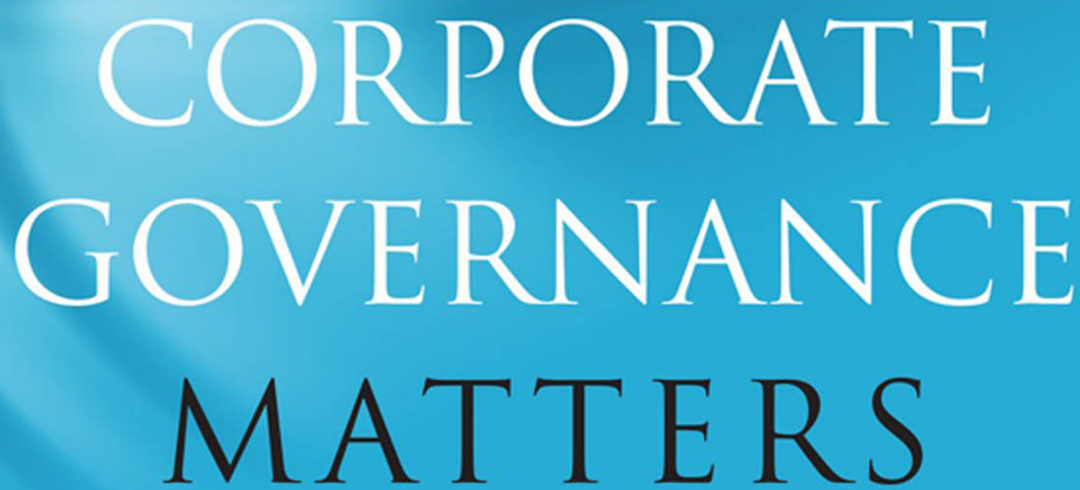


SECOND EDITION

A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES

DAVID LARCKER
BRIAN TAYAN

Praise for the First Edition of *Corporate Governance Matters*

"No board of directors ought to be without Larcker and Tayan's *Corporate Governance Matters*. In today's increasingly regulated environment, this comprehensive book is not only an important reference manual, but also an interesting read and a valuable roadmap."

—**Joel Peterson**, Chairman, JetBlue Airways, and former Lead Director, Franklin Covey

"An outstanding work of unique breadth and depth providing practical advice supported by detailed research. This should be required reading for all board members and everyone who serves as an advisor to boards."

—**Alan Crain, Jr.**, Senior Vice President and General Counsel, Baker Hughes Incorporated

"*Corporate Governance Matters* is by far and away the most useful, fact-based book on corporate governance available. It is essential reading for all current and prospective board members, anyone interested in how boards work, and for students of corporate governance. Its chapters on executive and equity pay, in particular, shine a bright light on a topic too often discussed without substance and context."

—**Mark H. Edwards**, Chairman and CEO, Compensia

"The complexity of corporate governance often lies in its propensity to become highly subjective. David and Brian's objective and unbiased approach to this important subject is very refreshing. This book reflects the meticulous and thorough manner in which the authors have approached corporate governance systems. They have an eye for detail and present every statement and observation with a firm factual foundation. Extensively researched, with highly relevant insights, this book serves as an ideal and practical reference for corporate executives and students of business administration."

—**Narayana N.R. Murthy**, Infosys Technologies Limited

"*Corporate Governance Matters* should be on the reading list for any public or private company director. The authors present comprehensive coverage of current topics using both research and real-world examples to drive home the issues and uncover the best practices. I found their survey of foreign practices and cultural differences to be particularly fascinating and helpful as I work with one of my companies on an offshore partnership. Fascinating, engaging, and full of useful information—a must-read!"

—**Heidi Roizen**, Founder, CEO and Chief Lyrical Officer, Skinny Songs

"A tour de force. David Larcker and Brian Tayan have written an easy-to-read, crucial-to-know overview of corporate governance today. Powerfully blending real-world cases with the newest scientific research, *Corporate Governance Matters* identifies fundamental governance concerns that every board and shareholder needs to know about. The book also provides a valuable, real-world discussion of succession planning and the labor market for executives. If you really want to know about corporate governance (as opposed to following media pundits and governance rating firms), you must read this book!"

—**Stephen A. Miles**, Founder and CEO, The Miles Group

"Larcker and Tayan have written a first-rate book on corporate governance.
Their analysis is unique in its logic, balance, and insistence on rigorous empirical evidence. This book should be required reading for directors, shareholders, and legislators."

—**Steven N. Kaplan**, Neubauer Family Professor of Entrepreneurship and Finance, University of Chicago Graduate School of Business

"David Larcker has long been recognized by practitioners and researchers alike for his exceptional empirical analysis of key factors in corporate governance. With this new book, Larcker builds on what he has taught us through his research over the years and masterfully weaves together the range of key issues that investors, managements, and boards must grapple with in order to achieve the corporate governance balance required for optimal outcomes today.

In plain language and with examples that bring to life the key points that every investor or board member should care about and that every student of corporate governance would want to understand, Larcker and Tayan walk us step by step through the most important factors in building and protecting long-term sustainable value in public companies. Recognizing, as good research has shown over the years, that one size does not fit all, this book provides thought-provoking questions and offers insights based on experience and history to help guide readers to their own conclusions about how to apply its lessons to the specific situations they may face in their own companies. *Corporate Governance Matters* is sure to become required reading for director education and an essential desk reference for all corporate governance practitioners."

