Corporate Finance

Lecture 3: Corporate Governance

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Quick Review of Last Lecture

- Basic form of OLS: $y = \alpha + \beta_1 x_1 + \cdots + \beta_k x_k + \epsilon$
- Endogeneity is correlation between the error term (ϵ) and explanatory variables (x).
- Endogeneity can be caused by omitted variables, measurement error, and reverse causality (simultaneity).
- Common tools to establish causality: IV, DID, and RDD.
- A valid IV must satisfy the relevance condition (testable) and the exclusion condition (not testable).
- 2SLS can be used to implement an IV estimation.
- **Natural Experiments**: situations where some "natural" event causes an exogenous change in x.
- Cross-sectional Difference and Time-series Difference estimators are problematic.
- Difference-in-Differences (DID) compares change in y pre- versus post-treatment for treated group to change in y pre- versus post-treatment for control group.
- For DID estimation, tests on the parallel trends assumption and internal validity are important.
- In RDD, observations are "treated" based on known cutoff rule.
- Observations around the cutoff are assumed to be similar, and whether a single observation receives the treatment (i.e., falling below or above the threshold) is due to randomness.
- Sharp RDD and fuzzy RDD can be estimated with *all data* or with *a small window*.

Outline for This Lecture

1. Agency Problems
2. Corporate Governance
3. Board of Directors
4. Executive Compensation Plans
5. Ownership Structure

Ownership versus Control in Corporations

- In a corporation, ownership is represented by shares of stock. The owner of stock is often referred to as shareholder, stockholder, or equityholder.
  - In a corporation, there are no limits on the total number of owners.
  - There are no limitations on who may own stock in a corporation.
- Managers (i.e., CEOs and other executives) make day-to-day decisions about the firm.
  - endowed with authority by the board of directors
  - Board of directors, elected by shareholders, have the ultimate decision-making authority.
- Ownership and direct control are typically separate.
  - Separation disappears if the CEO owns 100% of the firm.

Agency Problems

- Managers may act in their own interest rather than in the best interest of the shareholders.
  - Managers may seek excessive corporate perks (e.g., corporate jets).
  - Managers may engage in empire building.
  - Managers may prefer suboptimal risk-taking in investments.
- The problem of management not working in the interest of shareholders is known as the agency problem.
- Agency problems occur when there's a conflict of interest between principals (shareholders) and agents (managers), leading to potential misalignment in goals.
- Agency costs are the reductions in firm value that arise from agency problems. They fall into two categories:
  - Value lost because managers don't make value-maximizing decisions.
  - Costs of monitoring managers, setting rules and procedures to mitigate agency problems, and intervening when agency problems are sufficiently severe.

What Agency Problems Should You Watch Out For?

There are typically five important agency problems brought by managers:

- **Reduced Effort**: not put in sufficient effort
- **Private Benefits**: waste cash on perquisites and private benefits
- **Overinvestment**: overinvest in the search for power or prestige
- **Risk Taking**: be reluctant to take risks or take too many risks
- **Short-Termism**: focus on short-term results at the expense of long-term value

Reduced Effort

- Creating value for shareholders takes effort, and so managers may be tempted to slack off.
- "Reduced effort" doesn't mean CEOs spend their time on the golf course rather than in the office. In fact, CEOs aren't lazy–they frequently work 60-hour weeks and rarely switch off even during weekends or on vacation.
- Finding and implementing valuable projects can be a high-effort, high-pressure activity. It's much more comfortable to pursue the "quiet life," staying with the status quo, than to head into uncharted territory.
- While we often think of poor management as involving errors of commission (taking bad decisions), even more serious may be errors of omission (failing to take good decisions).
- Effort is required not only to take valuable investments, but also to identify underperforming projects and shut them down.
- Evidence confirms that managers tend to prefer the quiet life.
  - For example, when corporations are better protected from takeovers, managers are under less pressure to create shareholder value. In such cases, wages are more likely to increase and productivity and profitability to decline. Fewer new plants are built, and fewer old plants are shut down.

