanks to this, boards are multi-role performers, i.e. strategy, control and advise.

# РАЗДЕЛ 4 НОВОСТИ КОРПОРАТИВНОГО МИРА



# SECTION 4 CORPORATE WORLD NEWS

## USA

**July 2005.** The SEC has given activist shareholders guidance in the form of a staff legal bulletin on writing shareholder resolutions requesting that companies name an independent director as the board chair. The heart of the advice is as follows:

When a proposal is drafted in a manner that would require a director to maintain his or her independence at all times, we permit the company to exclude the proposal under rule 14a-8(i)(6) on the basis that the proposal does not provide the board with an opportunity or mechanism to cure a violation of the standard requested in the proposal. In contrast, if the proposal does not require a director to maintain independence at all times or contains language permitting the company to cure a director's loss of independence, any such loss of independence would not result in an automatic violation of the standard in the proposal and we, therefore, do not permit the company to exclude the proposal under rule 14a-8(i)(6).

"The guidance also follows a battle earlier this proxy season over the director independence issue between pioneering shareholder activist Bob Monks and ExxonMobil Corp. (XOM). Monks' proposal suffered the fatal flaw because there was no explicit out for the company if a chairman lost his or her status as an independent director, for whatever reason." (SEC Enters New Territory With Holder Proposal Guidance, Dow Jones Newswires, 7/13/2005) The bulletin also lays out how environmental and public health proposals need to be crafted to avoid a no action letter.

To the extent that a proposal and supporting statement focus on the company minimizing or eliminating operations that may adversely affect the environment or the public's health, we do not concur with the company's view that there is a basis for it to exclude the proposal under rule 14a-8(i)(7).

**July 2005.** Corporate Governance and Firm Valuation by Lawrence D. Brown and Marcus L. Caylor of Georgia State University create Gov-Score, a summary measure of corporate governance based on 51 Institutional Shareholder Services factors, representing both external and internal governance. After showing that Gov-Score is positively related to firm valuationGov-7, they create a parsimonious index based on seven of the 51 factors underlying Gov-Score, and show that Gov-7 fully drives the relation between corporate governance and firm valuation. The seven factors are as follows:

1. absence of a staggered board;
2. absence of a poison pill;
3. all directors attend at least 75% of board meetings or had a valid excuse for non-attendance;
4. nominating committee comprised solely of independent outside directors;
5. board guidelines are in each proxy statement;
6. option re-pricing did not occur within the last three years; and
7. average options granted in the past three years as a percent of basic shares outstanding did not exceed 3%.

**July 2005.** Dozens of US corporate executives and 33 companies have admitted using abusive tax shelters to under-report hundreds of millions of dollars in compensation as part of a settlement with the Internal Revenue Service. The IRS said 80 out of 114 executives accused by the tax regulator of using the scheme involving the transfer of stock options to family-controlled partnerships have agreed to pay taxes on $500m in under-reported income plus a 10% penalty. Another 19 executives who under-reported $400m in income have refused to settle and are under audit or face criminal investigation.

**July 2005.** Executives had until May 23 to report their involvement in the shelter and participate in the settlement program, which requires them to pay a 10% penalty -- half the 20% penalty that could have been applied. In the typical tax shelter, a corporation grants an executive stock options. The executive transfers the options to a family partnership established solely for receiving the options, usually owned by the executive, spouse and children. The executive takes a 15- to 30-year promissory note as payment for the options. The partnership sells the options and takes the position that taxes aren't due for 15 to 30 years. Tax laws say that executives owe tax when they exercise stock options.

**July 2005.** Investors representing $33 billion backed issued a set of nine guidelines for major retailers to use in making decisions about store site locations, land procurement and leasing. The guidelines developed by Christian Brothers Investment Services, Inc. and Domini Social Investments urge major retailers to embrace environmental stewardship; public disclosure of siting policies; advance consultation with affected communities; respect for Indigenous cultures; protection of cultural heritage; and adherence to "smart growth" practices. While companies are encouraged to adapt the guidelines to suit their unique business models, the report strongly recommends that all retailers should have a clearly formulated, well-monitored and effective policy for assessing and mitigating social and environmental risks associated with store siting. See Guidelines To Curb Controversies Over "Big Box" Store Locations Issued By Christian Brothers Investment Services, Domini Social Investments for the guidelines and endorsing funds. Adoption of the policies would go a long way toward reducing conflicts with communities and would reduce the risk of lawsuits, political action, and boycotts.

**UK**

**July 2005.** The Financial Times ran an article titled, True and fair view of British audits is in jeopardy, by Keith Jones (7/5/05), which laments that while the "true and fair view" assessment of a company's state of affairs has been a cornerstone of UK accounting, it is now in jeopardy. "Britain and Europe are moving dangerously close to a weak, narrow and limited US-style audit based on technical compliance."

Instead of making qualitative judgments about whether a company's accounts present a true and fair view of a business' state of affairs, auditors will check arithmetic compliance with accounting standards. This will open us up to more Enron's, which regularly received a clean bill of health under such restricted standards.