—**Abe M. Friedman**, Managing Partner, CamberView Partners

"Through a careful and comprehensive examination of organizational considerations, choices, and consequences, David Larcker and Brian Tayan have produced a valuable resource for anyone with an interest in the functions of corporate governance, or whose goal is to enhance their organization's governance system."

—**Cindy Fornelli**, Executive Director, Center for Audit Quality

"David Larcker and Brian Tayan are the premier students and among the most thoughtful authorities on corporate governance. They have written extensively on the subject with keen insight into the problems and possible solutions, and this book is the culmination of those efforts. It should be read by anyone interested in how corporations can be better governed."

—**Arthur Rock**, Principal of Arthur Rock & Co., former Chairman Intel and former Board Member Apple

"*Corporate Governance Matters* is a comprehensive, objective, and insightful analysis of academic and professional research on corporate governance. In contrast to legal treatments, these authors take an organizational perspective and present a fact-based, business-oriented, and long overdue reconsideration of how certain corporate governance features actually function."

—**Professor Katherine Schipper**, Thomas Keller Professor of Business Administration, Duke University, and former member of the Financial Accounting Standards Board

"They did it! Larcker and Tayan have cracked the code on the connections between corporate governance and corporate performance. Debunking lots of myths along the way, they give practical advice on what works and what doesn't. Their chapters on board composition and executive pay capture the challenge to directors to manage corporations in the best interests of shareholders. This is a must-read for anyone who is interested in improving the performance of corporations."

—**Ira Kay**, Managing Partner, Pay Governance

"When it comes to corporate governance, it seems that everyone has an opinion. David Larcker and Brian Tayan, however, have the facts. This refreshing, hard-headed review describes what we do and don't know about corporate governance.
It lays bare assumptions about governance that simply aren't correct and is destined to become a central reference for anyone interested in how corporate America governs itself."

—**Professor Joseph A. Grundfest**, The William A. Franke Professor of Law and Business,
Senior Faculty, Rock Center on Corporate Governance,
Stanford Law School

This page intentionally left blank

Corporate Governance Matters

Second Edition

This page intentionally left blank

Corporate Governance Matters

A Closer Look at Organizational Choices and Their Consequences

Second Edition

David Larcker
Brian Tayan

Publisher: Paul Boger
Editor-in-Chief: Amy Neidlinger
Executive Editor: Jeanne Levine
Cover Designer: Chuti Prasertsith
Managing Editor: Kristy Hart
Senior Project Editor: Lori Lyons
Copy Editor: Kitty Wilson
Proofreader: Paula Lowell
Indexer: Erika Millen
Senior Compositor: Gloria Schurick
Manufacturing Buyer: Dan Uhrig

© 2016 by Pearson Education, Inc.
Old Tappan, New Jersey 07675

This book is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional services or advice by publishing this book. Each individual situation is unique. Thus, if legal or financial advice or other expert assistance is required in a specific situation, the services of a competent professional should be sought to ensure that the situation has been evaluated carefully and appropriately. The author and the publisher disclaim any liability, loss, or risk resulting directly or indirectly, from the use or application of any of the contents of this book.

For information about buying this title in bulk quantities, or for special sales opportunities (which may include electronic versions; custom cover designs; and content particular to your business, training goals, marketing focus, or branding interests), please contact our corporate sales department at corpsales@pearsoned.com or (800) 382-3419.

For government sales inquiries, please contact governmentsales@pearsoned.com.

For questions about sales outside the U.S., please contact international@pearsoned.com.

Company and product names mentioned herein are the trademarks or registered trademarks of their respective owners.

All rights reserved. No part of this book may be reproduced, in any form or by any means, without permission in writing from the publisher.

Printed in the United States of America

First Printing July 2015

ISBN-10: 0-13-403156-3
ISBN-13: 978-0-13-403156-9

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educación de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Control Number: 2015939612

To Sally, Sarah, and Daniel,

Jack, Louise, and Brad

Contents-at-a-Glance

Preface xxi

Chapter 1 Introduction to Corporate Governance 1

Chapter 2 International Corporate Governance 19

Chapter 3 Board of Directors: Duties and Liability 57

Chapter 4 Board of Directors: Selection, Compensation, and Removal 79

Chapter 5 Board of Directors: Structure and Consequences 107

Chapter 6 Strategy, Performance Measurement, and Risk Management 151

Chapter 7 Labor Market for Executives and CEO Succession Planning . . . 181

Chapter 8 Executive Compensation and Incentives 211

Chapter 9 Executive Equity Ownership 247

Chapter 10 Financial Reporting and External Audit 279

Chapter 11 The Market for Corporate Control 311

Chapter 12 Institutional Shareholders and Activist Investors 343

Chapter 13 Corporate Governance Ratings 375

Chapter 14 Alternative Models of Governance 393

Chapter 15 Summary and Conclusions 413

Index 419

Contents

Preface . . . . **xxi**

Chapter 1 **Introduction to Corporate Governance** **1**

Self-Interested Executives 3

Defining Corporate Governance 7

Corporate Governance Standards 9

Best Practice or Best Practices? Does “One Size Fit All”? 11

Relationship between Corporate Governance and Firm Performance . .12

Chapter 2 **International Corporate Governance** **19**

Capital Market Efficiency 20

Legal Tradition 22

Accounting Standards 23

Enforcement of Regulations 26

Societal and Cultural Values 27

Individual National Governance Structures. 29

- United States 29
- United Kingdom 32
- Germany. 37
- Japan 38
- South Korea 41
- China 43
- India 44
- Brazil 45
- Russia 47

