Corporate Governance and Agency Problem

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Agenda

1. Investment and Financing Decisions
2. What is a Corporation?
3. Who Is the Financial Manager?
4. Goals of the Corporation
5. Agency Problems, Executive Compensation, and Corporate Governance
6. The Ethics of Maximizing Value

Investment and Financing Decisions

- Capital Budgeting Decision
  - Decision to invest in tangible or intangible assets
- ...also called
  - Investment Decision
  - Capital Expenditure (CAPEX) decision

<u>TANGIBLE ASSETS</u>

Southwest Airlines
Purchase new planes

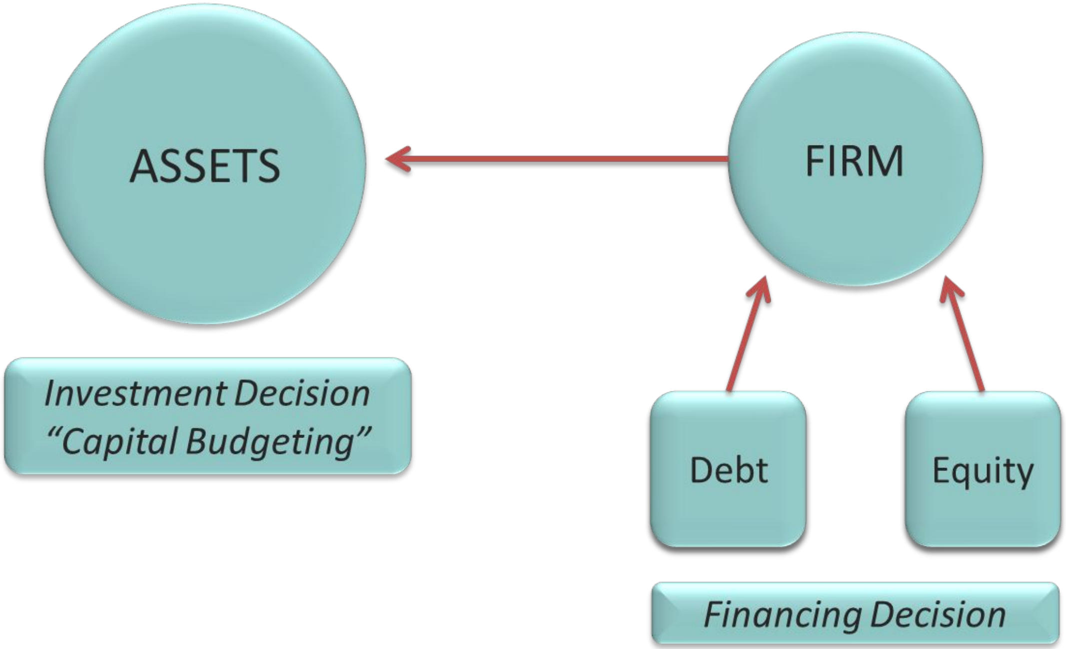
<u>INTANGIBLE ASSETS</u>

GlaxoSmithKline
R&D expenditures

Investment and Financing Decisions

- Financing Decision
  - Decision on the sources and amounts of financing
- Capital Structure
  - The mix of long-term debt and equity financing

Investing and Financing Decisions



Investment and Financing Decisions

- Real Assets
  - Assets used to produce goods and services
- Financial Assets
  - Financial claims to the income generated by the firm’s real assets

Example

Are the following capital budgeting or financing decisions?

1. Intel decides to spend $7 billion to develop a new microprocessor
2. BMW borrows 350 million euros (€350 million) from Deutsche Bank
3. Royal Dutch Shell constructs a pipeline to bring natural gas onshore from a production platform in Australia
4. Avon spends €200 million to launch a new range of cosmetics in European markets
5. Pfizer issues new shares to buy a small biotech company

Example Solution

Are the following capital budgeting or financing decisions?

1. Intel decides to spend $7 billion to develop a new microprocessor (Capital Budgeting)
2. BMW borrows 350 million euros (€350 million) from Deutsche Bank (Financing)
3. Royal Dutch Shell constructs a pipeline to bring natural gas onshore from a production platform in Australia (Capital Budgeting)
4. Avon spends €200 million to launch a new range of cosmetics in European markets (Capital Budgeting)
5. Pfizer issues new shares to buy a small biotech company (both; Acquisition is an investment decision, while issuing shares is a financial decision)

What is a Corporation?

