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CORPORATE GOVERNANCE AND SHAREHOLDER VALUE: HOW DID WE GET HERE AND WHERE ARE WE GOING?

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The Roots: Modern Financial Theory

Modern financial theory emerged in the late 1950s and early 1960s to provide a scientific basis for explaining corporate investment, financing and dividend decisions. I emphasize the word scientific because many academics believed the financial decision-making rules of practitioners were riddled with inconsistencies and made no logical sense.

For example, a typical story about why firms should use debt financing was that the stock price of the firm would be unaffected because investors wouldn't notice or care as long as not too much debt was used and, as a result, the overall cost of financing the company would fall. No "scientific" theory existed as to why this would happen, or for that matter, why and how any financing decision, including the decision to pay cash dividends, would affect the company's market value and stock price.

Lurking in the background of pre-modern finance was also the idea that the earnings a corporation retained and reinvested in the company were costless. And as this source of equity capital was costless, managers did not have to worry about how they invested these earnings or whether they earned an adequate return on this capital. This attitude about retained earnings is duly noted in Adolph Berle's preface to the 1967 re-issue of his classic work (Berle and Means 1967), where Berle writes:

> "The purchaser of stock does not contribute savings to an enterprise, thus enabling it to increase its plant operations. He does not take the "risk" on a new or increased economic operation; he merely estimates the chance of the corporation's shares increasing in value. The contribution his purchase makes to anyone other than himself is the maintenance of liquidity for other shareholders who may wish to convert their holdings into cash. Clearly, he cannot and does not intend to contribute managerial or entrepreneurial effort or service."

And then came the revolution of modern finance theory. It began with Harry Markowitz giving us portfolio theory and formalizing what the English merchants already knew in the 17th century – don't send all your cargo in one ship (Markowitz 1959). Benoit Mandelbrot (1966) and Eugene Fama (1970) gave us market efficiency – don't look for twenty-dollar bills on the floor; but if you find one, pick it up quickly before it's gone. Modigliani and Miller (1959) told us that in perfect capital markets financing and dividend decisions didn't matter – at least for the shareholders – so don't waste time with worrying about whether and how much debt to use. And, William Sharpe (1964) and others introduced us to beta and the capital asset pricing model.

Modern finance theory: "What determines the market value of a firm?"

Fundamentally, these founders of modern financial theory were concerned with a very important public policy as well as scientific question: What determines the market value of a company and, in particular, the per share stock price in efficient markets? The answer was: the greater the cash flows and the lower the risk, the more the company is worth. In other words, these "scientists" produced "scientific" models that showed a manager how to maximize the company's market value and share price. As to whether managers should and would make decisions to maximize share price was another matter. And, here is where corporate governance reemerged from historical debates about the modern corporation and how it should be controlled and managed.

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The Corporate Governance Debate

Especially in the United States, the debate was about how to ensure that managers of publicly owned corporations would manage the firm in the best interests of society rather than in their own personal interests or the interests of political oligarchy. A number of proposals were advanced; but the one that concerns us here is that which says the best way to make sure managers use resources efficiently is to have them maximize shareholder value and return any cash that cannot be profitably invested to the shareholders. This is the "should" part.

A good way to get a handle on the "should" part and how it has influenced the corporate governance debate in the post-"modern finance" era is to go back to the early 1980s and recall the often emotional debates about the demise of American corporations and the superiority of the German and especially Japanese corporate governance systems.

The German/ Japanese model vs. the U.S. model of corporate governance

In a classic article, Hayes and Abernathy (1980) were confident that America was in decline and they knew why. It was the short-term myopic behavior of managers who focused on quarterly earnings, ROI (return on investment) and other accounting performance measures that supposedly led to a reduction in R&D expenditures and the development of new technologies. And who was responsible for this? Well, supposedly it was short-term myopic stockholders who demanded high ROIs and quarterly increases in earnings per share at the expense of long-term growth – in other words, financial markets.

According to these and other critics, the problem with the American economy was a capital-market-based corporate governance system with public shareholders and institutional investors forcing management to make decisions not in the best interests of the economy as a whole. And, what was the solution? Imitate the Germans and the Japanese (Porter 1992).