Endnotes 49

Interlude. 55

Chapter 3 **Board of Directors: Duties and Liability** **57**

Board Responsibilities. 57

Board Independence 58

The Operations of the Board 59
Board Committees 60
Duration of Director Terms 64
Director Elections 64
Removal of Directors 66
Legal Obligations of Directors 66
Fiduciary Duty 67
Disclosure Obligations under Securities Laws 70
Legal Enforcement of State Corporate Law (Fiduciary Duties) 70
Legal Enforcement of Federal Securities Laws 71
Director Indemnification and D&O Insurance 72
Endnotes 75

Chapter 4 Board of Directors: Selection, Compensation, and Removal 79
Market for Directors 79
Active CEOs 82
International Experience 83
Special Expertise 84
Diverse Directors 85
Professional Directors 86
Disclosure Requirements for Director Qualifications 87
Director Recruitment Process 89
Director Compensation 91
Ownership Guidelines 96
Board Evaluation 97
Removal of Directors 99
Endnotes 102

Chapter 5 Board of Directors: Structure and Consequences 107
Board Structure 108
Chairman of the Board 112
Lead Independent Director 116
Outside Directors 119
Board Independence 121
Independent Committees 125
Bankers on the Board 126

Financial Experts on Board 127
Politically Connected Boards 128
Employee Representation 128
Boards with "Busy" Directors 131
Interlocked (or Connected) Boards 133
Committee Overlap 135
Board Size 136
Board Diversity 137
Female Directors 138
Summary 141
Endnotes 142
Interlude 150

Chapter 6 Strategy, Performance Measurement, and Risk Management 151

Organizational Strategy 152
Strategy Implementation Process 154
Business Model Development and Testing .156
Example 1: Fast-Food Chain and Employee Turnover 156
Example 2: Financial Services Firm and Investment Advisor Retention 158
Key Performance Measures 159
How Well Are Boards Doing with Performance Measures and Business Models? 163
Risk and Risk Management 164
Risk and Risk Tolerance 165
Risk to the Business Model 167
Risk Management 169
Oversight of Risk Management 171
Assessing Board Performance on Risk Management 173
Endnotes 175

Chapter 7 Labor Market for Executives and CEO Succession Planning. . . 181

Labor Market for Chief Executive Officers .181
Labor Pool of CEO Talent 184
CEO Turnover 186

Newly Appointed CEOs. 189
Models of CEO Succession 191
External Candidate 191
President and/or Chief Operating Officer. 193
Horse Race. 194
Inside–Outside Model 195
The Succession Process 196
How Well Are Boards Doing with Succession Planning? 200
The External Search Process 203
Endnotes 206

Chapter 8 Executive Compensation and Incentives 211
The Controversy over Executive Compensation 212
Components of Compensation 213
Determining Compensation 217
Compensation Consultants 220
Compensation Levels 221
Ratio of CEO Pay to Other Top Executive Pay 224
Ratio of CEO Pay to Average Employee Pay 227
Compensation Mix. 228
Short-Term Incentives 229
Long-Term Incentives. 232
Benefits and Perquisites 234
Compensation Disclosure 235
Say-on-Pay 236
Endnotes 240

Chapter 9 Executive Equity Ownership 247
Equity Ownership and Firm Performance .247
Equity Ownership and Risk. 250
Equity Ownership and Agency Costs 256
Accounting Manipulation 257
Manipulation of Equity Grants. 258
Other Examples of Value Extraction through Timing 260
Equity Sales and Insider Trading. 261

Rule 10b5-1 262
Hedging 264
Pledging 268
Repricing and Exchange Offers 270
Endnotes 273

Chapter 10 Financial Reporting and External Audit 279
The Audit Committee 280
Accounting Quality, Transparency, and Controls 280
Financial Reporting Quality 282
Financial Restatements 284
Models to Detect Accounting Manipulations 290
The External Audit 292
Audit Quality 296
Structure of Audit Industry 296
Impact of Sarbanes–Oxley 298
External Auditor as CFO 301
Auditor Rotation 302
Endnotes 304

Chapter 11 The Market for Corporate Control 311
The Market for Corporate Control 312
Stock Market Assessment of Acquiring and Target Firms 316
Who Gets Acquired? 316
Who Gets the Value in a Takeover? 319
Antitakeover Protections 322
Antitakeover Actions 323
Poison Pills. 325
Staggered Board 328
State of Incorporation 330
Dual-Class Shares. 331
Warding Off Unwanted Acquirers. 334
Endnotes 336

