Chapter 2
Financial Goals and Corporate Governance

The Globalization Process:
Learning Objectives

* Examine how businesses can be owned, and how this impacts the separation between ownership and management – the agency problem
* Evaluate the distinctions between the two major forms of management goals – stockholder wealth maximization versus stakeholder capitalism

Basic Questions

* Who owns the business?
* Do the owners manage the business themselves?
* Most companies start as 100% family owned and move toward being 100% publicly traded
* Sometimes publicly traded firms return to being privately held
* Family controlled firms often out-perform publicly traded firms
* Moving from family to public firms brings agency issues

Exhibit 2.1 Who Owns the Business?

Although most businesses begin their lives as privately held firms, others (e.g., larger firms) go public gradually. Often, only some family members are part of the public ownership, providing them greater control. The degree of public ownership varies, with some firms being fully publicly held while others are family owned. Family-controlled firms often outperform publicly traded firms.

What is the Goal of Management?

As Trident becomes more deeply committed to multinational operations, a new constraint develops – one that springs from divergent worldwide opinions and practices as to just what the firms’ overall goal should be:
* Shareholder Wealth Maximization – As characterized by Anglo-American markets
* Stakeholder Capitalism Model – As characterized by Continental European and Japanese markets
The Goal of Management

- Shareholder Wealth Maximization
  - A firm should strive to maximize the return to shareholders, as measured by the sum of capital gains and dividends, for a given level of risk
  - This view defines risk in a very strict financial sense
  - Risk is defined as the added risk a firm’s shares bring to a diversified portfolio (a fully diversified portfolio represents systematic risk)
  - The added firm-specific risk is known as unsystematic risk

Shareholder Wealth Maximization

- Agency Theory – the study of how shareholders (SH) can motivate management to act in SH’s best interests
- Long-term versus short-term value maximization
  - Impatient capitalism focuses on the short-term sometimes at the expense of long-term value
    - Exacerbated by improper management incentives from SH
  - Patient Capitalism focuses on long term shareholder wealth maximization

Stakeholder Capitalism Model

- A view that all a corporations stakeholders (employees, management, suppliers, local community, local/national government and creditors) need to be considered in addition to the equity holders
- The goal is to earn as much as possible in the long run, but also to make enough in the short run to increase the corporate wealth for the benefit of all
- The definition of corporate wealth is much broader than just financial wealth, it includes technical, market and human resources as well
- Doesn’t make an issue of market efficiency because long-term loyal SH should be more influential than transient portfolio SH

Stakeholder Capitalism Model

- Risk – Total risk, both operating and financial risk, is important
- Single versus Multiple Goals – Avoids the problem of impatient capital but fails to give clear expectations about tradeoffs among different groups of stakeholders
  - The Score Card – Firms worldwide are moving more toward the SWM model (?)

Operational Goals

- How do we define Shareholder Return?
  \[ \text{Shareholder Return} = \frac{\text{Dividend}}{\text{Price}_1} + \frac{\text{Price}_2 - \text{Price}_1}{\text{Price}_1} \]
- The first component is the dividend yield
- The second component is the capital gain
- Management generally believes that they have more direct contact over the first component

Operational Goals of MNEs

- Balance between three common operational financial objectives:
  1. Maximization of consolidated after-tax income
  2. Minimization of the firm’s effective global tax burden
  3. Correct positioning of the firm’s income, cash flows, and available funds as to country and currency.
Corporate Governance

• The relationship among stakeholders used to determine and control the strategic direction and performance of an organization is termed **corporate governance**

• The corporate governance of the organization is therefore the way in which order and process is established to ensure that decisions are made and interests are represented – for all stakeholders - properly

Corporate Governance

• The single overriding objective of corporate governance in the shareholder wealth model is the optimization over time of the returns to shareholders

• The most widely accepted statement of good corporate governance (established by the OECD) focus on the following principles;
  - The rights and equitable treatment of shareholders
  - The role of stakeholders in corporate governance
  - Disclosure and transparency
  - The responsibilities of the board

Exhibit 2.2 The Structure of Corporate Governance

• **The Board of Directors**
  - The legal body accountable for the governance of the corporation

• **Officers and Management**
  - Senior officers of the corporation, the CEO, CFO, COO, etc.

• **Equity Markets**
  - Reflect the market’s constant evaluation of the promise and performance of the company

The Structure of Corporate Governance

• **Debt Markets**
  - Provide funding and are interested in the financial health of the firm

• **Auditors and Legal Advisors**
  - Provide an external professional opinion as to the fairness, legality, and accuracy of financial statements

• **Regulators**
  - Require a regular and orderly disclosure process of corporate performance

The Structure of Corporate Governance

• **The origins of the need for a corporate governance process arise from the separation of ownership from management, and from the varying views by culture of who the stakeholders are and of what significance**

• A governance regime (system) is a function of;
  - Financial market development
  - The degree of separation between management and ownership
  - The concept of disclosure and transparency
Corporate Governance

- **Market-based** regimes (U.S. and U.K.) are characterized by relatively efficient capital markets with dispersed ownership
- **Family-based** regimes (Asia, Latin America) involve strong concentrations of family ownership
- **Bank-based** and **government-based** regimes result in only marginal public ownership and sometimes significant restrictions on business practices

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**Exhibit 2.3** Comparative Corporate Governance Regimes

- **Market-based**
  - Characteristics: Profits, equity markets, diversified ownership
  - Examples: United States, United Kingdom, Canada, Australia
- **Family-based**
  - Characteristics: Management and ownership are combined, family majority and minority shareholders
  - Examples: Hong Kong, Indonesia, Malaysia, Singapore, Taiwan, France
- **Bank-based**
  - Characteristics: Government in finance, lack of transparency, family ownership
  - Examples: Korea, Germany
- **Government-affiliated**
  - Characteristics: State ownership of enterprises, lack of transparency, lack of family ownership
  - Examples: China, Russia


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Corporate Governance

- Does good governance matter?
- Certainly, as in the case of Enron, many of the improprieties were overlooked as long as the company’s share price continued to rise
- However, after the fall of Enron, and the substantial losses sustained by investors, employees and society as a whole, many would say that corporate governance matters a lot
- Good governance is measured on the basis of accounting standards, the perceived legal standards in a country, and the number of Anglo-American board members

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**Exhibit 2.4** The Value of Good Governance

- How much more (as a premium) would you be willing to pay for a share in a company in good governance?