What was the "scientific" evidence behind these condemnations of markets and institutional investors? Not much! In fact, the evidence that began emerging from academic studies done by financial economists suggested just the opposite. Woolridge's study of market reactions to corporate investment decisions is typical of the accumulated evidence (Woolridge 1988). He found that company stock prices actually went up (not down) when companies announced increases in research and development expenditures, new product introductions and capital expenditures for capacity expansion and plant modernization.

What was going on here? Maybe the problem was not the investors but rather the managers and other organizational stakeholders who, like everyone else, acted in their own self-interest. Now we are back to the question: How do we get managers to make economically efficient investments and distribute any remaining cash to the shareholders rather than keep it for themselves? How do the suppliers of capital make sure they get back their investment as well as a return on their money?

Here is where corporate governance comes into its own.[1] What we want are ways to align the interests of managers with those of the shareholders, to ensure that managers and boards of directors represent the interests of the public shareholder or their representatives – the pension funds and mutual funds – and *make it possible for shareholders to monitor and replace management and directors who attempt to extract wealth from the public shareholders.*

Monitoring and Controlling Managers

One of the most popular answers in the 1990s for controlling managers and aligning their interests with the shareholders was pay for performance. But, how do you measure performance?

If we go back to the critique of Abernathy and Hayes about manager myopia, we find that they focused almost exclusively on ROI as the measure that was causing short-termism. This outcome occurred because ROI, like other financial statement measures such as net income and earnings per share, are backward looking accounting measures easily subject to the manipulation of managers. Instead, why not measure managerial performance and compensate managers using stock prices – the very thing shareholders wanted man-

[1] The "should" part remains controversial and lies at the heart of the growing protests and concerns over globalization, the power of multinational corporations and proposals for a new international architecture.

agement to maximize. Or, alternatively, award stock based on stock price performance. As long as you believe financial markets are efficient and investors are not myopic, stock options and stock ownership are reasonable means for aligning managerial interests with public shareholders. But for investors to properly price out the stock, they need dependable, trustworthy and transparent financial statements. No "cooked books", thank you!

Other useful ways for controlling managers from a disciplinary perspective have to do with the company's financing and dividend policies. In doing so, however, we transform the financing and dividend decision from one focused solely on identifying that capital structure which minimizes the company's cost of capital to a governance question of how investors control managers and prevent them from making unprofitable investments.

The best way to grasp this shift is to look at the data in the exhibit below. When we arrange a variety of investment and financing events according to whether they generate cash flows from the firm to investors or from investors to the firm, we find the former all have positive returns and the latter all negative returns. Why?

Michael Jensen's answer is the free cash flow theory of corporate finance (Jensen 1986). Investors like to get cash from companies and do not like to leave cash lying around for managers to spend on other things unless, and this is the big unless, they can invest these funds in growth opportunities. But how do you keep managers from squandering shareholder funds? You finance the company with debt instead of equity, because debt requires periodic outflows of cash from the company in the form of interest and principal payments. You also pay cash dividends or buy back your stock – the same thing as a cash dividend payment.

Of course, not all companies pay cash dividends and not all companies have debt in their capital structure. Does this mean something is wrong with the free cash flow story? Not really. For companies with substantial growth opportunities you want managers to have wide discretion over the cash flows so as to be able to take advantage of these opportunities. You also don't want to burden them with debt financing and the restrictions normally associated with bank loans. Thus, these are the firms who should not pay cash dividends and avoid debt.

How to align the interest of managers with those of the shareholders?

Now we have a story about why managers should maximize shareholder value and a governance story about how managerial compensation schemes and financing and dividend decisions can be used to align the interests of managers with those of shareholders and control managerial behavior. What we are missing is a story about why managers would do any of this or why boards and directors would be responsive to shareholder instead of management concerns. The question is: Suppose public investors don't like what the boards and management are doing with their money. What can they do about it? The answer is a market for corporate control, a legal system that protects the rights of public investors to vote their shares and fend off attempts by corporate boards and insiders to disenfranchise them and an accounting and financial reporting system that investors can trust.