Chapter 12 Institutional Shareholders and Activist Investors. 343
The Role of Shareholders. 343
Blockholders and Institutional Investors 346
Institutional Investors and Proxy Voting. 349
Activist Investors. 351
Pension Funds 353
Social Responsibility and Other Stakeholder Funds 355
Activist Hedge Funds 357
Shareholder Democracy and Corporate Engagement 360
Majority Voting in Uncontested Director Elections 360
Proxy Access. 361
Proxy Voting 362
Corporate Engagement 363
Proxy Advisory Firms 364
Endnotes 369

Chapter 13 Corporate Governance Ratings 375
Third-Party Ratings. 375
Credit Ratings 376
Commercial Corporate Governance Ratings 378
ISS: Corporate Governance Quotient. 378
ISS: Governance Risk Indicators. 380
ISS: QuickScore 380
GMI Ratings 381
Testing the Predictability of Corporate Governance Ratings. 382
Governance Rating Systems by Academic Researchers 383
The Viability of Governance Ratings 388
Endnotes 389

Chapter 14 Alternative Models of Governance 393
Family-Controlled Corporations 393
Venture-Backed Companies 396
Private Equity-Owned Companies 399
Nonprofit Organizations 402
Endnotes 407

Chapter 15 Summary and Conclusions 413
Testing Remains Insufficient 414
The Current Focus Is Misdirected 415
Important Variables Are Clearly Missing 416
Context Is Important 417
Endnotes 418

Index. 419

Acknowledgments

First and foremost, we would like to thank Michelle E. Gutman of the Stanford Graduate School of Business, without whom this book would not have been possible. Michelle provided incredible support throughout this project and was instrumental at each step of the way, from concept and outline, to research, editing, and production. Her incredible work ethic and positive attitude are a model that researchers should strive to emulate, and our work and lives have been greatly enhanced because of her.

We would also like to thank the many experts who provided insight, commentary, and feedback to this work. In particular, we would like to thank Michael Klausner (Stanford Law School), who was invaluable in clarifying legal constructs—particularly those described in Chapter 3, "Board of Directors: Duties and Liability," and Chapter 11, "The Market for Corporate Control." Priya Cherian Huskins (Woodruff-Sawyer & Co) was similarly invaluable in clarifying indemnifications and D&O insurance. Stephen Miles (The Miles Group), and Thomas Friel (Heidrick & Struggles) provided real-world insight into CEO succession planning, the executive recruitment process, and the labor market for directors. Ira Kay (Proxy Governance) provided important contextual understanding of executive compensation. Abe Friedman (CamberView Partners) helped us understand proxy voting from an institutional investor perspective.

The factual depth of this book would not have been possible without the generous resources made available to us by Stanford University. We would like to extend a special thank you to Arthur and Toni Rembi Rock for their generous funding of governance research through the Rock Center for Corporate Governance at Stanford University. We have been greatly enriched through the collaboration this center has allowed, particularly with our colleagues Robert Daines, Joseph Grundfest, Daniel Siciliano, and Evan Epstein. Thank you also to Dean Garth Saloner of Stanford Graduate School of Business for his support of the Corporate Governance Research Initiative. We appreciate the resources and collaboration provided by Wendy York-Fess and our colleagues in the Centers and Initiatives for Research, Curriculum & Learning Experiences (CIRLCE) at Stanford Graduate School of Business. We would also like to thank David Chun and Aaron Boyd (Equilar) for providing some of the compensation data used in the book.

We are grateful to Christopher Armstrong, Maria Correia, Ian Gow, Allan McCall, Gaizka Ormazabal, Daniel Taylor, Youfei Xiao, Anastasia Zakolyukina, and Christina Zhu for their excellent assistance and thoughtful conversations about corporate governance. They also tolerated the idiosyncrasies of the lead author, for which he is particularly thankful.

Thank you to Sally Larcker for her rigorous and methodical editing of this work as we approached publication, and to Jeannine Williams for her diligent assistance throughout this project.

We are grateful to the high-quality support provided by Jeanne Levine, Lori Lyons, Kitty Wilson, Paula Lowell, and others at Pearson. We would like to thank Stephen Kobrin for encouraging us to write this book.

Finally, thank you to our families—Sally, Sarah, Dan, Amy, and Alexa—who love and support us each day.

About the Authors

David Larcker is James Irvin Miller Professor of Accounting at Stanford Graduate School of Business; Director of the Corporate Governance Research Initiative; and Senior Faculty, Arthur and Toni Rembe Rock Center for Corporate Governance. David's research focuses on executive compensation, corporate governance, and managerial accounting. He has published many research papers and is frequently quoted in both the popular and business press.

He received his BS and MS in engineering from the University of Missouri–Rolla and his PhD in business from the University of Kansas. He previously was on the faculty of the Kellogg Graduate School of Management at Northwestern University and The Wharton School at the University of Pennsylvania. Professor Larcker presently serves on the Board of Trustees for the Wells Fargo Advantage Funds.

Brian Tayan is a member of the Corporate Governance Research Initiative at Stanford Graduate School of Business. He has written broadly on the subject of corporate governance, including studies and other materials on boards of directors, succession planning, executive compensation, financial accounting, and shareholder relations.

Previously, Brian worked as a financial analyst at Stanford University's Office of the CEO and as an investment associate at UBS Private Wealth Management. He received his MBA from the Stanford Graduate School of Business and his BA from Princeton University.