Example: Kodak's Error of Omission

In 1981, Sony released a prototype of the electronic camera. Kodak had every ability to respond—after all, it invented the digital camera in 1975 and held patents for it. But it was too tempting to stick with what it knew best, photography film. Why change? A study by Kodak's head of market intelligence predicted that digital would replace film. But this displacement would take 10 years, far too long to bother doing anything about it.

Kodak's inertia was an error of omission that led to its bankruptcy in 2012–a huge fall from grace for a company that had been worth $31 billion at its peak and had employed 150,000 people at one point.

Kodak has since emerged from bankruptcy, selling printing products and chemicals and licensing patents and technology. However, its market cap in February 2022 was only $300 million.

Private Benefits

- Managers may be tempted to extract private benefits, often in the form of perquisites or "perks."
  - They may spend too much on upscale offices, business meetings at luxury resorts, or redundant corporate jets.
- Such perks generally destroy value.
  - For example, U.S. companies that disclose the usage of a corporate jet subsequently underperform their peers by 4% per year, which translates into $300 million of value destruction (Yermack, 2006).
  - The corporate jet is only the tip of the iceberg. A company that allows its CEO to use a corporate jet may also permit other misbehaviors.
- The temptations to enjoy perks are often subtle and mundane. But an agency problem arises whenever managers think a little less hard about spending money that is not their own.

Example: China Evergrande's Jet

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China Evergrande, Strapped for Cash, Offloads Its Jets

The heavily indebted property developer sold two Gulfstreams last month as bond payments loomed

By Serena Ng Follow

Nov. 5, 2021 5:30 am ET

Overinvestment

- Managers should only take investments if they create value for shareholders.
- However, they may have personal incentives to pursue projects that do *not* create value.
- Here are three such temptations:
  - **Compensation**: There is a strong link between firm size and CEO pay. As a result, a CEO has a strong inducement to grow her firm, either through organic investment or by acquiring another company.
  - **Prestige**: Prestige can arise from two sources. The first is firm size—bosses of larger firms enjoy greater status. The second source of prestige is being viewed as socially responsible.
  - **Entrenching Investment**: A CEO may take projects that require a manager with special skills that he/she happens to possess even if these projects are value-destroying. Projects designed to require or reward skills of existing managers are called entrenching investments.
- Overinvestment is most dangerous when the firm has plenty of cash but limited good investment opportunities. This is known as the free cash flow problem.

Example: The Collapse of Countrywide Financial

In 2002, Countrywide Financial was third in U.S. mortgages by market share. CEO Angelo Mozilo was determined to make it number one.

Of course, companies should want to be the best in their industry, but for Mozilo, "best" was exclusively about market share — whether the mortgages could be repaid was a secondary consideration. So Countrywide plunged recklessly into subprime mortgages and fell into significant trouble when the financial crisis hit.

In January 2008, it was on the verge of bankruptcy and had to be bought out by Bank of America.

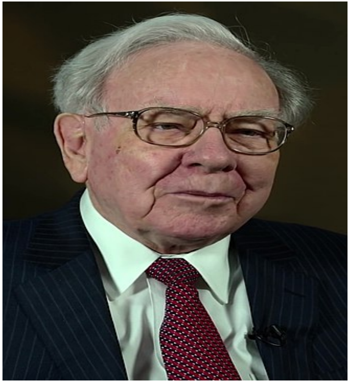
Risk Taking

- CEOs have incentives to avoid risky projects even if they are value-enhancing.
  - Managers typically hold large equity stakes in their firm.
  - Moreover, a manager's job prospects are tied to the firm's prosperity.
  - While a setback at one company has little effect on the wealth of a diversified shareholder, it may cost the CEO their job.
- Conversely, a manager may have an incentive to take too much risk.
  - Suppose that a regional office suffers large, unexpected losses. The regional manager may try a risky strategy that offers a small probability of a big, quick payoff.
  - If the strategy pays off, the losses are covered and her job may be saved. If it fails, she loses her job, but she would have lost it anyway.
- Companies often hesitate to curtail risky activities that are delivering — at least temporarily — rich profits.

