

CORPORATE GOVERNANCE

by Prof. Aliza Racelis

- 1. History and Nature of Corporate Governance**
Separation of Ownership from Control;
Principal-Agent Problem
- 4. The Environment of Corporate Governance: Influences**
Philippine Corporate Governance: Issues and Reforms
(Paper by Dr. Erlinda Echanis)
 - **Role of the following in Corporate Governance:**
 - Boards of Directors
 - Accountants and Auditors
 - Banks and Analysts
 - Creditors and Credit Rating Agencies
 - Shareholders and Shareholder Activism
- 4. Emerging Corporate Governance Issues:**
 - Sarbanes-Oxley Act of 2002
 - Others (Philippines)

- History and Nature of Corporate Governance
Separation of Ownership
from Control;
Principal-Agent Problem

Lessons learned from corporate scandals...

What have we learned from the business failures of the last decade?
Here's just a sampling.

1. Some corporate executives will do almost anything to meet earnings expectations and keep the firm's stock price stable or rising. Often, the goal is one of personal enrichment through the executives' exercise of options and the sale of company stock.
2. The ethical climate in a firm is set by top management. Chief executive officers and chief financial officers must establish and demand the integrity of the firm's disclosures—both financial and nonfinancial.
3. Auditors and their clients can get too close. An auditor's independence is a necessary condition for a meaningful audit, and auditing firms need to take a close look at the relationship(s) between a firm and its external auditors.
4. Application of GAAP is subject to significant management discretion and firms must make their earnings more transparent.
5. No matter how good or how effective the accounting principles are, there is no way for accounting standards to stop fraud. Auditors and the SEC, however, may be able to make some progress in reducing fraud.
6. Financial statements are only part of the information investors need to evaluate a company's past, present, and future. Over-reliance on a single amount—earnings per share—can be a disaster.



The stories of recent corporate debacles are accounts that are typically told in an emerging area of study called.....

- **CORPORATE GOVERNANCE =**
- **governs relationships among stakeholders that are used to determine and control the strategic direction and performance of organizations;**
- **means used by corporations to establish order between parties (the firm's owners and its top-level managers) whose interests may be in conflict.**

CORPORATE GOVERNANCE...

(cont'd)

- **“deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Schleifer & Vishny, “A Survey of Corporate Governance”, *Journal of Finance*, Vol. 52, No. 2).**
- **...mechanisms are economic and legal institutions that can be altered through the political process –sometimes for the better.**

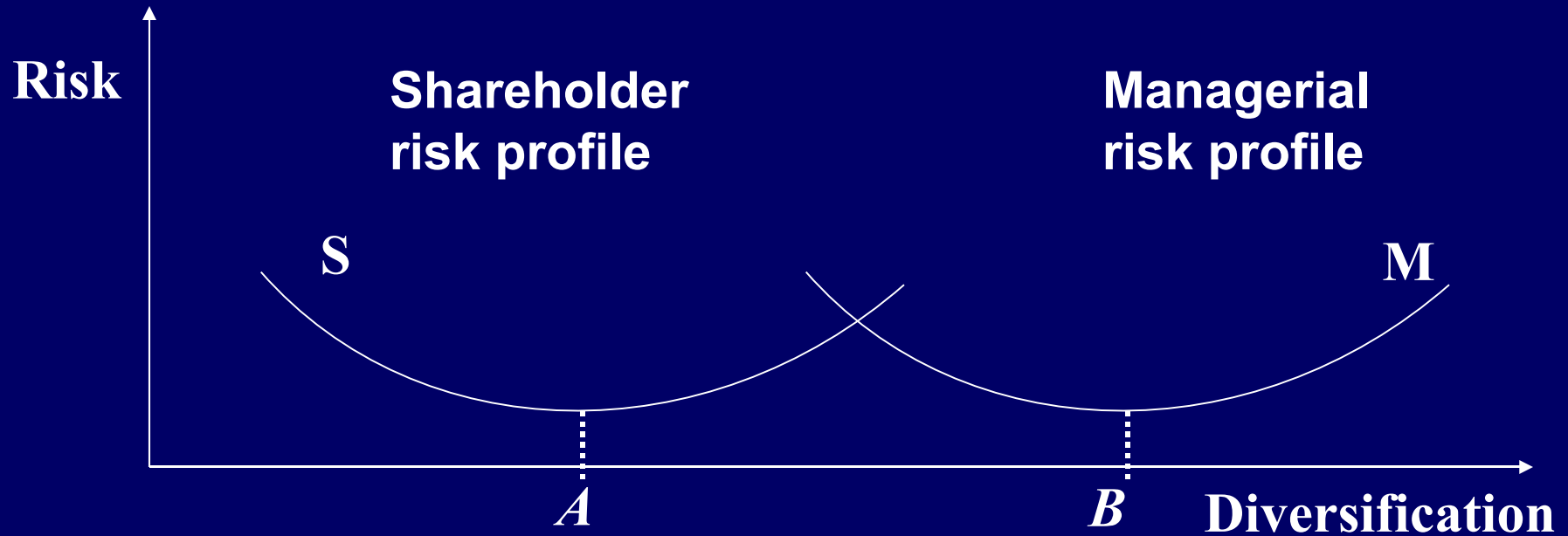
CORPORATE GOVERNANCE...

- **...reflects and enforces the company's values.**
- **"...provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (OECD Principles of Corporate Governance).**

CORPORATE GOVERNANCE...

- "...refers to a system whereby shareholders, creditors and other stakeholders of a corporation ensure that management enhances the value of the corporation as it competes in an increasingly global market place" (Philippines SEC Code of Corporate Governance)

ANSWER THIS:



- In a company, a strategy to diversify the firm's product lines can enhance a firm's strategic competitiveness and increase its returns, both of which serve the interests of shareholders and the top executives.

