Paper on which the presentation by John Coffee, Adolf A. Berle Professor of Law, Columbia Law School; ECGI Fellow is based

Why do the U.S. and Europe have characteristically different scandals? This is an essay in applied corporate governance. Its thesis is simple: different types of scandals tend to characterize different structures of shareholder ownership.

During the late 1990s, the U.S. witnessed an explosion of financial statement restatements. Slide One is taken from a report of the United States General Accounting Office ("GAO") (which is an arm of the U.S. Congress), and it shows a hyperbolically increasing rate of restatements that climaxed in 2002.

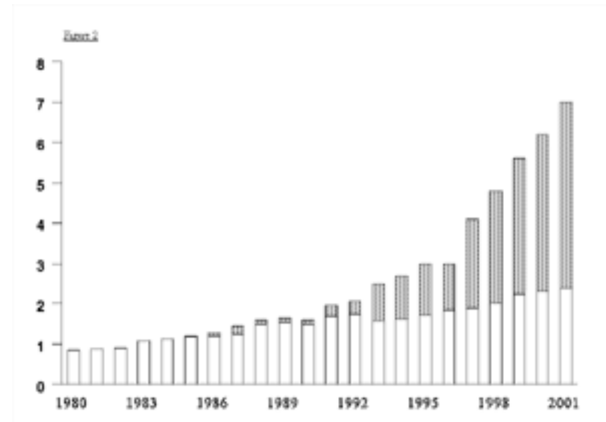
Between 1997 and 2002, the GAO found that over 10% of all listed companies in the United States announced at least one financial statement restatement. Here, you need to understand that in the United States a financial statement restatement is a serious event that, depending on its magnitude, often results in the filing of a class action, an SEC investigation, a major stock price drop, and often a management shake-up.

The GAO's data probably understates the severity of this sudden spike. Because there is no common way that all companies report a restatement, the GAO was not able to catch all restatements in its study. A later, fuller study in 2003 by Huron Consulting Group shows the following results: in 1990, there were 33 earnings restatements; in 1995, there were fifty; in 2000, there were 157; and in 2002, the number peaked at 330 (ten times the 1990 level).

Nor were these restatements merely technical adjustments. The GAO study found that the typical restating firm lost an average 10% of its market capitalization over a three day trading period surrounding the date of the announcement. All told, the GAO estimated the total market losses (unadjusted for other market movements) at $100 billion for restating firms in its incomplete sample for 1997-2002.

What caused this phenomenon? Of course, there was a world-wide bubble that burst in 2000. Interestingly, the recent stock market decline in percentage terms was greater in some European markets than in the U.S. But in Europe, there was not the same frequency of accounting and financial irregularity (certainly, one out of ten European public companies did not restate its financial statements). While multiple explanations can be given for most complex phenomena, one explanation does distinguish the U.S. from Europe, and it has increasingly been viewed as the best explanation for the sudden spike in financial irregularity in the U.S. Put simply, executive compensation abruptly shifted in the United States during the 1990s, moving from a cash-based system to an equity based system. More importantly, this shift was not accompanied by a corresponding and compensating changes in corporate governance to offset the predictably perverse incentives that stock options as compensation can create.

Figure Two shows the median compensation of a CEO of an S&P 500 Industrial company. As of 1990, this CEO was making $1.25 million with 92% of that amount paid in cash and 8% in equity. But during the 1990s, both the scale and composition of executive compensation changed. By 2001, the median CEO of an S&P level company was earning over $6 million, of which 66% was in equity.



Obviously, when you pay the CEO with stock options, you create incentives for short-term financial manipulation and accounting gamesmanship. Not only is this obvious, but financial economists have confirmed it, finding a strong statistical correlation between equity compensation and financial restatements. One such study, published this year by Efendi, Srivastava and Swanson, constructed two groups of companies, each composed of 100 listed public companies. One group had restated their financial statements in 2001 or 2002, while the control group was composed of otherwise identical firms that had not restated. What most distinguished the two groups? The leading factor that most influenced the likelihood of a restatement was found to be a CEO with a substantial amount of "in the money" stock options. The CEOs of the firms in the restating group averaged "in the money" options of $30.9 million, while CEOs in the non-restating control group averaged only $2.3 million – a nearly 14 to 1 difference. Further, if a CEO held options equaling or exceeding 20 times his annual salary (and this was the 80th percentile in this study – meaning that a substantial number of CEOs did exceed this level), the likelihood of a restatement increased by 55%.
You are probably aware that CEO compensation is uniquely high in the United States. Here is one statistic: CEO compensation as a multiple of average employee compensation is now 531:1 in the U.S., but only 16:1 in France, 11:1 in Germany, 10:1 in Japan, and 21:1 in nearby Canada. Even Great Britain, with the most closely similar system of corporate governance to the U.S., has only a 25:1 ratio.
What explains this? One partial answer is that institutional investors wanted it that way. Why? Institutional investors, who hold the majority of the stock in publicly held companies in the U.S., understand that, in a system of dispersed ownership, executive compensation is probably their most important tool by which to align managerial incentives with shareholder incentives. Throughout the 1960s and 1970s, they had seen senior managements of large corporations manage their firms in a risk-averse and growth-maximizing fashion, retaining "free cash flow" to the maximum extent possible. Such a style of management produced the bloated, and inefficient conglomerates of that era (remember Gulf & Western and IT & T). But this is exactly the incentives that a system of cash compensation creates: namely, to avoid risk and bankruptcy and grow the firm, regardless of profitability, because a larger firm size generally implies higher cash compensation for senior managers.
Once the U.S. tax laws and institutional pressure together produced a shift to equity compensation in the 1990s, managers' incentives changed, and they now sought to maximize share value (as the institutions wanted). But what the institutions failed to realize was that excessive incentives encourage the use of manipulative techniques to maximize

stock price over the short-run (during which period managers, having asymmetric information, can exercise their options and bail out).
What kinds of financial irregularities become common under a system based on equity compensation? The Sarbanes-Oxley Act required the SEC to study all its enforcement proceedings over the prior five years (i.e., 1997-2002) to ascertain what kinds of financial and accounting irregularities were the most common. Figure Three beloe shows what the SEC found.