Additional resources and supporting material for this book are available at:

Stanford Graduate School of Business
The Corporate Governance Research Initiative
www.gsb.stanford.edu/cgri-research

Preface

This is a book about corporate governance, written from an organizational perspective. It is intended for practitioners and aspiring practitioners who are interested in improving governance systems in their organizations. Unlike many other books on governance, this book is *not* written primarily from a legal perspective. Although we describe the legal obligations of selected organizational participants, our objective is not to rehash legal constructs. Books written by trained lawyers are much better for that purpose, and many fine works explain these obligations for the practitioner. Instead, our purpose is to examine the choices that organizations can make in designing governance systems and the impact those choices have on executive decision making and the organization's performance. This book is therefore relevant to corporate directors, executives, institutional investors, lawyers, and regulators who make organizational decisions.

Corporate governance is a topic that suffers from considerable rhetoric. In writing this book, we have attempted to correct many misconceptions. Rather than write a book that is based on opinion, we use the knowledge contained in the extensive body of professional and scholarly research to guide our discussion and justify our conclusions. This approach does not always lead to simple recommendations, but it has the advantage of being grounded in factual evidence. As you will see, not every governance question has been the subject of rigorous empirical study, nor is every question amenable to a simple solution. There are gaps in our knowledge that will need to be addressed by further study. Still, we hope this book provides a framework that enables practitioners to make sound decisions that are well supported by careful research.

In each chapter, we focus on a particular governance feature, describe its potential benefits and costs, review the research evidence, and then draw conclusions. Although the book is written so that it can be read from cover to cover, each chapter also stands on its own; readers can select the chapters that are most relevant to their interests (board structure, CEO succession planning, executive compensation, and so on). This book—along with our set of associated case studies and teaching materials—is also suitable for undergraduate and graduate university courses and executive education programs.

We believe it is important for organizations to take a deliberate approach in designing governance systems. We believe this book provides the information that allows them to do so.

This page intentionally left blank

1

Introduction to Corporate Governance

Corporate governance has become a well-discussed and controversial topic in both the popular press and business press. Newspapers produce detailed accounts of corporate fraud, accounting scandals, insider trading, excessive compensation, and other perceived organizational failures—many of which culminate in lawsuits, resignations, and bankruptcy. The stories have run the gamut from the shocking and instructive (epitomized by Enron and the elaborate use of special-purpose entities and aggressive accounting to distort its financial condition) to the shocking and outrageous (epitomized by Tyco partially funding a $2.1 million birthday party in 2002 for the wife of Chief Executive Officer [CEO] Dennis Kozlowski that included a vodka-dispensing replica of the statue *David*). Central to these stories is the assumption that somehow *corporate governance* is to blame—that is, the system of checks and balances meant to prevent abuse by executives failed (see the following sidebar).[1]

A Breakdown in Corporate Governance: HealthSouth

Consider HealthSouth Corp., the once high-flying healthcare service provider based in Birmingham, Alabama.[2]

- CEO Richard Scrushy and other corporate officers were accused of overstating earnings by at least $1.4 billion between 1999 and 2002 to meet analyst expectations.[3]
- The CEO was paid a salary of $4.0 million, awarded a cash bonus of $6.5 million, and granted 1.2 million stock options during fiscal 2001, the year before the manipulation was uncovered.[4]
- The CEO sold back 2.5 million shares to the company—94 percent of his total holdings—just weeks before the firm revealed that regulatory changes would significantly hurt earnings, causing the company's share price to plummet.[5]
- Former Chief Financial Officer (CFO) Weston L. Smith and other senior executives pleaded guilty to a scheme to artificially inflate financial results.[6]

- The CEO was found guilty of civil charges brought by shareholders in a derivative lawsuit and ordered to pay the company $2.88 billion in restitution.[7]

What was the board of directors doing during this period?

- The compensation committee met only *once* during 2001.[8]
- *Forbes* wrote that the CEO has "provided subpar returns to shareholders while earning huge sums for [himself]. Still, the board doesn't toss [him] out."[9]

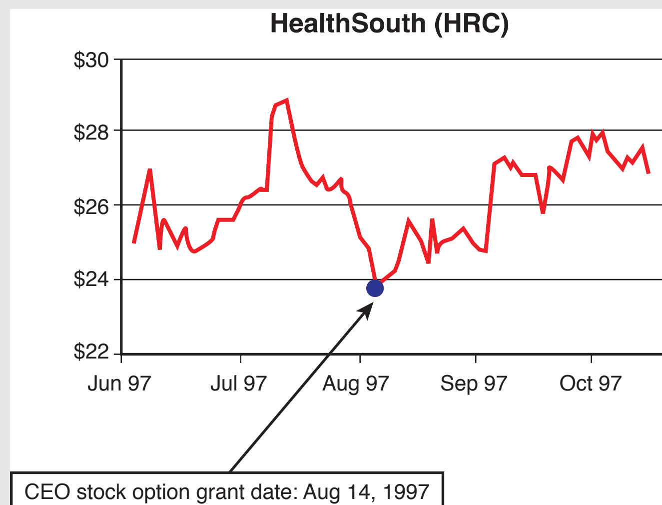
What was the external auditor (Ernst & Young) doing?

- The audit committee met only *once* during 2001.[10]
- The president and CFO both previously were employed as auditors for Ernst & Young.
- The company paid Ernst & Young $2.5 million in consulting and other fees while also paying $1.2 million for auditing services.[11]

What were the analysts doing?