Moral Hazard

- The various ways in which management may not act in the firm's (shareholders') best interest:
 2. Insufficient effort
 3. Extravagant investments
 4. Entrenchment strategies
 5. Self-dealing

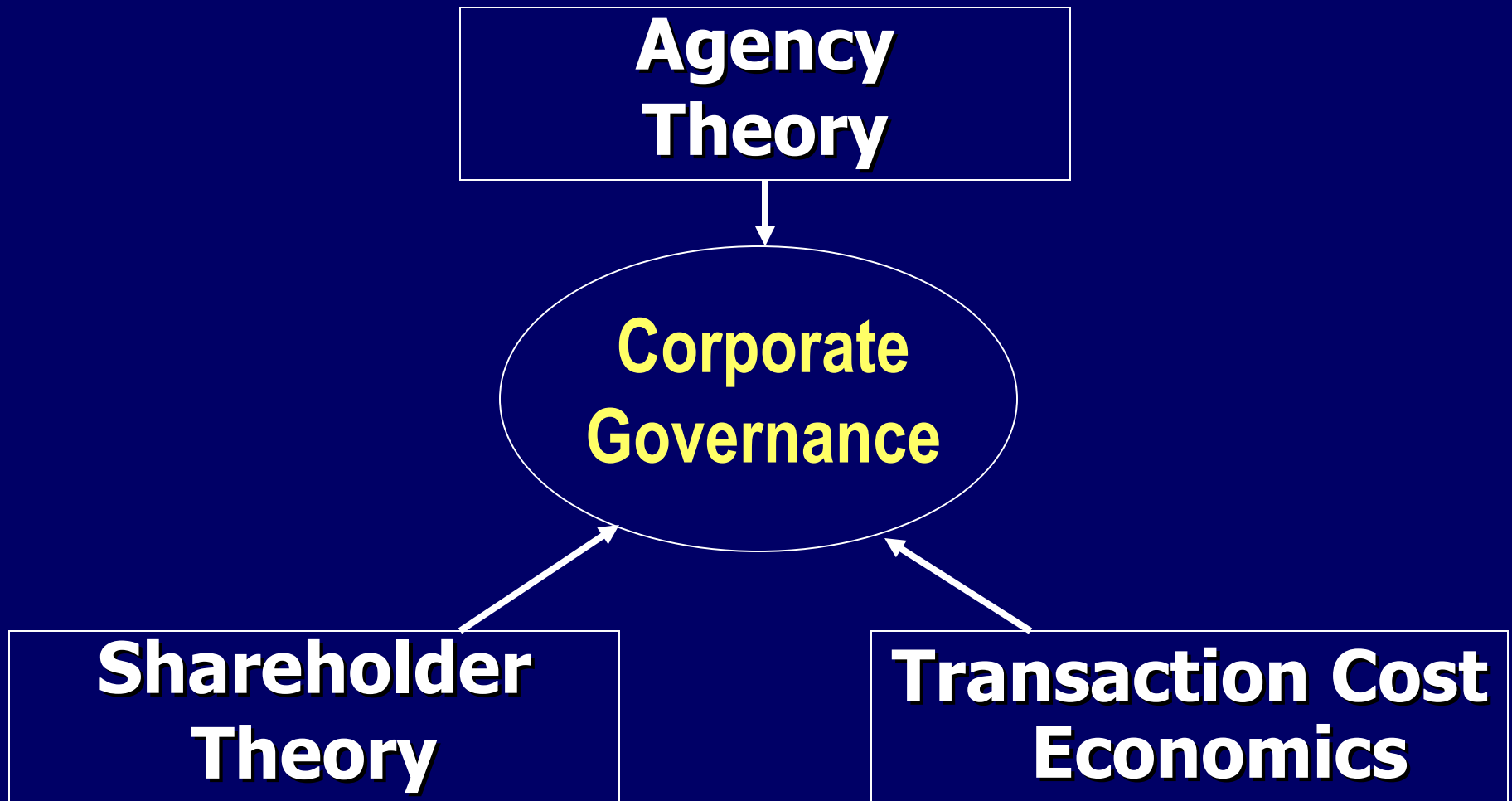
Two broad routes can be taken to alleviate insider moral hazard:

1. Insiders' incentives may be partly aligned with the investors' interests through the use of performance-based incentive schemes.
2. Insiders may be monitored by the current shareholders (or on their behalf by the Board or a large shareholder), by potential shareholders (acquirers, raiders), or by debtholders.

Dysfunctional Corporate Governance

- ***Lack of transparency (e.g. level of total compensation packages)***
- ***Tenuous link between performance and compensation***
 - ***Compensation package may be poorly structured***
 - ***Managers seem to manage to maintain or even increase their compensation despite poor performance***
 - ***Managers may succeed in "getting out on time"***
 - ***Managers receive large "golden parachutes"***
- ***Accounting manipulations***

Various Theories for thinking about corporate governance:



Separation of Ownership & Managerial Control (Principal-agent problem)

- **Principal—shareholders**
- **Agent—managers**
- **Principal-agent problem** represents the conflict of interest between management and owners. For example, if shareholders cannot effectively monitor the managers' behavior, then managers may be tempted to use the firm's assets for their own ends, all at the expense of shareholders.