SEC ENFORCEMENT PROCEEDINGS JULY 31, 1997 – JULY 31, 2002		
Total No. of Proceedings		227
Improper Accounting Practice	**Number of Enforcement Matters Involving Practice**	
Improper Revenue Recognition	126	55.5%
Improper Expense Recognition	101	44.5%
Improper Accounting in Connection With Business Combinations	23	10%
Inadequate Disclosures in MD&A and Elsewhere	43	19%
Failure to Disclose Related Party Transactions	23	10%
Inappropriate Accounting for Non-Monetary and Roundtrip Transactions	19	8.3%

What stands out here is that 55% of all SEC enforcement proceedings over this period involved "improper revenue recognition." Similarly, the GAO Study noted earlier found that 40% of all restatements in its survey were for revenue recognition timing errors. Figure Four shows us that when this revenue recognition category is examined in more detail, it principally consists either of premature revenue recognition or fictitious recognition.

Improper Revenue Recognition Practices (126 Proceedings)	
Improperly Timed Revenue Recognition	81
Fictitious Revenue	80
Improper Valuation	21

Either managers were recognizing the next period's revenues prematurely – or managers were simply inventing revenues that did not exist. Both forms of errors suggest that

managers were striving to manufacture an artificial (and possibly unsustainable) spike in corporate income.

Now, here is where Europe is different. Europe has concentrated ownership. Normally (not in every case, but in the vast majority of cases), there is a controlling shareholder. Why is this important? Because a controlling shareholder does not need to rely on indirect mechanisms of control, such as equity compensation or stock options, in order to incentivize management. Rather, it can rely on a "command and control" system because, unlike the dispersed shareholders in the U.S., it can directly monitor and replace management.

In addition, the controlling shareholder has much less interest in the day-to-day stock price of its company. Why? Because the controlling shareholder seldom, if ever, sells its control block into the public market. Rather, if it sells at all, it will make a privately negotiated sale at a substantial premium over the market price to an incoming, new controlling shareholder. Such control premiums are characteristically much higher in Europe than in the United States. As a result, controlling shareholders in Europe do not obsess over the day-to-day market price and rationally do not engage in tactics to prematurely recognize revenues to spike their stock price. These two explanations – lesser use of equity compensation and lesser interest in the short-term stock price – explain why there were less accounting irregularities in Europe than in the U.S. during the late 1990s.

Perhaps you will throw up counter-examples to my analysis: Vivendi Universal, Royal Ahold, Skandia Insurance or Adecco – all European companies that did experience accounting irregularities. But these are exceptions that prove the rule. All were companies whose accounting problems emanated from U.S. based subsidiaries or that had transformed themselves into American-style conglomerates (the leading example being Vivendi) which either awarded stock options or needed to maximize their short-term stock price in order to make multiple acquisitions.

Does this analysis imply that European shareholders are better off than their American counterparts? Not necessarily! Instead, concentrated ownership encourages a different type of financial overreaching: the extraction of private benefits of control. This is in essence the Parmalat story, and Parmalat is the Europe paradigmatic fraud (just as Enron and WorldCom are the representative frauds in the United States). Parmalat essentially involved the balance sheet, not the income statement. It failed when a 3.9 billion euros account with Bank of America proved to be fictitious. At least, $17.4 billion in assets seemed to vanish from its balance sheet. Efforts by its trustee to track down these missing funds have found that at least 2.3 billion euros were paid to affiliated persons and shareholders. In short, private benefits appear to have siphoned off to controlling shareholders to at least this extent. Unlike the short-term stock manipulations that occur in the U.S., this was a scandal that continued for many years, probably for decades. In Enron, the chief victims were shareholders; in Parmalat, the chief villains were shareholders (i.e., the controlling shareholders).

In this light, I cannot tell you that European companies are more ethical or respectable than U.S companies, or vice versa, but only that they commit characteristically different sins. Different styles of fraud characterize different structures of shareholder ownership. On both sides of the Atlantic, auditors have been overreached and may in some cases have willingly acquiesced in fraud.

The one difference that I will concede is that the U.S./U.K. system of corporate governance, which is characterized by a separation of ownership and control, probably depends more on the independence of its gatekeepers, including in particular the auditor, because it relies on a system of governance based on monitoring by part-time independent directors. Still, shareholders on both sides of the Atlantic depend upon independent auditors to protect them

from characteristically different evils: the extraction of private benefits in Europe, and the manipulation of earnings in the U.S.

In that light, I would conclude by stressing that much as Sarbanes-Oxley may have evoked fears of American imperialism in Europe, both Europe and the United States have a common interest in protecting and strengthening the independence of the outside auditor.