- A UBS analyst had a "strong buy" recommendation on HealthSouth.
- UBS earned $7 million in investment banking fees for services provided to the company.[12]

Perhaps not surprisingly, the CEO also received backdated stock options during his tenure—stock options whose grant dates were retroactively changed to coincide with low points in the company's stock price (see Figure 1.1).



Source: Chart prepared by David F. Larcker and Brian Tayan (2010).

Figure 1.1 HealthSouth: CEO stock option grant date.

Interestingly, Scrushy was not convicted of accounting manipulations in a criminal trial brought by the U.S. Justice Department. However, he was ordered to pay $2.9 billion in a civil suit and, separately, was sentenced to seven years in prison for bribing a former Alabama governor.

As the case of HealthSouth illustrates, the system of checks and balances meant to prevent abuse by senior executives does not always function properly. Unfortunately, governance failures are not isolated instances. In recent years, several corporations have collapsed in prominent fashion, including American International Group, Bear Stearns, Countrywide Financial, Enron, Fannie Mae, Freddie Mac, General Motors, Lehman Brothers, MF Global, and WorldCom. This list does not even include the dozens of lesser-known companies that did not make the front page of the *Wall Street Journal* or *Financial Times* but whose owners also suffered. Furthermore, this problem is not limited to U.S. corporations. Major international companies such as Olympus, Parmalat, Petrobras, Royal Bank of Scotland, Royal Dutch Shell, Satyam, and Siemens have all been plagued by scandals involving breakdowns of management oversight. Foreign companies listed on U.S. exchanges are as likely to restate their financial results as domestic companies, indicating that governance is a global issue (see the following sidebar).

A Breakdown in International Corporate Governance: Olympus

In October 2011, Michael Woodford was fired as CEO of Olympus Corporation of Japan, after only two weeks in the position. Woodford uncovered evidence of fraud while investigating the legitimacy of a $687 million “advisory fee” made in association with a recent acquisition. When he confronted the board of directors, he was dismissed and replaced by former CEO Tsuyoshi Kikukawa. An independent investigation eventually exposed the details of a massive, long-running scheme to hide more than $1.5 billion in investment losses dating back to the 1980s.[13] Members of the board, current and former executives, auditors, and bankers were implicated. Kikukawa was arrested and sentenced to three years in prison.

Self-Interested Executives

What is the root cause of these failures? Reports suggest that these companies suffered from a “breakdown in corporate governance.” What does that mean? What is corporate governance, and what is it expected to prevent?

In theory, the need for corporate governance rests on the idea that when separation exists between the ownership of a company and its management, self-interested executives have the opportunity to take actions that benefit themselves, with shareholders and stakeholders bearing the cost of these actions.[14] This scenario is typically referred to as the **agency problem**, with the costs resulting from this problem described as **agency costs**. Executives make investment, financing, and operating decisions that better themselves at the expense of other parties related to the firm.[15] To lessen agency costs, some type of control or monitoring system is put in place in the organization. That system of checks and balances is called **corporate governance**.

Behavioral psychology and other social sciences have provided evidence that individuals are self-interested. In *The Economic Approach to Human Behavior*, Gary Becker (1976) applies a theory of "rational self-interest" to economics to explain human tendencies, including one to commit crime or fraud.[16] He demonstrates that, in a wide variety of settings, individuals can take actions to benefit themselves without detection and, therefore, avoid the cost of punishment. Control mechanisms are put in place in society to deter such behavior by increasing the probability of detection and shifting the risk–reward balance so that the expected payoff from crime is decreased.

Before we rely on this theory too heavily, it is important to highlight that individuals are not always uniformly and completely self-interested. Many people exhibit self-restraint on moral grounds that have little to do with economic rewards. Not all employees who are unobserved in front of an open cash box will steal from it, and not all executives knowingly make decisions that better themselves at the expense of shareholders. This is known as **moral salience**, the knowledge that certain actions are inherently wrong even if they are undetected and left unpunished. Individuals exhibit varying degrees of moral salience, depending on their personality, religious convictions, and personal and financial circumstances. Moral salience also depends on the company involved, the country of business, and the cultural norms.[17]

The need for a governance control mechanism to discourage costly, self-interested behavior therefore depends on the size of the potential agency costs, the ability of the control mechanism to mitigate agency costs, and the cost of implementing the control mechanism (see the following sidebar).