Short-Termism

- CEOs may take short-term actions at the expense of long-term value.
- This issue is particularly serious today, because intangible assets are increasingly important and they take especially long to nurture.
  - E.g., a patent takes years to develop and outside investors can see few signs of interim progress.
- Executives have incentives to boost short-term earnings and stock prices due to external pressures (from shareholders, analysts, etc.). They tend to take value-destructive actions in response to these pressures.
  - If either slump, the CEO might be fired. If it soars, she might be poached by an even larger firm—and even if the rise is temporary and later reverses, she may not care if she has since moved on.

Warren E. Buffett's Letter: Short-Termism Is Harming the Economy



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Short-Termism Is Harming the Economy

Public companies should reduce or eliminate the practice of estimating quarterly earnings.

By Jamie Dimon and Warren E. Buffett

June 6, 2018 10:00 pm ET

Every generation of Americans has a responsibility to leave behind a stronger, more prosperous society than the one it found. The nation's greatest achievements have always derived from long-term investments. In both national policy and business, effective long-term strategy drives economic growth and job creation.

For public companies, these same principles are true. That's why today, together with Business Roundtable, an association of nearly 200 chief executive officers from major U.S. companies, we are encouraging all public companies to consider moving away from providing quarterly earnings-per-share guidance. In our experience, quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability.

Corporate Governance

- Corporate governance refers to the ways in which suppliers of capital seek to ensure that their capital is wisely managed.
  - Corporate governance aims to mitigate agency problems by aligning management decisions with shareholder interests.
  - Effective corporate governance enhances firm value by reducing agency-induced inefficiencies.

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- A broader view of corporate governance concerns stakeholder interests.
  - Stakeholders of a firm are individuals or groups that have an interest in the company's activities, decisions, and performance.
  - Examples of stakeholders include shareholders, creditors, managers, employees, customers, suppliers, regulators, and community.
  - Effective corporate governance balances the needs and interests of all stakeholders.

Governance Components

- Board of Directors
- Managerial Incentive Compensation Plans
- Ownership Structure

Boards of Directors

- What is the board of directors?
  - The board of directors consists of a group of elected or appointed individuals who collectively oversee corporate activities, ensuring that it operates in the best interest of its stakeholders.
  - All corporations typically have a board of directors.
  - In a legal sense, the board of directors is a requirement for the corporate structure.
  - Boards typically consist of both *inside executive directors*, who are also the company's executives (such as the CEO and CFO), and *outside nonexecutive directors*, who serve in a part-time, advisory capacity.
  - Most nonexecutive directors are *independent* — that is, not linked to the company by a business relationship (e.g., a lucrative consulting contract) that may bias them toward management.

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- What do directors do?
  - Hiring, monitoring, and, if necessary, firing CEOs.
  - Advising and providing strategic guidance to management.
  - Overseeing major corporate actions and financial performance.
  - Ensuring the integrity of financial reports and compliance with regulations and laws.

Dual Role of the Board

- The board is at the apex of a firm's internal control system and its job is to advise and to monitor the CEO and top management (Jensen, 1993).
  - Advisory role: provide high-level counsel
  - Monitoring role: hire, fire, and compensate
- Directors, especially those with external commitments (e.g., directors who sit on multiple boards), face finite time resources, influencing their ability to balance advisory and monitoring roles.
  - Directors may have to make tradeoffs between their advising and monitoring responsibilities.
- Several papers discuss the tradeoff between advising and monitoring.
  - E.g., Masulis, Wang, and Xie (2012); Field Lowry, and Mkrtchyan (2013); Clifford, Ellis, and Gerken (2018); Coles, Daniel, Durrani, and Naveen (2022).

Board and Director Traits Influencing the Dual Role

- **Board Size**
  - A large board may have a *free-rider problem*. Research shows that companies with smaller boards enjoy higher valuations, and their CEO is more likely to depart after bad performance (Weisbach, 1988).
  - A large board is associated with higher firm value if the company is itself large or diversified. If the firm is more complex, you might need more directors to understand its different business lines.

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- **Board Independence**
  - Independent directors are more likely to monitor managers.
  - The evidence is that when a board contains more outside directors, the CEO is more likely to leave following poor performance (Weisbach, 1988).
  - Regulations often set a minimum for the fraction of directors that are independent. For example, China requires that at least *one-third* of the board members be independent directors.

