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Nigel Peace,
Secretary,
Committee on the Financial Aspects of Corporate
Governance,
P.O. box 433,
Moorgate Place,
London,
EC2P 2BJ

29th July 1992

Dear Mr Peace,

DRAFT REPORT - COMMITTEE ON THE FINANCIAL ASPECTS OF
CORPORATE GOVERNANCE

We enclose a comment in response to the above Draft
Report.

Yours sincerely,

K. Cleaver,
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**THE ROLE OF CONTRACTING IN CORPORATE GOVERNANCE AND THE
IMPLICATIONS FOR FINANCIAL REPORTING**

Submission to the Committee on The Financial Aspects of
Corporate Governance.

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Introduction

The Draft Report of the Committee on Financial Aspects of Corporate Governance (hereafter the Report) focuses attention upon a number of crucial issues concerning how companies operate; how responsibilities can best be discharged; and how rights may best be protected.

While the Report makes wide-ranging proposals with respect to these issues, it appears to ignore the role of contracts despite their widespread use in the context of corporate governance.

The omission is a serious one given the pervasive nature of legally binding contracts for all companies. Of particular concern, however, given the emphasis upon the *financial aspects* of corporate governance, are accounting based contracts, i.e. those contracts which include terms based upon published accounting information. In the context of corporate governance, examples of such contracts include: restrictions on directors' powers to borrow in the articles of association; restrictive covenants in loan agreements or debentures; and directors' remuneration contracts. In each case, published accounting information acts as a yardstick which sets limits to the directors' actions or determines the level of their remuneration. Thus, the role of contracts in general, and that of accounting based contracts in particular, would have appeared to offer a number of fruitful lines of investigation for the Committee with respect both to the nature and usage of contracts on the one hand, and the role of accounting information on the other.

The nature and usage of corporate contracts

With respect to the nature and usage of contracts, the Committee has missed the opportunity to discuss such questions as:

- Which groups should be involved in the drawing up and subsequent monitoring of contracts?
- Should the terms of material contracts be publicly disclosed or should they be private contracts - the terms of which are unavailable to shareholders and other users?
- Are contracts an effective means of setting a limit on the actions of directors?

The Report does address some of these issues in the context of directors' remuneration contracts, but has missed the opportunity to broaden the argument to discuss all contracts which attempt to control directors, particularly accounting based contracts.

Accounting Information

The Report appears to advocate an increased standardisation, or narrowing, of accounting treatments (p.21). Its justification for so doing is based upon what the Report apparently considers to be the only objective for accounting, that of providing useful information to users. It observes that (para.4.39):

"The need to sift and correct the information put out by companies, adds costs and uncertainty to the market's pricing function."

while in para.4.40

"In addition, the wider the scope for alternative treatments, the less useful financial reports become in terms of comparability - over time and between companies."

This line of justification is particularly weak. It appears to suggest that if a common accounting policy was adopted then accounts would somehow be comparable and that analysts would not need to sift and correct the information, or at least the need for such sifting and correcting would be greatly reduced. This is clearly not the case, particularly given the continued use of historic cost accounting. Further, the cost imposed on analysts by the use of alternative accounting policies is likely to be marginal and there is, moreover, no attempt in the Report to weigh these costs against benefits in the form of an improved signal obtained by using an accounting policy which is appropriate to a particular set of circumstances rather than the "off the shelf" policy provided by imposed regulation.

It is our contention that there is a much better justification for reducing the availability of alternative accounting policies if the role of accounting information in the contractual process is accepted as legitimate. One role of accounting based contracts is to restrict or motivate the actions of directors, however, where regulations permit a number of accounting policies, the accounting figures used in contracts become an elastic yardstick. Moreover, accounting policies are chosen by directors, creating the situation where those being controlled by contracts effectively control the measuring device by which the contracts operate. In this context, the reduction of available options for accounting policies would make such contracts more effective in controlling the actions of directors and in safeguarding the interests of shareholders and creditors. Whether this role in corporate governance is a sufficient justification for yet more standardisation is an open question, but at least it would have been an appropriate area for discussion by the Report. There is, however, an alternative, or additional, strategy to standardisation which was mentioned by the Report: that of increased disclosure.

Disclosure

Para 4.32 of the Report states:

"The overriding principle in respect of board remuneration is that of openness. Shareholders are entitled to a complete disclosure and explanation of directors' present and future benefits... and of how they have been determined."

The Committee's intention of explaining the basis of calculation of performance related pay for directors is to be applauded. There are, however, wider implications than "openness" which have not been fully considered by the Committee. Despite the above argument for a reduction in the choice of available accounting policies, it is clear that there will always be some discretion in the hands of directors with respect to accounting measurement. This being the case, greater disclosure of the terms of accounting based contracts, including directors' remuneration, is to be advocated. With greater disclosure the actions of the directors become more observable, and understandable, by shareholders and others, even if only retrospectively. As a result, directors may be less likely to manipulate accounting policies in order to circumvent contract terms. Where the Committee's recommendations fall short is in not recognising this general contracting role and therefore in not extending the additional disclosure requirements to other significant accounting based contracts.

A recent example of the above principle is the debate over intangibles, and in particular brand accounting, where there is increasing evidence that companies were able to circumvent contract terms in debenture covenants and articles of association, and also certain Stock Exchange Regulations, by including brands as an intangible asset. While the debate has focused on greater disclosure for intangible assets, there is also a case for disclosing the relevant terms of major accounting based contracts in order to reveal the consequences to corporate governance of accounting policy choice.

Conclusion

It has been argued that the Committee has made two serious omissions. First, it has failed to consider the role of contracts as a legitimate means of exercising control in the context of corporate governance. Second, it has focused too narrowly upon the role of accounting information in making economic decisions thereby ignoring the part that published accounts also play in the contracting process, and therefore in corporate governance.

To be fair, the Committee has recommended greater disclosure of directors' remuneration contracts but we are left with the impression that they have stumbled across a treasure chest without fully appreciating the wider significance of its contents.