Evidence of Self-Interested Behavior

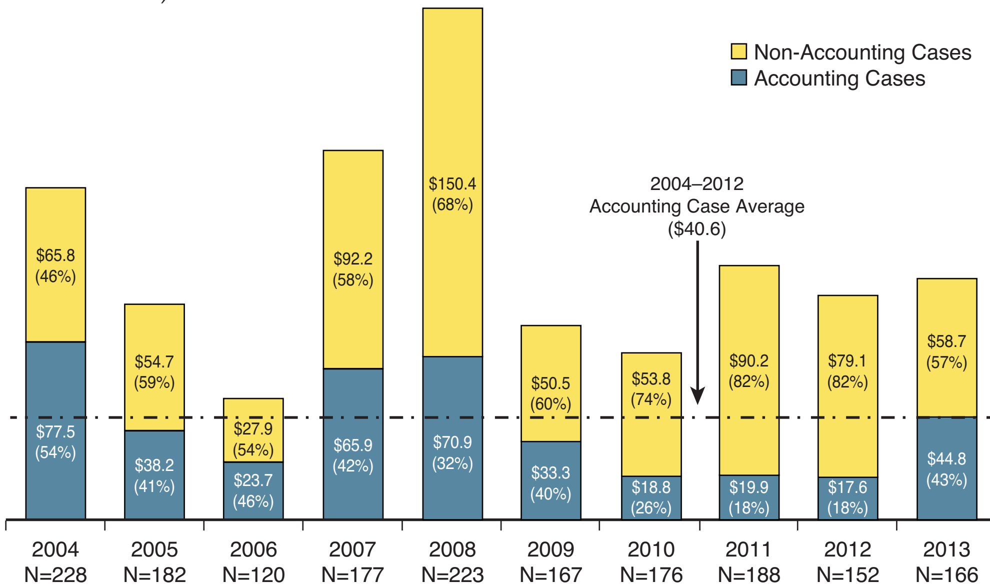
How prevalent are agency problems? Are they outlier events or an epidemic affecting the broad population? How severe are agency costs? Are they chronic and frictional or terminal and catastrophic?

To gain some insight into these questions, it is useful to consider the frequency of negative corporate events that, in whole or in part, are correlated with agency problems. However, before looking at the statistics, we also need to highlight that not all bad outcomes are caused by self-seeking behavior. A bad outcome might well occur even though the managerial decision was appropriate (that is, other management might have made the same decision when provided with the same information). With that important caveat, consider the following descriptive statistics:

- **Bankruptcy**—Between 2004 and 2013, 1,118 publicly traded companies filed for Chapter 11 bankruptcy protection in the United States.[18] Of these, approximately 10 percent were subject to a Securities and Exchange Commission (SEC) enforcement action for violating SEC or federal rules, implying that some form of fraud played a part in the bankruptcy.[19] Bankruptcies linked to fraud are a severe case of agency problems, usually resulting in a complete loss of capital for shareholders and a significant loss for creditors.
- **Financial restatement**—Between 2005 and 2012, publicly traded companies in the United States issued 8,657 financial restatements. Although some financial restatements result from honest procedural errors in applying accounting standards, financial restatements also can occur when senior management manipulates reported earnings for personal gain. According to the Center for Audit Quality, approximately half of the restatements announced during this period were "serious," meaning that the company's previously published financial reports were no longer reliable.[20]
- **Class action lawsuits**—Between 2004 and 2013, almost 200 class action lawsuits were filed annually against corporate officers and directors for securities fraud. No doubt some of this litigation was frivolous. However, market capitalization losses for defendant firms totaled approximately $110 billion each year (measured as the change in market capitalization during the class period). This somewhat crude approximation averages $640 million per company (see Figure 1.2).

Disclosure Dollar Loss Index™

2004–2013
(Dollars in Billions)



Source: Cornerstone Research, Stanford Law School, Securities Class Action Clearinghouse, "Security Class Action Filings: 2013 Year In Review."

Figure 1.2 Annual number of class action filings and stock market loss following disclosure of lawsuit (2004–2013).

- **Foreign Corrupt Practices Act violations**—The Foreign Corrupt Practices Act (FCPA) of 1977 makes it illegal for a company to offer payments to foreign officials for the purpose of obtaining or retaining business, to fail to keep accurate records of transactions, or to fail to maintain effective controls to detect potential violations of the FCPA. Between 2004 and 2013, the SEC and the U.S. Department of Justice filed approximately 30 enforcement actions per year against U.S. listed corporations for alleged FCPA violations. Notably, this figure has trended upward. Violations are settled through a disgorgement of profits and other penalties. In 2013, the average settlement amount came to $80 million per violation.[21]
- **"Massaging" earnings**—Senior executives are under considerable pressure from the investment community to forecast future earnings and then to deliver on those targets. In a survey of senior financial executives, Graham,

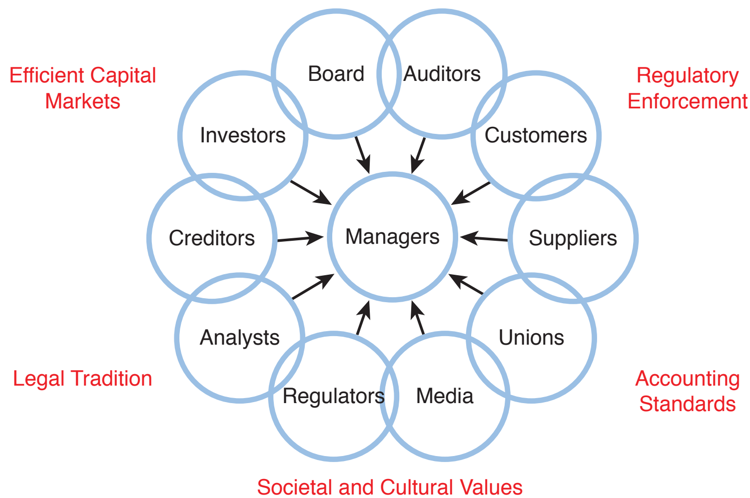
Harvey, and Rajgopal (2006) found that a majority are willing to massage the company's earnings to meet quarterly forecasts.[22] For example, 55 percent state that they would delay starting a new project, even if the project is expected to create long-term value. Separately, respondents were given a scenario in which initiating a new project would cause earnings per share in the current quarter to come in $0.10 lower. The respondents reported an 80 percent probability that they would accept the project if doing so enabled them to still meet their earnings target but only a 60 percent probability if the project caused them to miss their earnings target.

