Mark Latham
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The Management Auditing Firm

Here is a simple and direct way to make the management of a corporation better serve the interests of its shareholders: let the shareholders choose a management consulting firm to give them an independent appraisal of how the corporation is being run, and if necessary, to solicit proxies for proposals opposing management. A consulting firm offering this service could be called a Management Auditing Firm.

Two features distinguish this mechanism from other ways of increasing shareholder power. One is that selecting the auditing firm and setting its budget can be done with minimal influence from the corporations management. But the more important feature is the role of reputation for the auditing firm. Because it does management audits of many corporations, it can demonstrate that it is neither a rubber stamp nor a knee-jerk antagonist to management, but rather that it provides balanced professional judgment.

Such a firm could tell shareholders when it believes management is empire-building — expanding a line of business that will return substandard profits. Or when existing assets are being used inefficiently and should instead be sold. The auditing firm could give an independent assessment of a takeover offer, or of anti-takeover proposals. It could recommend changes in management’s compensation as well as its composition — hiring, firing and promotion.

Voting For An Auditor

The hard part is mustering enough shareholder support for such a vote to take place. Management is likely to oppose the proposal. So if management controls a majority of the votes (as is common under the existing proxy system) then it can block such a movement. But if it could be brought to shareholder vote, here is how the voting might be organized:

Rather than having nominations which would tend to be heavily influenced by management, any would-be management auditor could nominate itself by paying a fee of, say, $5,000 to discourage frivolous entries. Then auditing firms can market themselves to shareholders by sending proposed budgets and plans for what kind of audit they would perform. While the question of how shareholders would choose the budget and the scope of the management audit may seem problematic, it is solvable. A simple and fair way to set the budget is for each shareholder to write down any amount of money they consider ideal for the total budget; the auditing firm is then allocated the (share-weighted) median amount, to be paid by the firm and thus by each shareholder proportionally. The great advantage of using the median is that no one can sway the outcome by voting for spending a huge sum; and if a majority vote for zero then no auditor is hired.

As for what should be the scope and focus of the audit I can see no better mechanism than for the auditing firm to decide that quite freely, with the shareholders depending on the auditor’s reputation (or loss of reputation and future business) to ensure effectiveness.

The New Power Structure

Experiment and experience will show which arrangement of roles is most effective. A likely strategy for management auditors would be to routinely solicit proxies from all shareholders, so as to vote in opposition to management when they see fit. This would correct a major shortcoming of the existing corporate control structure -- the lack of a ready focal point for shareholder opposition.

The auditor should probably have a close link with the other entity that is supposed to represent shareholders -- the board of directors. It could oppose management's board nominees and submit its own. Perhaps a newly-chosen management auditing firm should be allowed to attend all board meetings but not vote. Then after a year of proving itself to shareholders it can propose that it be granted a vote -- in other words, a seat on the board.

It Costs Nothing

Management auditing can substitute out some existing providers of management and oversight services, so that the net cost may be zero. The cost savings would come from reduced use of conventional management consulting, shrinking the board of directors, and/or needing fewer managers in the corporation. The auditor's contribution to managing the company would be more valuable than what gets substituted out, because it is a completely independent view from the rest of the management team.

It is instructive to compare management auditors with three other types of external analysts: accounting auditors, security analysts, and rating agencies.

<u>Accounting auditors</u> are similar to management auditors in that their reputation for giving an assessment independent of management's wishes is perhaps their most highly valued attribute; also, the kind of assessment they give is essentially a critique of some aspects of how the company is managed. But they differ in two main ways: their scope is typically limited to accounting, and they are not chosen by the shareholders. This latter difference is probably the reason why the occasional foray by accounting auditors into broader criticism of management practices has never grown into a full confrontation.

<u>Security analysts</u> are compensated not by management but by the shareholder-investors, albeit indirectly. They are thus independent (of the managers, at least) and can be trusted to be critical of policies which seem unprofitable based on their research. However, their influence in ameliorating such policies falls well short of that of a management auditing firm for two reasons: First, their goal is passive not active -- estimating the value of the firm given the way it is managed, rather than trying to change the way it is managed. Second, they face a huge free-rider problem — they review the firm and its management only to a fraction of the degree that is in the interests of shareholders as passive stock-trading individuals; they will never be paid enough to support a review of the full range of management decisions to the ongoing level of depth that is in the interests of the shareholders as an active group influencing how the firm is run.

Rating agencies have minimized the free-rider problem by being few in number. With only two or three major agencies, they get reasonably well compensated for their information services. Like management auditors, their reputation for objectivity is crucial for maintaining the respect of investors. Although it is management who decides whether to pay their fees, for most large companies there is in practise little choice but to pay. But here again the main distinguishing feature is their scope -- essentially limited to assessing the risk of bankruptcy.

Access to Inside Information

Should management auditors have privileged access to information within the firm? If so, to what degree, and how should the process of acquiring the information be governed? Management may not have an incentive to cooperate in supplying the most relevant information.

A useful reference point is the degree of access typically granted to management consulting firms. The tradeoff of improving the quality of advice, versus increasing the risk of leaking competitive secrets, would seem to be similar to the case of management auditors. Important aspects of the auditing firm's reputation would be a high degree of confidentiality, and minimization of conflicts of interest arising from auditing two firms in the same industry. But the fact that a management audit must by nature be able to cover any part of the firms activities, argues for greater access to information.

The solution is probably for shareholders to vote on broadly defined principles of information access, and for the auditing firm to rate managements cooperation as part of its annual report.

Two-edged Sword

As with any monitoring arrangement, there is ample potential not only for criticism but also for praise and support of management policies. Firms that seek to invest in expansion or upgrading of plant and equipment, for example, often need to issue equity or cut dividends to raise the funds. Such proposals tend to meet with healthy skepticism from boards and shareholders concerned about depressed short-run profits and nebulous long-run profit forecasts. A management auditing firm with a strong reputation for skepticism and independence, plus professional well-paid full-time analysis of the client firm, can provide a valuable recommendation on the decision.

Thus management auditing may alleviate "short-termism" by giving shareholders and the stock market better information about longer term returns on investment, enabling that to be reflected in today's stock price and today's management compensation. Besides fixed assets, of course, this argument applies to investment in market share, R&D, product quality and consumer reputation, risk management, employee training, morale, and measures to reduce employee turnover.