Managerial Incentives

- *Explicit and implicit incentives, in practice, partly align managerial incentives with the firm's interest.*
- **Bonuses and stock options**
- **(implicit) Threat of being fired by the Board or removed by the market for corporate control through a takeover or proxy fight; the possibility of being put on receivership during financial distress; etc.**
- **Capital market monitoring & product-market competition**
- **(other non-economic incentives) Intrinsic motivation, fairness, horizontal equity, morale, trust, corporate culture, social responsibility & altruism, feelings of self-esteem**

Governance mechanisms used in the modern Western-style corporation*:

- Internal governance mechanisms:
 1. *Ownership concentration*
 2. *Board of directors*
 3. *Executive compensation*
- External governance mechanisms:
 6. *Market for corporate control*
 7. *Others*

*From *Strategic Management: Competitiveness and Globalisation*,
Chapter 10: Corporate Governance

1. Ownership Concentration

= the no. of large-block shareholders and the total percentage of shares they own.

- large-block shareholders are increasingly active in their demands that corporations adopt effective governance mechanisms to control managerial decisions.
- In general, *diffuse ownership* produces weak monitoring of managerial decisions (makes it difficult for owners to coordinate their actions effectively; weak monitoring might result in product diversification beyond shareholders' optimum level.)

Growing influence of institutional investors

Institutional owners = financial institutions, such as banks, mutual funds, pension funds, etc. that control large-block shareholders positions.

- Because of their prominent ownership positions, institutional investors are a powerful governance mechanism.
- Institutional owners have both the size and the incentive to discipline ineffective top-level managers and are able to influence significantly a firm's choice of strategies and overall strategic decisions.

Case in Point:

- **Rupert Murdoch's trips to Adelaide for News Corp's AGMs are occasions for a display of 'corporate triumphalism'. But at the meeting held on 18 Oct. 2000, there were some dissident elements in attendance, determined to challenge the agenda of News Corp's Board. They represented big investment institutions and spoke for a substantial bloc of votes. A proposal to grant options to some senior News executives, incl. Lachlan Murdoch, Peter Chernin & David DeVoe, was passed with only 392.7 million votes for, and 253.4 million against, a very narrow victory compared to previous experience.**

*From *Strategic Management: Competitiveness and Globalisation*,
Chapter 10: Corporate Governance

Comparison of shareholders by sector

(Data are for 1990, except for France – 1992.) (*Source: Prowse (1995) p. 13 for U.S., & Institute of Fiscal & Monetary Policy, 1996 for other countries; reproduced in "Comparing of Financial Systems", Franklin Allen & Douglas Gale, Chap. 4 'Corporate Governance', MIT Press, 2001.*)

	Indivi- duals	Pension funds	Financial Inst'ns	Non- fin'l Inst'ns	Public sector	Foreign indiv's & Inst'ns	Other
U.S.	50%	20%	5%	14%	0	5%	6%
U.K.	20	31	30	3	4	12	
Japan	23		41	25	1	4	6
France	34		23	21	2	20	
Germany	17		22	42	5	14	

2. Board of Directors

- “The Board of Directors is primarily responsible for the governance of the corporation. It needs to be structured so that it provides an independent check on management. As such, it is vitally important that a number of board members be independent from management” (Phils. SEC Code of Corporate Governance).**

Classification of Board of Directors' Members:

Insiders

- The firm's CEO & other top-level managers

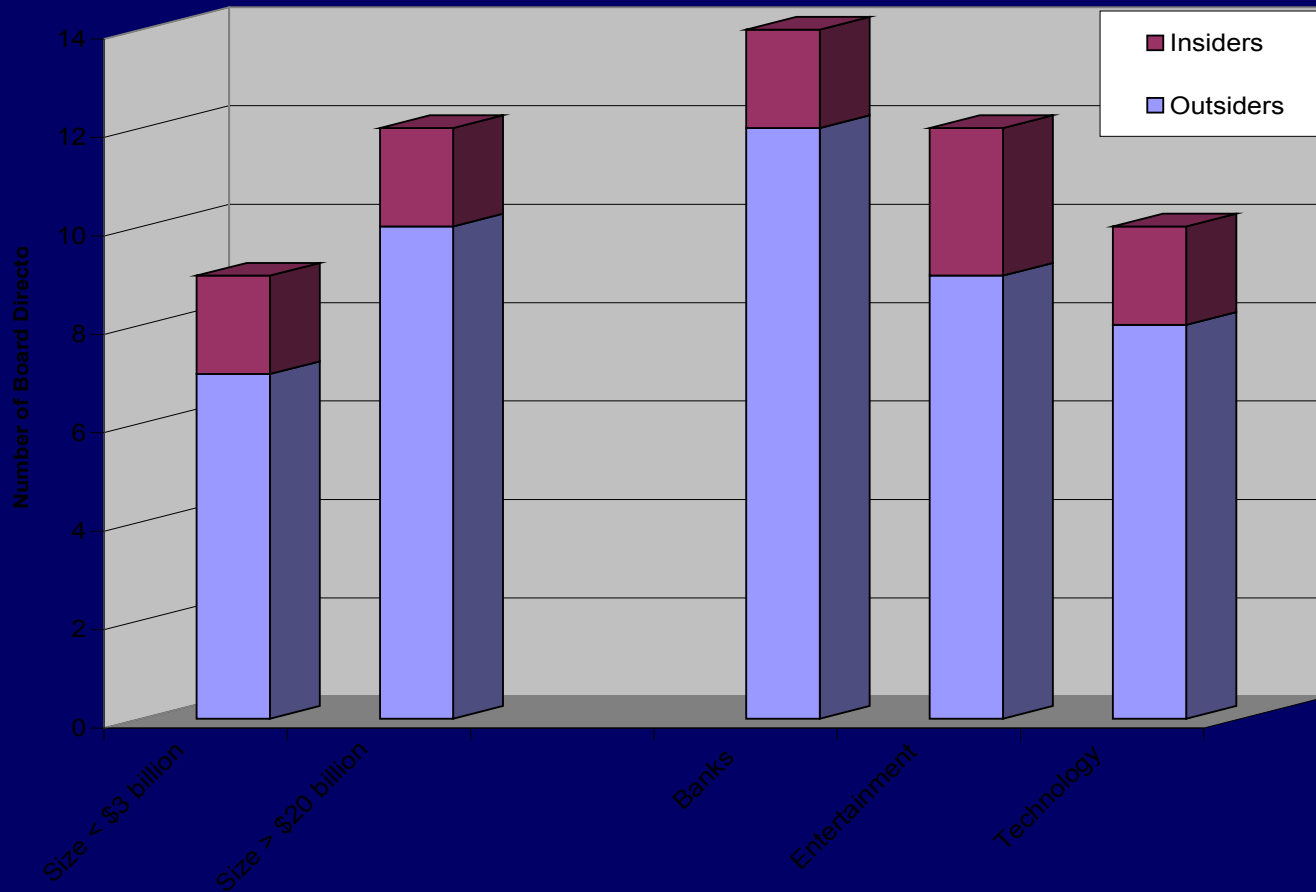
Related outsiders

- Individuals not involved with the firm's day-to-day operations, but who have a relationship with the company.

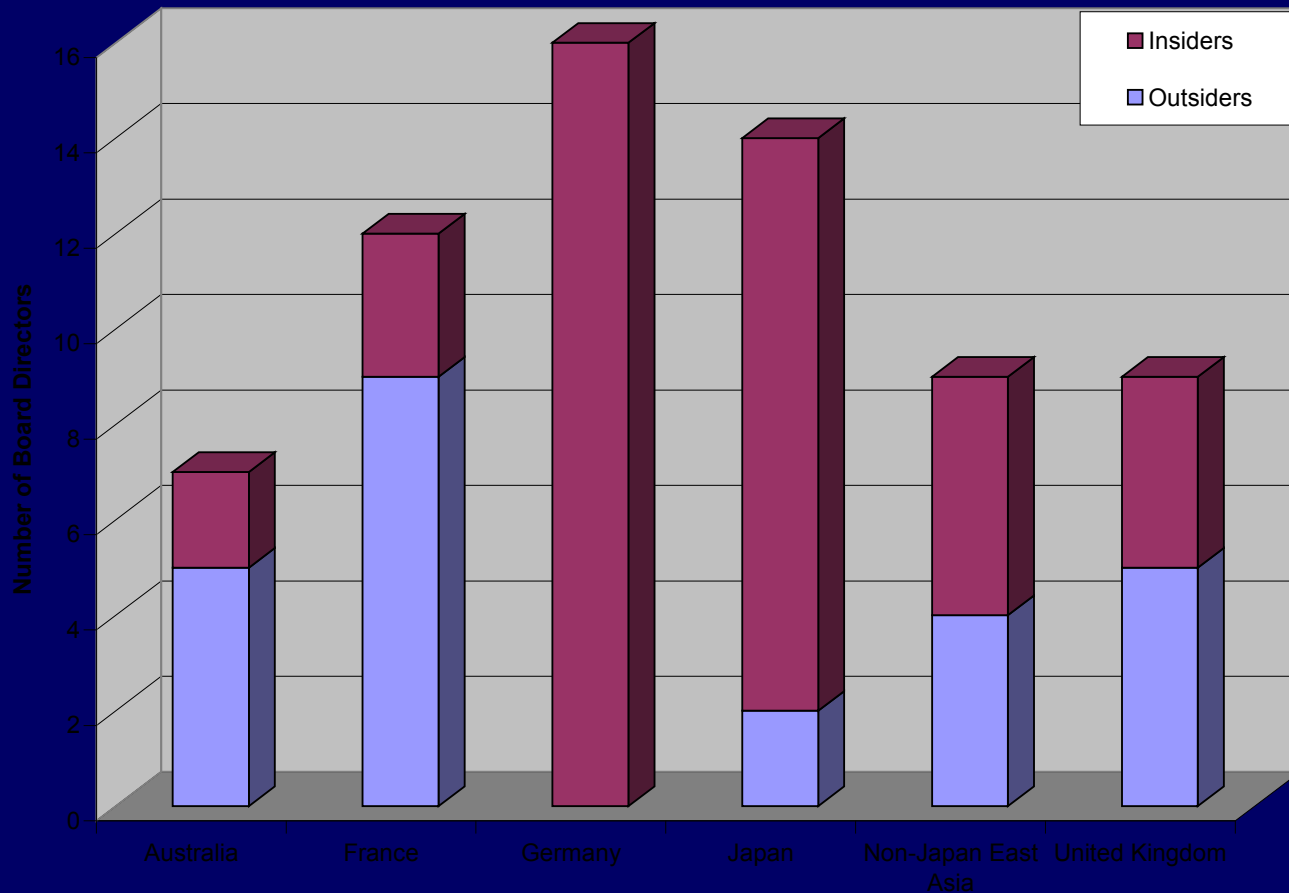
Outsiders

- Individuals who are independent of the firm in terms of day-to-day operations and other relationships

Average U.S. Board Size and Independence by Company Size and Industry



Average Board Size and Independence Around the World, 2004



Number of members on Boards of Directors

(Source: Institute of Fiscal & Monetary Policy, 1996; reproduced in "Comparing of Financial Systems", Franklin Allen & Douglas Gale, Chap. 4 'Corporate Governance', MIT Press, 2001.)