These statistics suggest that agency problems caused by self-interested executives are likely to be quite prevalent, and the cost of managerial self-interest can be substantial. Dyck, Morse, and Zingales (2013) estimate a 14.5 percent probability that an average company engages in fraud in a given year and that, when uncovered, fraud costs investors 22 percent of the firm's enterprise value.[23]

Certain behavior attributes are known by the Association of Certified Fraud Examiners to be "red flags" displayed by fraudulent agents. These include living beyond one's means (44 percent of fraud cases), financial difficulties (33 percent), unusually close association with vendors (22 percent), control issues and a lack of willingness to share duties (21 percent), a "wheeler dealer" attitude (18 percent), divorce or family problems (17 percent), irritability or suspiciousness (15 percent), and addiction problems (12 percent). Other red flags include complaints about inadequate pay; previous employment problems; refusal to take vacations; excessive organizational pressure; social isolation; and other financial, legal, or personal stresses.[24]

Defining Corporate Governance

We define **corporate governance** as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders. At a minimum, the monitoring system consists of a board of directors to oversee management and an external auditor to express an opinion on the reliability of financial statements. In most cases, however, governance systems are influenced by a much broader group of constituents, including owners of the firm, creditors, labor unions, customers, suppliers, investment analysts, the media, and regulators (see Figure 1.3).



Source: Chart prepared by David F. Larcker and Brian Tayan (2011).

Figure 1.3 Selected determinants and participants in corporate governance systems.

For a governance system to be economically efficient, it should decrease agency costs more than the costs of implementation. However, because implementation costs are greater than zero, even the best corporate governance system will not make the cost of the agency problem disappear completely.

The structure of the governance system also depends on the fundamental orientation of the firm and the role that the firm plays in society. From a **shareholder perspective** (the viewpoint that the primary obligation of the organization is to maximize shareholder value), effective corporate governance should increase the value of equity holders by better aligning incentives between management and shareholders. From a **stakeholder perspective** (the viewpoint that the organization has a societal obligation beyond increasing shareholder value), effective governance should support policies that produce stable and safe employment, provide an acceptable standard of living to workers, mitigate risk for debt holders, and improve the community and environment.[25] Obviously, the governance system that maximizes shareholder value might not be the same as the one that maximizes stakeholder value.

A broad set of external forces that vary across nations also influence the structure of the governance system. These include the efficiency of local capital markets, legal tradition, reliability of accounting standards, regulatory enforcement, and societal and cultural values. These forces serve as an external disciplining mechanism on managerial behavior. Their relative effectiveness determines the extent to which additional monitoring mechanisms are required.

Finally, any system of corporate governance involves third parties that are linked with the company but do not have a direct ownership stake. These include regulators (such as the SEC), politicians, the external auditor, security analysts, external legal counsel, employees and unions, proxy advisory firms, customers, suppliers, and other similar participants. Third parties might be subject to their own agency issues that compromise their ability to work solely in the interest of the company. For example, the external auditor is employed by an accounting firm that seeks to improve its own financial condition; when the accounting firm also provides nonaudit services, the auditor *might* be confronted with conflicting objectives. Likewise, security analysts are employed by investment firms that serve both institutional and retail clients; when the analyst covers a company that is also a client of the investment firm, the analyst might face added pressure by his firm to publish positive comments about the company that are misleading to shareholders. These types of conflicts can contribute to a breakdown in oversight of management activity.

Corporate Governance Standards

There are no universally agreed-upon standards that determine good governance. Still, this has not stopped blue-ribbon panels from recommending uniform standards to market participants. For example, in December 1992, the Cadbury Committee—commissioned by the accountancy profession and London Stock Exchange "to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing"—issued a *Code of Best Practices* that, in many ways, provided a benchmark set of recommendations on governance.[26] Key recommendations included separating the chairman of the board and chief executive officer titles, appointing independent directors, reducing conflicts of interest at the board level because of business or other relationships, convening an independent audit committee, and reviewing the effectiveness of the company's internal controls. These standards set the basis for listing requirements on the London Stock Exchange and were largely adopted by the New York Stock Exchange (NYSE). However, compliance with these standards has not always translated into effective governance. For example, Enron was compliant with NYSE requirements, including requirements to have a majority of independent directors and fully independent audit and compensation committees, yet it still failed along many legal and ethical dimensions.

Over time, a series of formal regulations and informal guidelines has been proposed to address perceived shortcomings in governance systems as they are exposed. One of the most important pieces of formal legislation relating to governance is the Sarbanes–Oxley Act of 2002 (SOX). Primarily a reaction to the failures of Enron and others, SOX mandated a series of requirements to improve corporate controls and reduce conflicts of interest. Importantly, CEOs and CFOs found to have made material misrepresentations in the financial statements are now subject to criminal penalties. Despite these efforts,