- Corporation
  - A business organized as a separate legal entity owned by shareholders
  - Shareholders elect the board of directors, who appoint managers and monitor their performance
  - Separation of ownership and control; Permanence.
- Types of Corporations
  - Public Companies: Traded in public markets
  - Private Corporations: Closely held by a small group of investors

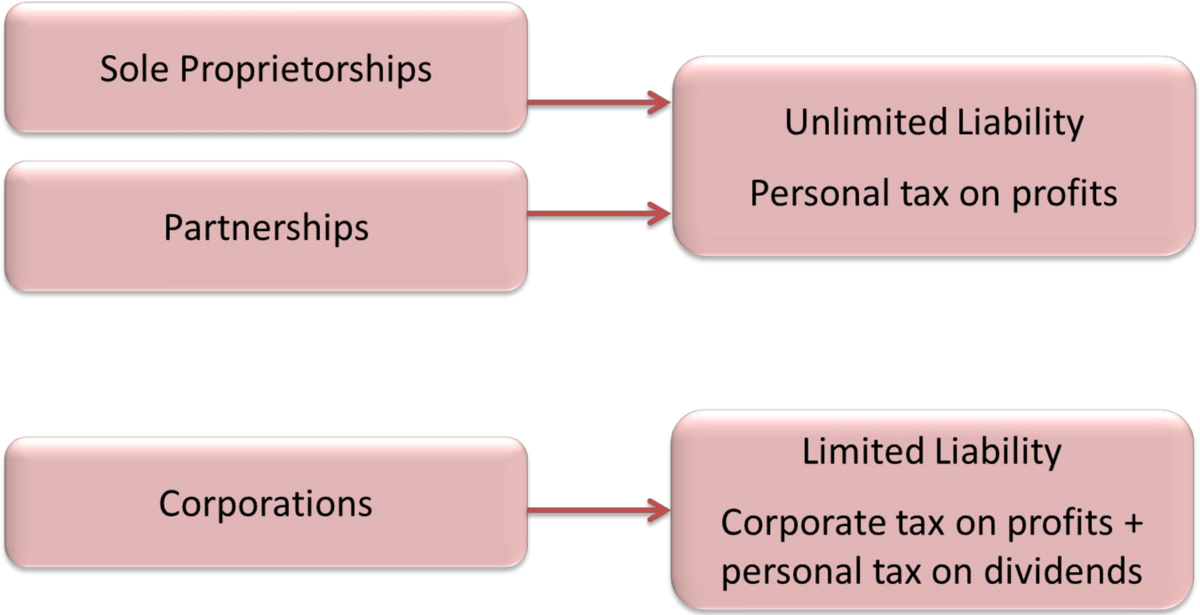
What is a Corporation?

- Types of Business Organizations
  - Sole Proprietorships: Owned and controlled by an individual
  - Partnerships: Owned and controlled by at least two people
  - Corporations: Separate legal entity
  - Others
    - Limited Liability Partnerships or Limited Liability Companies: Limited liability and no double taxation
    - Professional Corporations: Corporation with limited liability, however professionals can be sued for malpractice etc.
- Limited Liability
  - The owners of a corporation are not personally liable for its obligations

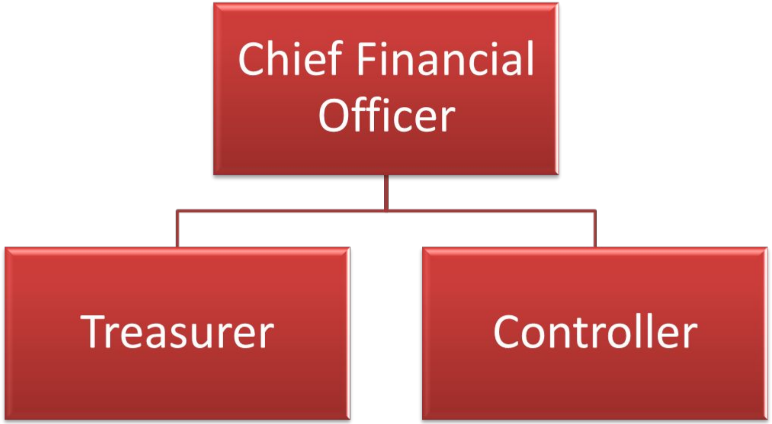
What is a Corporation?

	Sole Proprietorship	**Partnership**	**Corporation**
Who owns the business?	The manager	Partners	Stockholders
Are managers and owners separate?	No	No	Usually
What is the owner’s liability?	Unlimited	Unlimited	Limited
Are the owner and business taxed separately?	No	No	Yes

What is a Corporation?



Who is the Financial Manager?



Who is the Financial Manager?

- Chief Financial Officer (CFO)
  - Responsible for financial policy and corporate planning
- Treasurer
  - Responsible for cash management, raising of capital and banking relationships
- Controller
  - Responsible for preparation of financial statements, accounting and taxes

Who is the Financial Manager?