UNITED STATES			UNITED KINGDOM			JAPAN			FRANCE			GERMANY		
Ford	15	(10)	Glaxo	16	(7)	Toyota	60	(1)	Saint Gobain	16		Hoechst	21	11
IBM	14	(11)	Hanson	19	(8)	Hitachi	36	(3)	AGF	19	(5)	BASF	28	10
Exxon	12	(9)	Guinness	10	(6)	Matsushita	37	(6)	Usinor Sacilor	21	(5)	Robert Bosch	20	11
Mobil	16	(10)	British Airways	10	(6)	Nissan	49	(5)	Alcatel Alsthom	17		Krupp	22	7
Philip Morris	16	(4)	Allied Domecq	12	(4)	Toshiba	40	(3)	Elf Aquitaine	11		Bayer	22	11
RJR Nabisco	9	(6)	G.Metropolitan	14	(1)	Honda	37	(3)	Renault	18		DaimlerBenz	20	8
Texaco	13	(11)	BTR	10	(4)	Sony	41	(6)	Thomson	8		Volkswagen	20	7
Johnson&J	14	(12)	Ass.BritFoods	7	(1)	NEC	42	(5)				Thyssen	23	27
GAP	11	(8)	Brit. Steel	8	(0)	Fujitsu	36	(7)				Siemens	20	15
						MitsubishiElec	37	(3)						
						MitsubishiMotor	43	(4)						
						Mitsu.HeavyInd	43	(3)						
						Nippon Steel	53	(1)						
						Mazda	45	(8)						
						Nippon Oil	22	(0)						

3. Executive Incentives

- **Explicit and implicit incentives, in practice, partly align managerial incentives with the firm's interest.
(Salary, Bonus & Stock options)**
- **Capital market monitoring and product-market competition further keep a tight rein on managerial behavior.**
- **Also: 'intrinsic motivation', fairness, horizontal equity, morale, trust, corporate culture, social responsibility & altruism, feelings of self-esteem, interest in the job, etc.**

Types of Executive Compensation

□ Base Salary and Bonus

- The base salary is usually determined through the benchmarking method.
- At the end of every year, CEOs often receive cash bonuses whose size is computed based on the performance of the firm over the past year.
- Comparison of awarding bonuses with giving large raises.

Types of Executive Compensation (continued)

□ Stock Option

- Executive stock options—the most common form of market-oriented incentive pay.
- Stock options give the executive of the firm the incentive to manage the firm.
- Stock options are believed to align managers' goals with shareholders' goals.
- Stock options have asymmetric incentives.

4. Market for Corporate Control

= composed of individuals and firms that buy ownership positions in (or take over) potentially undervalued corporations so they can form new divisions in established diversified companies or merge two previously separate firms.

= The purchase of a firm that is underperforming relative to industry rivals in order to improve its strategic competitiveness.

Market for corporate control (cont'd)

Terminology:

- **Takeovers, hostile takeovers.**
- **Mergers & acquisitions (M&As)**
- ***Corporate raiders***
- **Managerial takeover defense tactics:**
 - ***Golden parachutes*** (managerial pay augmented, even after takeover)
 - ***Greenmail*** tactic (money is used to repurchase shares from a corporate raider to avoid the takeover of the firm)
 - ***Poison pill*** (designed to stop a takeover by the parent company)

Market for corporate control (cont'd)

The 1980s were known as a time of merger mania, with approx. 55,000 acquisitions valued at approx. US\$1.3 trillion in the United States.

However, there were many more acquisitions in the 1990s, and the value of mergers & acquisitions (M&As) in that decade was more than US\$10 trillion.

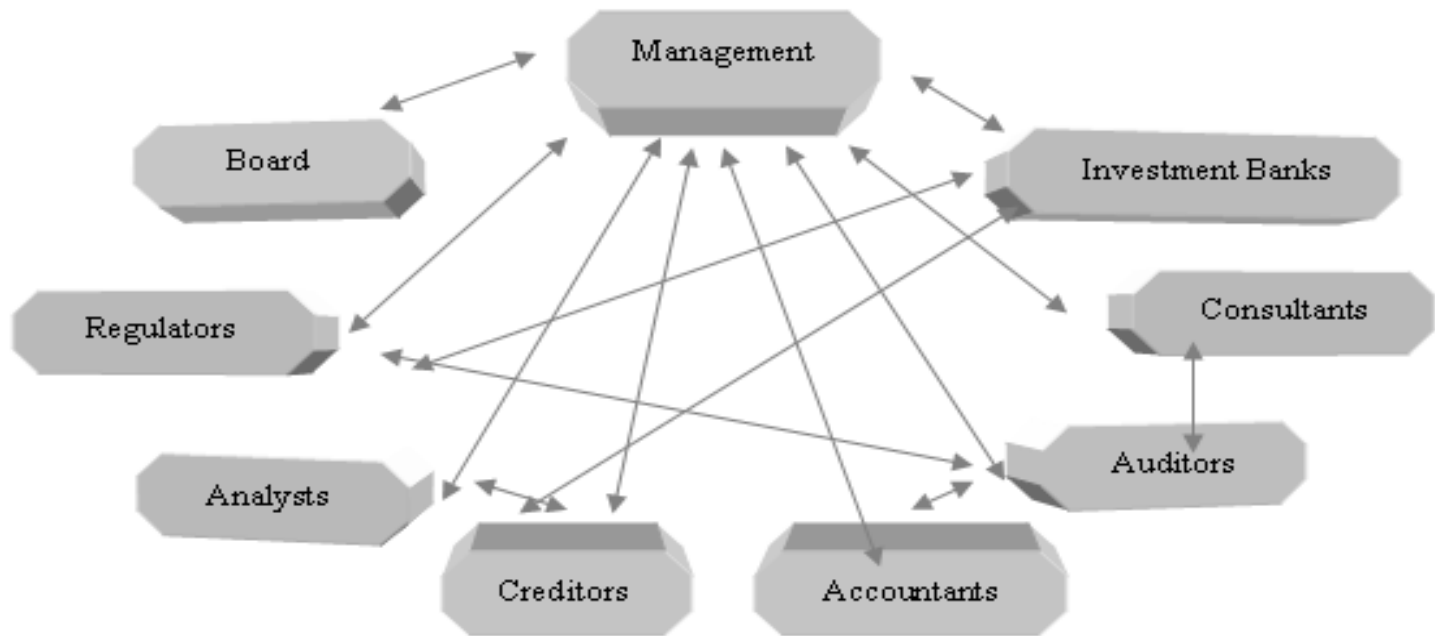
Potential problem with the market for corporate control...