Board and Director Traits Influencing the Dual Role

- **Director Time Constraints/Busyness**
  - Some directors serve on multiple boards.
  - These directors build network and obtain valuable information (e.g., industry trends, market conditions, and regulatory changes) for the firm; but they may not be able to monitor the firm intensively because they have to split limited time and attention across firms.
  - Empirical evidence on the value of busy directors is mixed (e.g., Masulis and Zhang, 2019).

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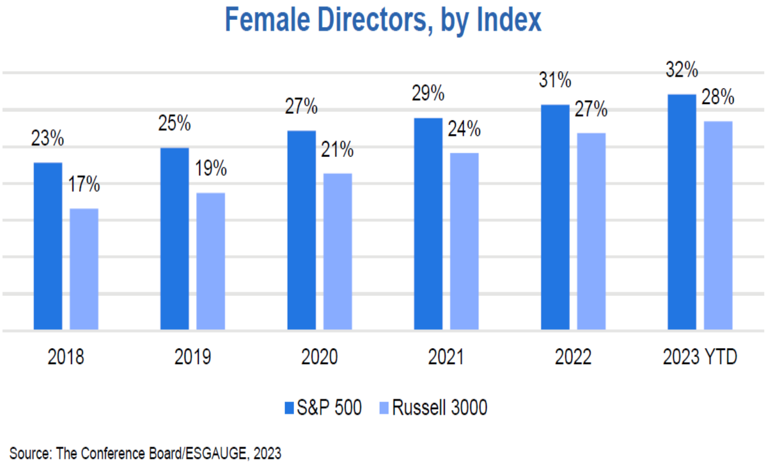
- **Director Diversity**
  - Diversity among directors is believed to enhance decision-making, as more homogenous, less diverse boards are prone to groupthink.
  - Diversity may impair decision-making by raising coordination and communication costs among directors.
  - Diversity might not affect board decisions if minority members feel too intimidated to critique others.
  - Academic evidence on the value of diversity in corporate boards is somewhat mixed.

Director Diversity



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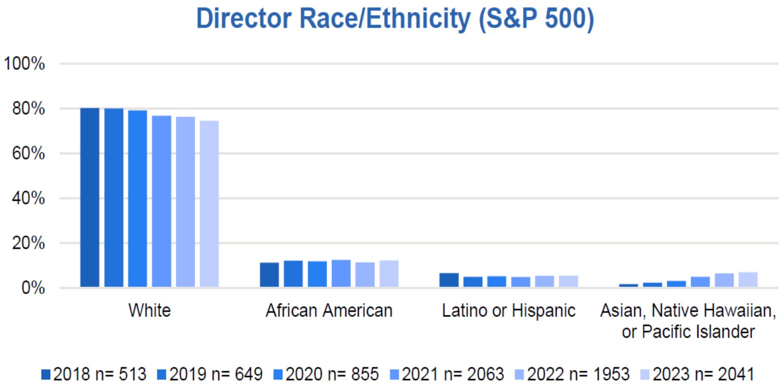
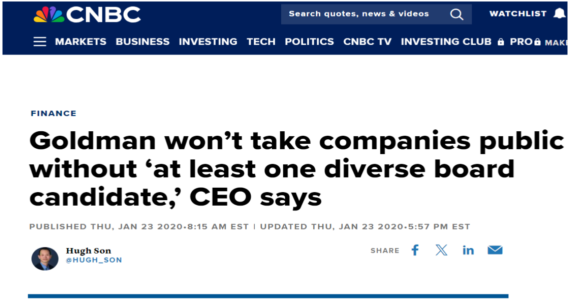


Source: The Conference Board/ESGAUGE, 2023

Director Diversity

- Large institutional investors and financial intermediaries have also increased pressure on listed firms to increase diversity and enhance disclosure in this regard.