Also important in the U.S. was the growth of institutional investors in the 1990s. As these became more active, corporate boards and management came under increased scrutiny and, by the 1990s, were confronted with a set of cor-

Exhibit

Stock Returns Adjusted for Overall Market Performance with Respect to Cash Flows Between the Firm and its Shareholders

	Two-Day Stock Return
CASH FLOWING FROM THE COMPANY TO THE SHAREHOLDERS	
Common stock repurchases	
Tender offer	16.2%
Open-market purchases	3.6
Dividend Increases	
Dividend initiation	3.7
Dividend increase	0.9
Special dividend	2.1
Investment increases	1.0
CASH FLOWING FROM SHAREHOLDERS TO THE COMPANY	
Security sales	
Common stock	– 1.6
Preferred stock	0.1
Convertible preferred	– 1.4
Convertible debt	– 2.1
Straight debt	– 0.2
Dividend decreases	– 3.6
Investment decreases	– 1.1

Source: Clifford W. Smith, Jr., 1986, "Raising Capital: Theory and Evidence," *Midland Corporate Finance Journal*, 4, pp. 6–22.

porate governance guidelines such as those developed by the largest US institutional investor (TIAA-CREF 2000).

TIAA-CREF (Teachers Insurance and Annuity Association – College Retirement Equity Fund) is really quite blunt about its corporate governance concerns. It says that "corporate governance initiatives – in which TIAA-CREF monitors the companies it invests in and presses for improved management when appropriate – is an important aspect of ensuring that the investments we make on behalf of participants produce the highest possible returns."

A market for corporate control and active institutional investors

And then came Enron, Tyco, WorldCom and a host of other governance fiascos. What failed and why?

What Went Wrong?

Popular attention in these high profile debacles has focused on the pay of senior management, especially pay-for-performance schemes connected to stock options. Essentially, management sought ways to inflate and aggressively manage and manipulate revenues and earnings so as "to fool" or mislead investors into driving up the company's stock price and make their stock options ever more valuable. Additionally, balance sheets were managed so as to keep debt off the books, again misleading investors. For example, Citigroup and J.P. Morgan lent Enron billions of dollars disguised as energy trades on Enron's balance sheet. But, how could this happen in a world where companies were audited and financial statements certified by public accounting firms such as Arthur Andersen so as to prevent just such an outcome from happening?

Cooking the books and conflicts of interest

Well, the public accounting firms may have been more interested in earning consulting fees from the managers of the firms they were auditing and retaining the company's auditing business than in representing the clients who, in theory, had hired them – the shareholders. In 2001, for example, non-audit fees comprised over fifty percent of the fees paid to accounting firms by 28 of the 30 companies making up the Dow Jones Industrial Average.[2]

And the directors? Where were the directors?

[2] "Accounting Industry Fights Calls for 'Audit Only' Rules," *Wall Street Journal*, March 7, 2002, p. C1.

It turns out that directors are effectively appointed by corporate management, not by the shareholders – even if they are the so-called independent directors with no direct ties to the company. Consequently, the directors often face their own conflicts of interest with respect to keeping their directorships and the benefits that go with them and guarding the interests of the public shareholders.

Tyco Corporation offers an example of a board member receiving consulting fees as well as having the company donate money to a selected charity. Tyco International paid a total of $20 million to an outside director and to a charity he controlled, in return for his help in brokering a major acquisition in 2001.[3] Similar donations appear to have occurred at Enron.[4]

What can be done to eliminate these abuses?

The Board Of Directors

Clearly, independent directors must be independent and they should be a majority of the board. Past executives, consultants and individuals beholden to current management for charitable contributions and so forth are not independent.

As for the election of directors, reforms are needed to make it much easier for shareholders to elect directors other than those proposed and beholden to management. One such reform would be to have institutional investors nominate directors in addition to the management nominees. Also, much easier access to shareholders of record by competing control groups would help by permitting the contesting groups to "campaign" for votes.

Other board reforms could include requiring independent board members to meet separately from inside members for evaluating corporate and managerial performance, requiring the Board chairman to be selected from the independent members or at least prohibiting the CEO from also serving as the Board chairperson and restricting the number of boards on which a person can serve.

[3] "Tyco Paid Director For Advisement on CIT Merger," Monitor Daily, January 29, 2002, http://www.monitordily.com/story_page.cfm?News_id.
[4] Janet Elliott, "UT dean's Enron ties questioned," *Houston Chronicle*, January 17, 2002, http://www.HoustonChronicle.com.