According to Jones, who is the CEO of Morley Fund Management, International Auditing Assurance Standards Board's US-derived international standards of auditing (ISAs) gives priority to rules at the expense of robust judgment and common sense. Given a legislative footing under the European Union's proposed eighth company law directive, ISAs could change the application and interpretation of existing auditing principles, reducing the scope and rigor of UK audits.

Jones reminds readers the purpose of the audit is to act as a safeguard and check on "agency problems and costs" that arise from the separation of ownership and control in companies. The risk is that management may not always act in the best interests of the shareholders.

We need to decide whether we want the focus to be on ensuring that they are properly empowered to carry out substantive audits or whether we subordinate them to a US-style, process-based framework...There is no sense in introducing further safe harbour provisions for those who carry out audits when there are serious concerns about the nature of the audit itself. In short, the auditor liability regime should not be changed until the quality of the audit has been ensured. To do otherwise is to put the cart before the horse.

**India**

**July 2005.** The government estimates corporate India will need 3,000-4,000 "independent directors" within the next six months to comply with the Securities and Exchange Board of India's (Sebi) listing requirements.

To ensure that corporates are able to find qualified people, the company affairs ministry is facilitating the formation of databases of potential "independent directors" through professional bodies and industry chambers.

**Hong Kong**

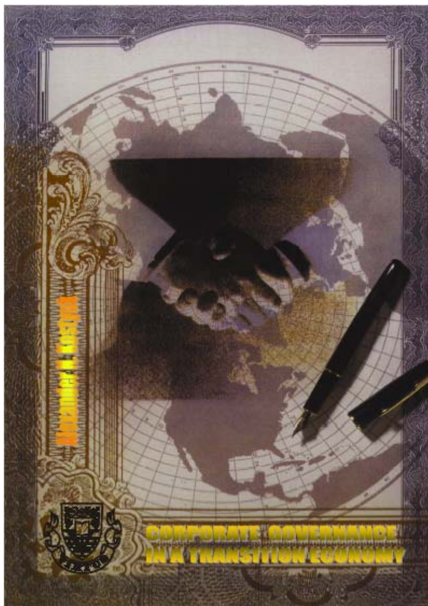
**July 2005.** Researchers studying the corporate governance of 168 of Hong Kong's largest listed companies have found a positive and significant correlation between corporate governance scores and price-to-book ratio. (see Webb-site.com for details and links) Here is a highlight:

A significant and positive relationship is found between CGI and MTBV after taking account of a comprehensive set of control variables. Results show that a worst-to-best change in CGI, from 32.86 to 76.34, implies a 147% increase in MTBV. The transparency-related performance is significant in explaining variations in firm value as well. After comparing the regression results between China-related firms and Hong Kong firms, we find that corporate governance practice matters more for China-related firms.



VIRTUS INTERPRESS ®

# CORPORATE GOVERNANCE IN A TRANSITION ECONOMY




Publishing house Virtus Interpress introduces a new book on corporate governance titled "Corporate Governance in a transition economy". The author of the book is Dr. Alexander Kostyuk, Chair in Governance at Ukrainian Academy of Banking (Ukraine). This book is a result of a five-year research conducted by the author.

The new book has three chapters. The first chapter narrates on the theory of corporate governance with an application to the basic corporate governance models and concepts. Besides that the author introduced a new theoretical approach to investigate origin and consequences of agent conflict. There is an innovative, empirical methodology to evaluate the agency costs.

The second chapter contains a comparative analysis of the evolutionary development of ownership structures in developed economies and Ukraine. The author intended to conclude what type of the development of ownership structures, i.e. the US, UK or Germany, the evolutionary development of ownership structures follows in Ukraine.

The third chapter narrates on the system of mechanisms of corporate governance in Ukraine. The author researched 270 joint stock companies for the period between 1998 and 2004. The author investigated in details board practices, executive compensation, ownership structures, capital structures, credit structures, decision system, monitoring system, bankruptcy system, market for executives. There are unique data on the level and structure of executive remuneration in Ukraine, board committee practices.

Total number of pages is 204 (paperback).

Rates per a copy of the book:

1. Single copy - US$48.
2. Five and more copies - US$46 each.
3. Ten and more copies - US$44 each.

To order the book, please, contact Dr. Alexander Kostyuk at:

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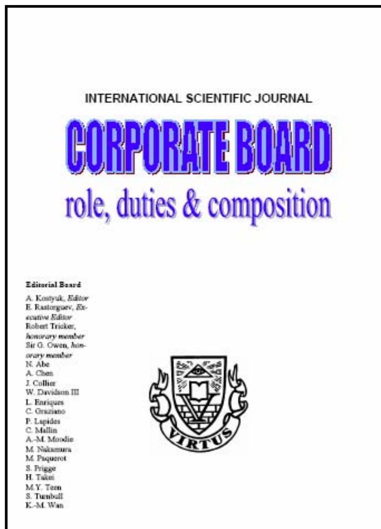
# LAUNCHING A NEW JOURNAL "CORPORATE BOARD: ROLE, DUTIES & COMPOSITION"

*Our mission is to compose*
*corporate board only of accountable,*
*transparent and responsible professionals.*




Publishing house "Virtus Interpress" is pleased to launch a new journal "Corporate Board: role, duties & composition". Establishers of the journal were driven by two factors. The first is a lack of periodicals throughout the world, purely devoted to corporate board practices. Such journals as Directors & Boards, Directorship magazine have a lack of deep research. The second factor is a need to facilitate development of the best corporate board practices to prevent bankruptcies and corporate scandals.