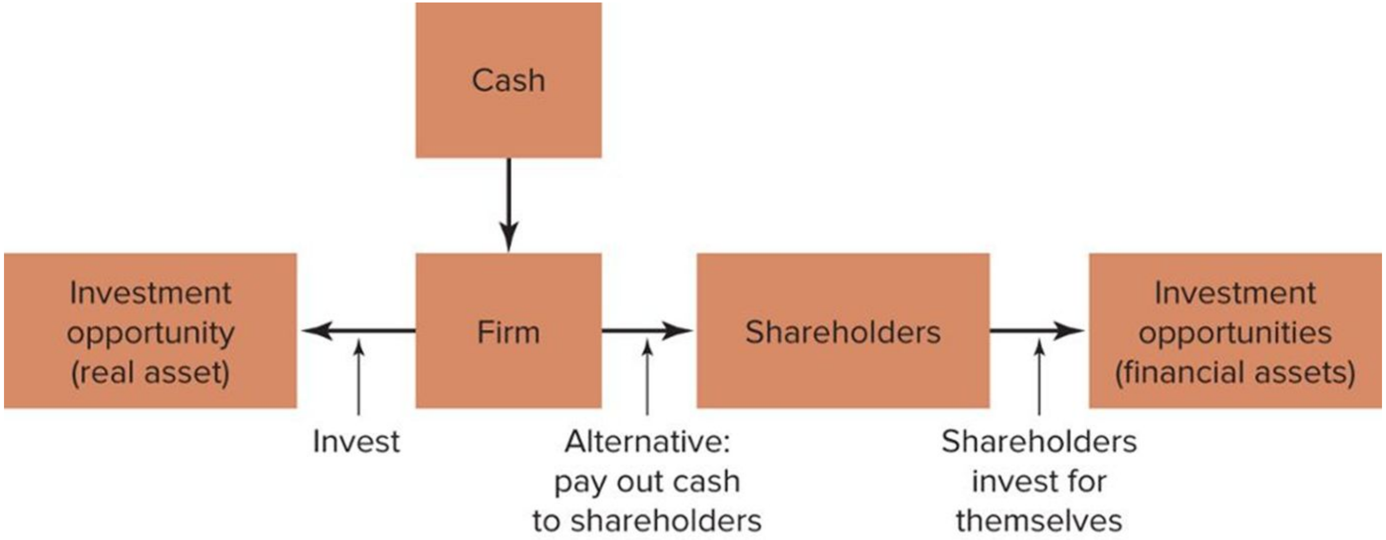
(1) Cash raised from investors
(2) Cash invested in firm
(3) Cash generated by operations
(4a) Cash reinvested
(4b) Cash returned to investors

Goals of the Corporation

- Shareholders desire wealth maximization
  - Maximize current market value of shareholder’s investment in the firm
- Why not profit maximization?
  - Maximize profits? Which year’s profits?
  - Earning manipulation
- Opportunity cost of capital
  - The minimum acceptable rate of return on capital investment is set by the investment opportunities available to shareholders in financial markets

Goals of the Corporation

The Investment Trade-off



Agency Problem

- Do managers maximize shareholder wealth or manager wealth?
- Managers have many constituencies called "stakeholders"
- Stakeholder
  - Anyone with a financial interest in the corporation
- Agency problem
  - Managers are agents for stockholders and are tempted to act in their own interests rather than maximizing value
- Agency cost
  - Value lost from agency problems or from the cost of mitigating agency problems

Agency Problem

- Executive Compensation
  - A fixed base salary plus an annual award tied to earnings or any other financial performance measure (more senior ➔ smaller the base salary as a fraction of total compensation)
  - Stock options as part of compensation package
- Corporate governance
  - The laws, regulations, institutions, and corporate practices that protect shareholders and other investors
- Elements of good corporate governance
  - Legal requirements
  - Board of directors
  - Activist shareholders
  - Takeovers
  - Information for investors: Accounting and reporting standards

Ethics of Maximizing Value

“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.” –Adam Smith, 1776

Does value maximization justify unethical behavior?

- Volkswagen: Software that cut back pollution when cars were tested. Stock price dropped by 35% in 2015, when the software was discovered.

Is it ethical?

- Short selling: Borrowing the security, selling it for cash, and waiting in the hope of buying it back cheaply
- Corporate raiders: Breaking up a portfolio of business could mean a gain for shareholders, but potential difficult adjustments and job losses
- Tax avoidance: How do companies decide which tax schemes are ethical and which are not? Can a company act in shareholders’ interest if it voluntarily pays more tax than it is legally obligated to pay? E.g. Starbucks in UK and Apple in US.

References

Much of this presentation is derived from the course textbook: Fundamentals of Corporate Finance by Richard A. Brealey, Stewart C. Myers and Alan J. Marcus, 10th edition, McGraw Hill Education.