Accounting And Financial Reporting

Many people would address the aggressive accounting and manipulation of earnings problem by simply prohibiting the accounting firm that audits the company's financial statements from also providing consulting services to the company. Some institutional investors have already moved in this direction with regard to how they vote their shares. The California Public Employees' Retirement System (Calpers) has announced it will vote against reappointing auditors at companies where the auditors also provide consulting services. And, recent legislation enacted in the U.S. prohibits auditors from also selling certain consulting services to their clients.

But, the most important task here is to restore the integrity of the accounting profession and the confidence investors have in the way financial statements are prepared. The U.S. has moved in this direction by establishing an independent government board to oversee corporate audits. Still, more than independent oversight is necessary.

A good place to start (in addition to getting rid of special entity vehicles used to hide debt) is with reporting stock options as expenses. These options are compensation and compensation is an expense; therefore it should be recognized as such on the income statement. The argument against expensing options is that it would drive down the company's stock price making it more difficult to attract employees. In other words, the argument against expensing options is that companies need to fool investors into paying more for the company than it is worth!

Maybe what is really needed is to jettison the current U.S. accounting system, which relies extensively on rules. Under this system, accountants and managers are more likely to ask whether they are "breaking the rules" rather than whether they are reporting the true financial position of the company and complying with the spirit of the accounting standards. The European system under the U.K based International Accounting Standards Board (IASB) has far fewer rules. Instead, the objective is to provide a true and honest representation of the transaction.

Managerial Pay

One of the biggest scandals arising out of the Enron fiasco is CEO pay. In theory, agency costs can be reduced by tying managerial pay to performance through stock options and bonuses dependent on achieving certain financial goals such as return on equity. But, it now appears that managers were manipulating financial statements so as to drive up stock prices and cash in on the bonuses and options. Furthermore, CEOs of now bankrupt companies walked away with millions of dollars while the companies were going under and employees were losing their jobs.[5] How did these and other managers manage to get these pay packages?

Restoring the integrity of the accounting profession

Once again we are back to the cozy relationship that exists between senior managers and their boards, because the boards must approve these packages. And, we are also back to the lack of transparency regarding managerial pay. Without considerable effort, it is nearly impossible to figure out the "true" compensation of an executive from forms filed with the SEC.

What is the answer? Tying compensation more closely to the performance of the company relative to other firms in its industry and the overall stock market would help. Another solution would be to have the shareholders vote on the pay for senior managers.

New legislation in the U.S. has addressed the "pay" issue by banning personal loans to the top executives of public companies and by requiring shareholder approval of option plans. But more needs to be done, especially with regard to the transparency question and letting shareholders vote on overall compensation plans.

Making transparent the true compensation of managers

Where Are We Going?

In 1776, Adam Smith had the following to say about public corporations, then called joint-stock companies (Smith 1776):

"The directors of such [joint stock] companies, however, being the managers of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. …

[5] Ian Cheng, "Survivors Who Laughed All the Way to the Bank," *Financial Times*, July 30, 2002.

Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

Today, it looks like Smith was prescient. The Board of Directors of many U.S corporations have failed to carry out the spirit of their "duty of care" to the public shareholders. Instead, they let management, and some would say assisted it in the act, extract wealth from the public by manipulating earnings, awarding themselves excessive compensation and engaging in dubious schemes to hide the deteriorating financial performance of their companies.

In other words, we are still muddling our way through the morass of how to ensure that managers of publicly held corporations (where management is separated from owners) don't misuse scarce resources or line their own pockets at the expense of the other stakeholders of the firm. The lesson of the current "crisis" is that public shareholders need to be better empowered to control managers and to hold accountable the directors of public corporations. For such empowerment to occur, major accounting reforms are needed along with governance changes designed to protect the individual (small) investor. Without such changes, we are likely to see an exit of the small investor and an increased concentration of ownership of corporations as the solution to holding management accountable, a governance arrangement commonly found in countries with weak investor protection laws. We are also likely to see an increase in the cost of equity capital leading to a reduction in investment and the overall performance of the economy.

The board of directors must be held accountable

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