- ... is that it may not be totally efficient.
- A study of several of the most active corporate raiders in the 1980s showed that approx. 50 per cent of takeover attempts targeted firms with above-average performance –corporations that were neither undervalued nor poorly managed.

2. The Environment of
Corporate Governance:
Philippine Corporate
Governance: Issues and
Reforms (paper by Dr.
Erlinda Echanis)

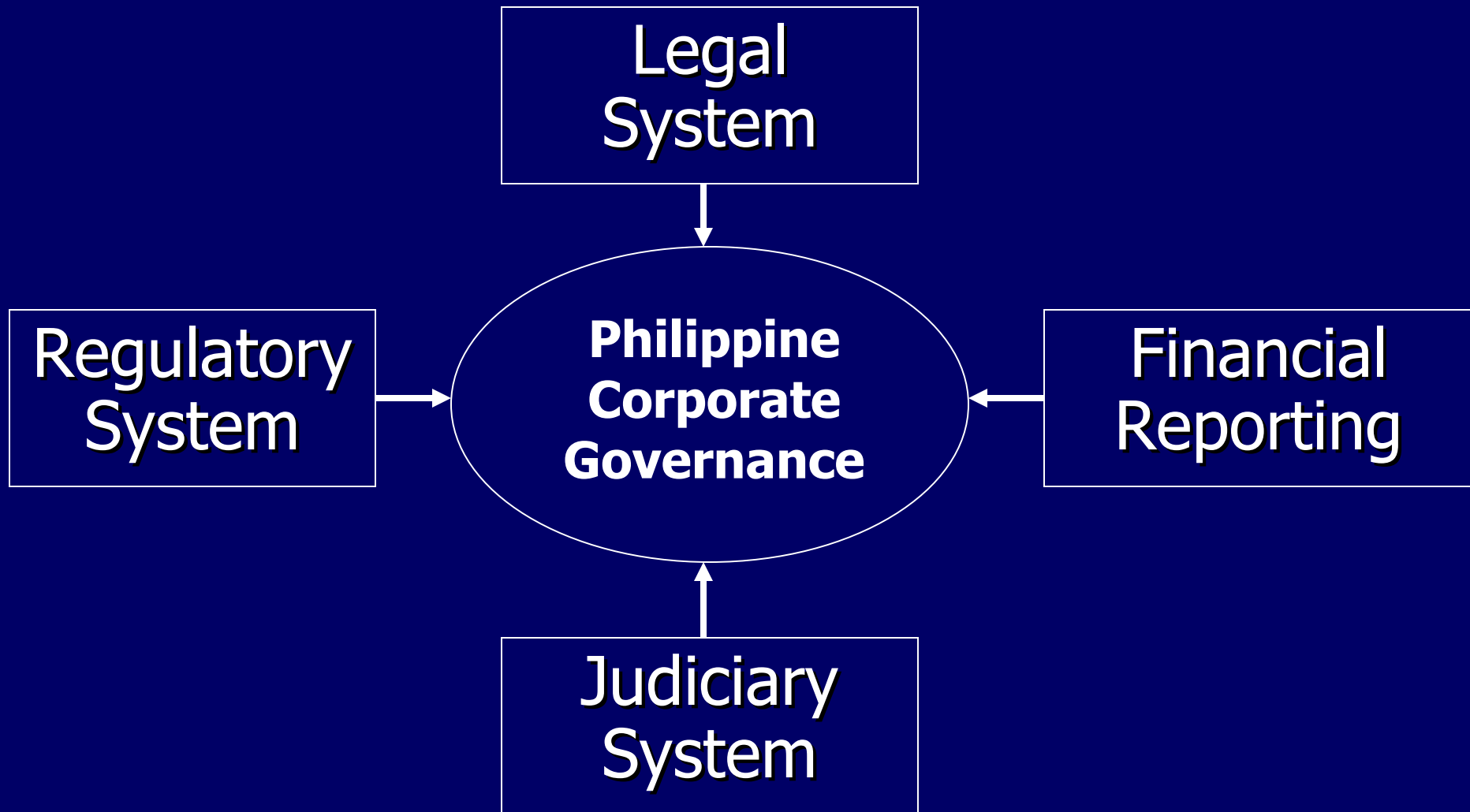
An Integrated System of Governance

FIGURE 1.2 INTERLINKING RELATIONSHIPS AMONG BUSINESS PARTICIPANTS



From textbook 'Corporate Governance' (2nd Ed.) by Kim & Nofsinger, Fig. 1.2, p. 7.