At the beginning of 2004 an initiative group consisting of *Shann Turnbull, Hideki Takei, Ann-Maree Moodie*, headed by *Alex Kostyuk* assumed responsibility to establish a new corporate board journal "Corporate Board: role, duties & composition". An editorial board of the journal includes the leading specialists from twelve countries of the world such as Bob Tricker, Sir Geoffrey Owen, Masao Nakamura, Clara Graziano, Luca Enriques, Jane Collier and others.

The major objective of the publication is the improvement of existing and development of new board practices and further dissemination of research results by enabling renowned and young researchers, and practitioners to present their findings and share their experience. We are going to be a bridge between theory and practice of corporate boards.

The journal will be published in English three times a year. This will make it possible to introduce the latest findings to the wide public.

The journal is comprised of two sections – academic investigations and concepts and the practitioner's corner. From this perspective the journal will be interesting both to academics and practitioners. Sections - academic investigations and concepts - will be devoted to the board practices in both developed and developing countries. The practitioner's corner section will contain "the field notes" in the form of cases from real board practices performed by large corporations and written by practitioners such as members of the boards of directors and CEOs.

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# ABSTRACTS OF THE PAPERS PUBLISHED IN THE FIRST ISSUE OF CORPORATE BOARD: ROLE, DUTIES & COMPOSITION

### Why Anglo Corporations Should Not Be Trusted: and How They Could Be Trusted

*Shann Turnbull*

This paper identifies eight reasons why it is rational not to trust large complex Anglo corporations and how these reasons could be removed. Two reasons are that directors are overloaded with information but also lack information independent of management to evaluate management and the business. A third reason is that directors do not have systemic processes to discover if their trust in management is misplaced. A fourth and fifth reason is that directors have absolute power to manage their own conflicts of interest and a dominant shareholder can enter into related party transactions that can unfairly extract value. The sixth and seventh reasons are the incentive for directors not to blow the whistle on their colleagues and the impotence of a director to act alone. The eighth reason is that shares can be manipulated and traded covertly. Four changes in corporate constitutions are identified that could remove these concerns. These are to establish a watchdog board, introduce cumulative voting for directors, establish stakeholder councils and introducing sunlight share trading.

### The Kostyuk Report: Corporate Board Practices in Ukraine

*Alexander N. Kostyuk*

The author reports on the corporate board practices in Ukraine. The roles of board of directors are mainly about control. The strategic and advisory roles are not developed. Mode of strategic involvement of the members of supervisory boards in Ukraine is mainly about reviewing and approving. Thus, the board of directors in Ukraine is "a rubber stamp". The degree of independence of directors is very low. Major board practices in Ukraine are: small number of independent directors on the board; low frequency of meeting of the board; small number of committees on the board; the management board influences the supervisory board. Board practices in Ukraine need a sort of recommendations, similar to those, made in UK at the end of 1990s, and at the start of the third millennium.

### "Outside" Directors in SME Boards: a Call for Theoretical Reflections

*Jonas Gabrielsson & Morten Huse*

Good governance for SMEs is critical for economic development and growth in both developed and developing economies. In this paper we focus on boards and governance in small and medium sized enterprises (SMEs) by investigating the role and contribution of "outside" directors in this setting. By contrasting board role theories against different types of SMEs, firms are expected to recruit "outside" board members for various reasons. Illustrated by 52 empirical studies of "outside" directors in SMEs we show how agency theory, resource based view of the firm, and resource dependence theory can be applied to understand the multiple roles that "outside" directors can play in family firms, venture capital-backed firms and other SMEs. The illustration shows that the concept "outside" director is not the same in different theories and in different empirical settings.

### Between Controlled Co-option and Direct Election. The Current Debate on the Functioning and Composition of the Supervisory Board in the Netherlands

*Rienk Goodijk*

This paper first describes the complex Dutch corporate governance system and the functioning of the Supervisory Board under the rules of the structure regime and co-option model up to the present time. The critiques of the parties and stakeholders involved in this model are investigated next, followed by a description and explanation of the recent developments of the Dutch model and a discussion of the pros and cons of the alternatives with regard to the interests of the various stakeholders. Finally, some key factors for improving the boards' functioning in the – changing – Dutch corporate governance system are presented. The findings and recommendations are based on case-studies and interviews conducted in large Dutch companies over several years and on extensive analyses of documents and recent evolutions. This research method however, is only suitable for a process of exploration, clarification and development of hypotheses.

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