INTRODUCTION TO CORPORATE GOVERNANCE
• Accused of **overstating earnings** by at least $1.4 billion between 1999 and 2002 to meet analyst targets.

• CEO paid a salary of $4.0 million, cash bonus of $6.5 million, and granted 1.2 million stock options during fiscal 2001.

• Former CFO and others pleaded guilty to a scheme of artificially inflating financial results.

• CEO sold 2.5 million shares back to the company (94% of his holdings) just weeks before the firm revealed that regulatory changes would hurt earnings, battering its stock price.
• What was the board of directors doing?
  – Compensation committee met only once during 2001.
  – *Forbes* (April 30, 2002): CEO has “… provided sub-par returns to shareholders while earning huge sums for himself. Still, the board doesn’t toss him out.”

• What was the external auditor (E&Y) doing?
  – Audit committee met only once during 2001.
  – President and CFO were previously auditors for E&Y.
  – Audit fee = $1.2 million versus other fees = $2.5 million.

• What were the analysts doing?
  – UBS analyst had a “strong buy” on HealthSouth.
  – UBS earned $7 million in investment banking fees.
Perhaps not surprisingly, the CEO repeatedly received stock options dated at low points in the company’s stock price ("backdating").
U.S. Companies
AIG, Bear Stearns, Countrywide, Enron, Fannie Mae, Lehman Brothers, MF Global, WorldCom etc…

Non-U.S. Companies
Olympus, Parmalat, Petrobras, Royal Dutch Shell, Royal Bank of Scotland, Satyam, Siemens etc…

U.S. and Non-U.S. Companies
Equally likely to restate earnings
“Self-Interested Executives”

- The owners of the company are separate from the management of the company.
- **Agency problem.** Management takes self-interested actions that are not in the interest of shareholders.
- **Agency costs.** Shareholders bear the cost of these actions.

To meet Wall Street estimates:

- 80% of CFOs would reduce discretionary spending
- 60% of CFOs would delay investment in a valuable new project
- 40% of CFOs would accelerate recognition of revenue (if justified)
- 40% of CFOs would provide incentives to customers to buy early
- 30% of CFOs would draw down reserves

Graham, Harvey, Rajgopal (2006)
EXAMPLES OF AGENCY COSTS

• Insufficient time and effort on building shareholder value
• Inflated compensation or excessive perquisites
• Manipulating financial results to increase bonus or stock price
• Excessive risk taking to increase short-term results and bonus
• Failure to groom successors so management is “indispensible”
• Pursuing uneconomic acquisitions to “grow the empire”
• Thwarting hostile takeover to protect job
Control mechanisms to prevent self-interested managers from taking actions detrimental to shareholders and stakeholders.
ARE THERE “BEST PRACTICES” IN GOVERNANCE?

• In 1992, the Cadbury Committee in London recommended independent directors and independent audit committee.
  – Enron was compliant with independence standards, yet collapsed.

• In 2002, Sarbanes Oxley in the U.S. enhanced the penalties for misrepresentations.
  – Refco hid $430 million in loans to its CEO, two months after it went public.

• ISS gave HealthSouth a governance rating that placed it in the top 8% of its industry.
  – The next year, HealthSouth officials were charged with fraud.
Investors say they are willing to pay a premium for a “well governed” company.

The size of the premium varies by country.

- Higher premium: countries with weaker legal/regulatory protections for minority shareholders.
- Lower premium: countries with stronger protections.

WHAT PREMIUM WOULD YOU BE WILLING TO PAY FOR A WELL-GOVERNED COMPANY IN:

- Russia: 40%
- China: 30%
- Brazil: 20%
- India: 10%
- South Korea: 10%
- United States: 10%
- Germany: 10%
- United Kingdom: 10%

Is the governance of Company A worse than the governance of Company B?

What is the evidence?

WOULD YOU BE WILLING TO PAY A PREMIUM FOR COMPANY B STOCK?

Company A: “Poor” Governance
- Minority of outside directors
- Outside directors have financial ties with management
- Directors own little or no stock
- Directors compensated only with cash
- No formal director evaluation process
- Very unresponsive to investor requests for information on governance issues

Company B: “Good” Governance
- Majority of outside directors
- Outside directors are independent; no ties to management
- Directors have significant stock
- Directors compensated with cash & stock
- Formal director evaluation is in place
- Very responsive to investor requests for information on governance issues

• Corporate governance is an important device for controlling self-interested executives.

• However, would you know “good governance” if you saw it?

• Governance is a controversial topic. The debate is characterized by considerable hype but few hard facts.

• To get the story straight, we must look at the evidence. Sometimes the evidence is inconclusive.

• Still, it is important for investors, directors, and regulators to understand the data so they can make informed decisions.