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**Exhibit 2.5** The Premium Paid for Voting Shares: Accounting Standards

- The lower the premiums paid, the higher the perceived quality of corporate governance present.


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**Exhibit 2.6** The Premium Paid for Voting Shares: Law Enforcement

- The lower the premium paid, the higher the perceived quality of corporate governance present.

Corporate Governance Reform

• Sarbanes Oxley (SOX) has four major requirements:
  1. Signature Clause – CEOs and CFOs must vouch for accuracy of the published financial statements
  2. Firm audit and compensation committees must be comprised of independent/outside directors
  3. Loans by the firm to corporate officers and directors are prohibited
  4. Internal controls must be tested for protection against financial fraud

Corporate Governance Reform

• Board Structure and Compensation
  – Some suggest that U.S. corporate boards should be more like European boards
  – Research suggests that compensation for board members is not a significant problem
• Transparency, Accounting and Auditing
  – U.S accounting practices are rule-based and can be abused by smart accountants
  – European accounting practices are conceptually-based
• Minority Shareholder Rights are still an issue

Exhibit 2.7 Board Composition and Compensation, Fortune 100

<table>
<thead>
<tr>
<th>Size of Company (Sales)</th>
<th>Total Directors</th>
<th>Outside Directors</th>
<th>Average Annual Retainer</th>
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</thead>
<tbody>
<tr>
<td>$0 to less than $5M</td>
<td>5</td>
<td>2</td>
<td>$47,700</td>
</tr>
<tr>
<td>$5-9.9 billion</td>
<td>9</td>
<td>8</td>
<td>$32,160</td>
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<td>$10-19.9 billion</td>
<td>12</td>
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<tr>
<td>$20-49.9 billion</td>
<td>12</td>
<td>11</td>
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</tr>
<tr>
<td>$50 billion and over</td>
<td>13</td>
<td>11</td>
<td>($49)</td>
</tr>
</tbody>
</table>

Source: Moody’s International, as quoted in “The sky is falling” The Economist, January 2000 (p. 43).

Exhibit 2.8 Potential Responses to Shareholder Dissatisfaction

Possible Actions
- Remain Quietly Disgruntled
- Sell the Shares
- Walk Away
- Change Management
- Shareholder Activism
- Initiate a Takeover
- Maximum Threat

Summary of Learning Objectives

• Most companies are created by entrepreneurs
• Over time some firms choose to go public
• The U.S. and UK stock markets are characterized by widespread ownership of shares. In the rest of the world, ownership is usually characterized by controlling shareholders. Typical controlling shareholders are government, institutions, family, and consortiums
• Publicly held firms are typically run by professional managers whose interests may not be perfectly aligned with owners thus creating an agency problem

Summary of Learning Objectives

• In the Anglo-American markets the firm’s objective is to maximize shareholder’s wealth
• In the non-Anglo-American (i.e., stakeholder capitalism model) markets shareholders are more constrained by other stakeholders, primarily labor unions, government, and banks
Summary of Learning Objectives

- Returns to shareholders in publicly traded firms combine current income and capital gains
- Privately held firms try to maximize current and sustainable income and waste no resources on influencing the market’s opinion
- The MNE must balance among maximizing consolidated after tax income, minimizing global taxation, and positioning of income, cash flow and currency.

Summary of Learning Objectives

- The MNE must determine for itself the proper balance between three common operational objectives:
  - Maximization of consolidated after-tax income
  - Minimization of the firm’s effective global tax burden
  - Correct positioning of the firm’s income, cash flows, and available funds as to country and currency

Summary of Learning Objectives

- The relationship among stakeholders used to determine and control the strategic direction and performance of an organization is termed corporate governance
- Dimensions of corporate governance include agency theory; composition and control of boards of directors; and cultural, historical, and institutional variables
- Failures in corporate governance, especially in the United States, have recently been in the spotlight and have been given partial blame for the decline in value of the U.S. stock markets

Summary of Learning Objectives

- As MNEs become more dependent on global capital markets for financing they may need to modify their policies of corporate governance
- A trend exists for firms resident in non-Anglo-American markets to move toward being more “stockholder friendly” while Anglo-American markets are moving toward being more “stakeholder friendly”

Summary of Learning Objectives

- Shareholders who are dissatisfied with their firm’s performance typically have four choices: remain quietly disgruntled; sell their shares; change management; or initiate a takeover
- The recent failures in corporate governance in the United States have spawned a flurry of government and private initiatives to prevent the same kind of failures in the future
- The United States has already reacted; passing the Sarbanes-Oxley act in 2002

Summary of Learning Objectives

- Sarbanes Oxley (SOX) has four major requirements:
  1. Signature Clause – CEOs and CFOs must vouch for accuracy of the published financial statements
  2. Firm audit and compensation committees must be comprised of independent/outside directors
  3. Loans by the firm to corporate officers and directors are prohibited
  4. Internal controls must be tested for protection against financial fraud