“Philippine Corporate Governance: Issues and Reforms”
(paper by Dr. Erlinda Echanis, available here:
<http://www.upd.edu.ph/~cba/PMR/2006.htm>)



LEGAL SYSTEM

- Corporation Code
- Securities Regulation Code (R.A. 8799)
 - August 8, 2000 - “to encourage widest participation of ownership in enterprises”
 - filing of annual reports and periodic reports
- General Banking Law
- Central Bank Act

FINANCIAL REPORTING SYSTEM

- Philippine GAAP, as promulgated by:
 - Philippine SEC,
 - Financial Reporting Standards Council,
 - Standards issued by the International Financial Reporting Standards Board (IFRSB),
 - Accounting principles and practices for which there is a long history of acceptance and usage.
- Other: Code of Corporate Governance

REGULATORY SYSTEM

- Rule & regulations issued by agencies that regulate:
 - corporate entities (Securities and Exchange Commission [SEC]),
 - publicly-listed firms (Philippine Stock Exchange [PSE]),
 - financial institutions (Bangko Sentral ng Pilipinas [BSP]).

JUDICIARY SYSTEM

- Philippine judiciary now vested with original jurisdiction to hear cases that used to be resolved by the SEC.
 - Examples: Acts of Board of Directors or officers which are detrimental to the interest of the public or stockholders; controversies between and among stockholders; controversies in the election or appointments of directors, officers or managers of corporations; etc.

3. Other 'Corporate Monitors':

- Accountants and Auditors**
- Banks and Analysts**
- Creditors and Credit Rating Agencies**
- Shareholders and Shareholder Activism**

3a) Governance Issues in Accounting and Auditing:

- **Accounting vs. Auditing**
- **The changing role of accounting—managing earnings**
- **From manipulation to fraud**
- **Auditors as consultants**
- **Accounting oversight (PCAOB of Sarbanes-Oxley Act)**

3b) Banks and Analysts:

- **Review of Investment banking activities**
 - Issuing new debt and equity securities
- **(via "Underwriting" or "Best efforts" method)**
- **Criticisms of investment banks (e.g., PETS.com IPO by Merrill Lynch; Enron's web of partnerships)**
- **Securities analysts (Buy-side vs. Sell-side analysts)**
- **Potential conflicts of interest that analysts face (e.g., Martha Stewart indictment)**

3c) Creditors and Credit Rating Agencies:




- Debt as a disciplinary mechanism**
- Institutional lenders as corporate monitors**
- Credit rating agencies**
- Problems with WorldCom and Enron**
- International perspective**

3d) Shareholders and Shareholder Activism:

- **What is shareholder activism?**
- **Does institutional shareholder activism work?**
- **Potential roadblocks to effective shareholder activism**
- Example: **Cadbury Schweppes** said it was separating its British-based confectionery and American-based beverages businesses and would provide more details in June. The announcement came after it was revealed that Nelson Peltz, a shareholder activist, had taken a 3% stake in the company, which led to speculation about a buy-out.




- **Emerging Issues in Corporate Governance:**
 - Sarbanes-Oxley Act of 2002;
 - Philippines SEC Code of Corporate Governance;
 - Institute of Corporate Directors (ICD)

Key Elements of Sarbanes-Oxley

Group	Area		Description
Management	Reporting		Management must assess and report on the effectiveness of the company's internal control structure and procedures over financial reporting. This is part of section 404 of SOX.
	Insider Accountability		New rules require a code of ethics and a report on it in the annual 10-K.
	Penalties		New penalties exist for management if the financial statements are inaccurate or incomplete. A misrepresentation in connection with the certification can result in a fine of up to \$1 million and imprisonment of up to ten years. A willful misrepresentation is punishable by a fine of up to \$5 million and imprisonment of up to 20 years.



Key Elements of Sarbanes-Oxley

Group	Area	Description
Board of Directors	Strengthening the Board	 <p>New rules for the composition of the boards of directors, requiring some directors to be independent of management, will strengthen the boards and the audit committees of the boards.</p>
The External Auditors	Strengthening Auditor Independence	 <p>New rules for auditors include stronger rules regarding auditor independence.</p>
The Public Company Accounting Oversight Board (PCAOB)	Enforcement	 <p>The new Public Company Accounting Oversight Board has the power to regulate auditing firms.</p>



Will the Act Be Beneficial?

- The Act addresses problems with auditing, boards of directors, executive behavior, the SEC, and analysts.
- However, legal scholars, corporate executives, and, to a lesser extent, large shareholders, have been critical of the Act.
- E.g., aside from giving loans to the executives, they argue that ENRON would have complied with the governance rules of Sarbanes-Oxley.

Will the Act Be Beneficial?

- ...Yet that did not inhibit Enron from governance failures that caused it to collapse.
- In addition, many argue that compliance with the Act is too burdensome & costly: companies report that the average expense for implementing the Act was \$5.1 million and that the average ongoing annual cost of compliance is \$3.7 million.
- It will probably take some time before the Act can be determined a success or a failure.

International Perspective

- Countries all over the world were examining their own corporate governance policies.
- Tables on the following slides show the principle outcomes of these efforts for various countries.