Regulations on Director Diversity

- In 2006, Norway mandated that at least 40% of a firm's directors should be female.
  - This was followed by several European countries mandating gender diversity on boards.
  - Baik, Chen, and Godsell (2024, AR) investigate the effects of board gender diversity (BGD) on corporate investment efficiency by exploiting 83 BGD interventions implemented in 59 countries between 1999 and 2021.
- In 2018, California became the first U.S. state to impose quotas for female directors on boards.
  - Some other states have enacted or are considering to enact similar requirements.
- In August 2021, the SEC approved a new rule requiring NASDAQ-listed companies to have, or explain why they do not have, at least two diverse directors (e.g., females, race, LGBTQ+).
  - The new rule also mandated standardized public disclose of board-level diversity statistics.

Executive Compensation and Corporate Governance

- Executive contracts can be used to alleviate agency problems by aligning managers' interests with those of shareholders (Jensen and Meckling, 1976).

- A significant portion of executive compensation is linked to shareholder value metrics, such as stock performance and financial achievements, motivates managers to prioritize the company's success.
    - Performance-based compensation aligns executives' financial interests with those of shareholders.

- The design of effective compensation contracts is a complex issue.
    - Genuinely aligning managerial actions with shareholder value without leading to adverse outcomes like excessive risk-taking or short-term focus.
    - Refining executive contracts over time to ensure its effectiveness.

Components of Executive Compensation

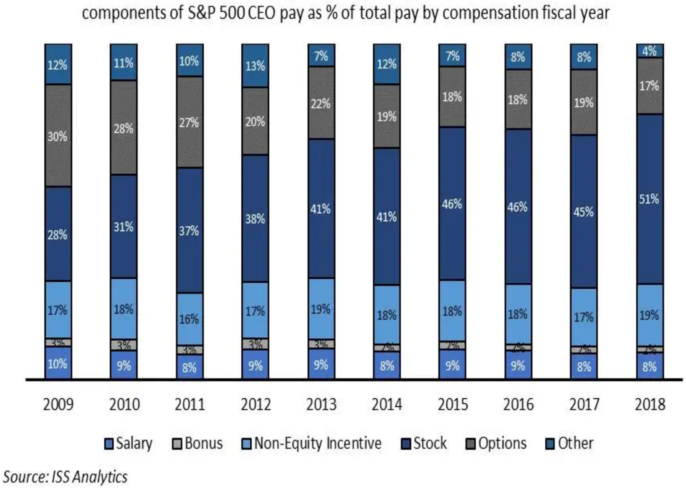
- Most executive pay packages contain five basic components:
  - **Salary**: A fixed amount of money paid regularly, typically monthly or biweekly, as compensation for the executive's role in the company.
  - **Annual Bonus**: A performance-based payment given once a year, often calculated as a percentage of salary, to reward the executive for achieving specific company or personal performance targets.
  - **Restricted Stock Grants**: Awards of company stock given to executives that cannot be sold until certain conditions, typically related to time or performance, are met, aligning the executives' interests with those of the shareholders by promoting long-term value creation.
  - **Restricted Option Grants**: The right, but not the obligation, to purchase company stock at a set price, which becomes available (or "vests") over a certain period of time, encouraging executives to contribute to the company's long-term success.
  - **Payouts from Long-Term Incentive Plans (LTIPs)**: Financial compensations that are awarded after a period of several years, based on the achievement of predetermined performance criteria, intended to align the executive's efforts with the company's long-term goals.
- In addition, top executives often receive perks, defined-benefit pension plans, and severance payments upon departure.

The Sensitivity of Pay to Performance

- In principle, executive pay should reflect signals indicating whether the executive has taken actions that maximize shareholder value (Holmström, 1979).
  - Such a design helps mitigate agency problems.
- In reality, shareholders are unlikely to know which actions are value maximizing.
  - Incentive contracts are often directly based on the principals' ultimate objective, i.e., shareholder value.
- Granting performance-based bonus and equity-linked compensation creates incentives to take actions that benefit shareholders.
- Pay-to-performance sensitivity is essential for the alignment of interests.
  - Granting performance-based bonus and equity-linked compensation increases the pay-to-performance sensitivity.
  - Executives should receive enough compensation after good corporate performance and receive penalty after poor performance.

The Structure of Executive Compensation

- The portion of equity-linked compensation in U.S. increased over time.



International Evidence

- Equity-linked compensation is common but its weight varies across countries.

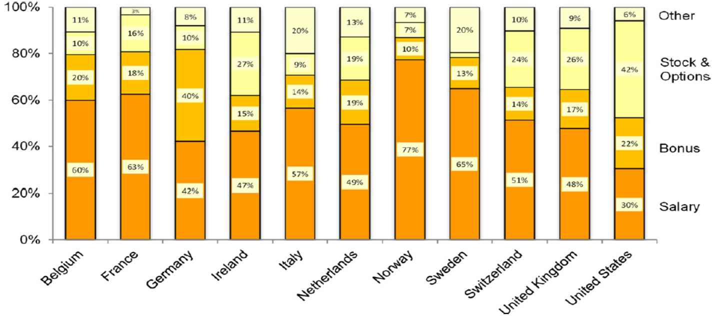


Figure 12 The structure of CEO compensation by country. This diagram shows the average composition of CEO pay in 11 countries from 2002–2009. The U.S. data is from ExecuComp and the non-U.S. data is from BoardEx. First-year CEOs, firms that cannot be matched to Worldscope, and firm-years with incomplete compensation data are dropped. Bonus includes all non-equity incentive payments, Stock & Options include grant-date values of stock options and restricted stock (including performance shares), and Other includes pensions and other benefits.

Source: Edmans, Gabaix, and Jenter (2017)

Ownership Structure and Corporate Governance

- Ownership structures carry significant implications for corporate governance practices.
  - Public vs. Private Ownership
  - Concentration of Ownership
  - Institutional Ownership
  - State Ownership

Public vs. Private Ownership

- Agency costs tend to be more severe among public firms (Gogineni et al., 2022).
  - The investor base is more disperse.
  - Managerial ownership is lower.
- Public firms tend to have higher monitoring demands.
- Public firms face stricter regulatory requirements for transparency and disclosure.
  - Corporate activities are often closely scrutinized by shareholders and the public.

Concentration of Ownership

- Ownership concentration refers to the extent to which a company's shares are held by a small number of shareholders.
- Ownership concentration brings both benefits and costs for corporate governance.
  - Large shareholders have the incentive and power to closely monitor management's actions.
  - High ownership concentration can also lead to entrenchment, where controlling shareholders make decisions that benefit themselves at the expense of minority shareholders.

Institutional Ownership

- Institutional ownership refers to the share of a company's equity owned by institutional investors, such as mutual funds, pension funds, and insurance companies.
- Institutional investors may contribute to better corporate governance practices through
  - **Active monitoring**: institutional investors have the resources and expertise to actively monitor a company's management and operations.
  - **Influence on board decisions**: institutional investors, with their large shareholdings, significantly influence board decisions (e.g., director appointments, major corporate actions).
  - **Proxy voting**: institutional owners may use their proxy voting power to influence governance.
- High institutional ownership does not necessarily indicate good corporate governance.
  - **Institutional herding**: institutions may follow others' decisions.
  - **Exit**: institutional investors could exit their investment ("voting with their feet").

State Ownership

- State owned enterprises (SOEs) have their own unique and significant agency problems.
- SOEs may prioritize social, economic, or political goals over or alongside profit maximization.
  - The government is obliged to maintain social stability (Bai, Lu, and Tao, 2006).
- The state may extract resources from SOEs to satisfy state objectives (Shleifer and Vishny, 1998).
- SOEs face the problem of "owner vacancy".
  - The owners of SOEs are the citizens in general.
  - State owners do not actively oversee day-to-day operations.
  - Managers may be able to engage in self-serving behavior at the expense of both state and other shareholders.
- SOEs often face stricter regulatory compliance requirements compared to other entities.

Scholars to Follow for Corporate Governance

- Ronald Masulis (UNSW)
- Michael S. Weisbach (OSU)
- Dirk Jenter (LSE)
- Alex Edmans (LBS)
- Steven Kaplan (Chicago)
- Carola Frydman (Northwestern)
- Xavier Gabaix (Harvard)