Corporate Governance Codes around the World

Country	Law or Recommendation	Date
Australia	Principles of Good Corporate Governance and Best Practice Recommendations	March 2003
Austria	Austrian Code of Corporate Governance	November 2002, updated April 2005
Belgium	Belgian Corporate Governance Code	December 2004
Brazil	Code of Best Practice of Corporate Governance	March 2004
Canada	National Policy 58-201 Corporate Governance Guidelines	December 2003
China	The Code of Corporate Governance for Listed Companies in China	January 2001
Denmark	Revised Recommendations for Corporate Governance in Denmark	August 2005
Finland	Corporate Governance Recommendations for Listed Companies	December 2003
France	The Corporate Governance of Listed Corporations	October 2003

Corporate Governance Codes (continued)

Country	Law or Recommendation	Date
Germany	The German Corporate Governance Code (The Cromme Code)	February 2002, amended May 2003
Greece	Principles of Corporate Governance	July 2001
Hong Kong	Hong Kong Code on Corporate Governance	November 2004
Italy	Corporate Governance Code (il Codice di Autodisciplina delle società quotate rivisitato)	July 2002
Japan	Principles of Corporate Governance for Listed Companies	April 2004
Netherlands	The Dutch corporate governance code	December 2003
Norway	The Norwegian Code of Practice for Corporate Governance	December 2004
Philippines	SEC Code of Corporate Governance	April 2002
Portugal	Recommendations on Corporate Governance	November 2003

Corporate Governance Codes (continued)

Country	Law or Recommendation	Date
Russia	The Russian Code of Corporate Conduct	April 2002
South Korea	Code of Best Practice for Corporate Governance	September 1999
Sweden	Swedish Code of Corporate Governance <i>Report of the Code Group</i>	December 2004
Switzerland	Swiss Code of Best Practice for Corporate Governance	June 2002
Taiwan	Taiwan Corporate Governance Best-Practice Principles	2002
Thailand	Code of Best Practice for Directors of Listed Companies	October 2002
Turkey	Corporate Governance Principles	June 2003
United Kingdom	The Combined Code on Corporate Governance	July 2003

U.S. SEC vs. Philippines SEC

- **In the U.S., the SEC is such a potent force that it can enter into litigation with violators.**
- **Recent classic cases:**
 - **AIG**
 - **Enron**
 - **WorldCom**
 - **others**
- **Phils. SEC:** Recent cases: College Assurance Plan (CAP), other pre-need cos.

Implications:

- A recent study finds that countries' quality of public securities enforcement is unrelated to stock market development. In contrast, countries' quality of disclosure is strongly related to their stock market development.
- This study suggests that securities laws do matter but probably not as much as many of us would have thought.
- In any case, we find that the SEC is an important corporate monitor.
- Empirical work required: Relationship between quality of public securities enforcement and stock market development; Relationship between quality of disclosure and stock market development.

Philippines SEC “Code of Corporate Governance”

- Resolution No. 135, dd. 4 April 2002
- Stated Objectives:
 - actively promote corporate governance reforms, aimed to:
 - Raise investor confidence
 - Develop the capital market
 - Help achieve high sustained growth for the corporate sector & the economy

Do Codes suffice?

- Unlike codes, corporate laws do have a binding impact on the design of corporate charters (even though the exact nature of the regulatory constraint is subject to debate...)
- *Regulation vs. Deregulation*

Do Codes suffice? (cont'd)

- **Even if not mandatory, corporate law matters for roughly the same reasons that codes are relevant:**

First: transaction costs of contracting around the default point may be substantial.

Second: there are “network externalities” with regard to codes (i.e., abiding by the statutes provides for a more competent enforcement by the legal infrastructure).

Third: legal rules matter most when firms cannot choose where to incorporate and/or be listed.

Asian Corporate Governance Roundtable

- Search www.oecd.org
- Many of the Meetings were chaired by the Philippines' Dr. Jesus Estanislao (former Minister of Finance), head of the Philippines' *Institute of Corporate Directors*.
- The Report's Appendix A contains "Quick Reference Tables on Corporate Governance Frameworks in Asia" (see next slides for Outline of the Survey done among Asian countries)

White Paper on Asian Corporate Governance OUTLINE of APPENDIX A

I/II. Shareholders' rights & equitable treatment:

- 1. Shareholder Information**
- 2. Shareholder Participation**
- 3. Share in the profits of the Corporation**
- 4. Corporate Control**
- 5. Shareholder Redress**
- 6. Insider Trading**
- 7. Related Party Transactions**

White Paper on Asian Corporate Governance OUTLINE of APPENDIX A (Cont'd)

III. The Role of Stakeholders

- 1. Codes of Conduct**
- 2. Employees' Rights**
- 3. Creditors' Rights**

IV. Disclosure and Transparency

- 1. Consolidated financial reporting**
- 2. Non-financial information**
- 3. Audit/Accounting**
- 4. Reporting Requirements**

V. The Responsibilities of the Board

Philippines Institute of Corporate Directors (ICD):

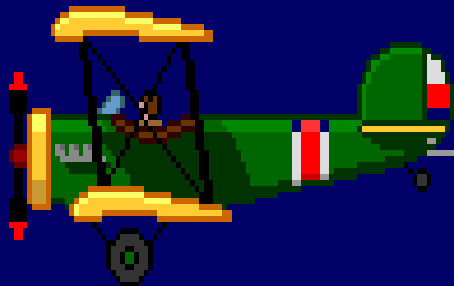
- Consultancy group made up of top executives;
- Has come up with “Corp. Governance Scorecard” (CGS), which measures actual improvement in corporate governance practices of the various government agencies and institutions based on the following categories:
 - responsibilities of the board,
 - relations with stakeholders,
 - implementation of an effective regulatory framework,
 - government acting as owner, and
 - transparency and disclosure.

Philippines Institute of Corporate Directors (ICD):

- **Corp. Governance Scorecard (CGS) recent ratings resulted in ff. rankings:**
 - **Private firms: ChinaBank, AyalaLand, Petron...**
 - **31 GOCCs: Development Bank of the Philippines (DBP), Philippine Deposit Insurance Corp. (PDIC), Philippine Export-Import Credit Agency, Land Bank of the Philippines (Landbank), and the National Telecommunications Commission (NTC), Bases Conversion Development Authority (BCDA).**

Corporate Governance

Most experts—managers, the SEC, and academic researchers—agree that the most important factor in good corporate governance is an ethical climate, which top management sets.



The End