Praise for

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, Vice Chairman, Heidrick & Struggles

“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 Director, Global Head of Corporate Governance & Responsible Investment, BlackRock

“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
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A Closer Look at Organizational Choices and Their Consequences

David Larcker
Brian Tayan
To Sally, Sarah, and Daniel,
Jack, Louise, and Brad
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About the Authors

**David Larcker** is James Irvin Miller Professor of Accounting at the Graduate School of Business of Stanford University; Director of the Corporate Governance Research Program; 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 Program at the Stanford Graduate School of Business. He has written broadly on the subject of corporate governance, including case 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 Program
www.gsb.stanford.edu/cgrp/
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 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, (strategic oversight and risk management, 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.
Introduction to Corporate Governance

Corporate governance has become a well-discussed and controversial topic in both the popular 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).

A Breakdown in Corporate Governance: HealthSouth

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

- 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.
- 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.
• 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).
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, Adelphia, Bear Stearns, Enron, Global Crossing, Lehman Brothers, Tyco, 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 Ahold, Parmalat, Royal Dutch/Shell, Satyam, and Siemens were all plagued by scandal that involved a breakdown 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.
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. 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. 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. 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.\textsuperscript{16}

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 2000 and 2005, 1,009 publicly traded companies filed for Chapter 11 bankruptcy protection in the United States.\textsuperscript{17} 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.\textsuperscript{18} 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 2004 and 2008, approximately 8 percent of publicly traded companies in the United States had to restate their financial results.\textsuperscript{19} 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 Glass Lewis, the average market-adjusted two-day return for companies announcing a restatement was approximately –0.5 percent. In the case of “severe restatements” (classified as those affecting revenue recognition, core earnings, or involving fraud), share losses were –1.5 percent to –2.0 percent. Losses persist well beyond the announcement period, suggesting a material long-term impairment of shareholder value (see Figure 1.2).

Number of U.S.-listed companies that restated, restatements and restatement rate

![Graph showing restatements in the United States]


Figure 1.2  Restatements in the United States

- **Class action lawsuits**—Between 1996 and 2008, 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 $130 billion each year (measured as the change in market capitalization during the class period). Although this is a somewhat crude approximation, this averages $677 million per company (see Figure 1.3).
• **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 2008, the SEC and the U.S. Department of Justice filed approximately 20 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 2008, the SEC enforced more than $380 million in disgorgements, a record amount.20

• **Stock option backdating**—Backdated stock options are those whose grant dates have been retroactively changed to coincide with a relative low in the company's share price. This practice reduces the strike price of the option and increases the potential payoff to its recipient. The *Wall Street Journal*
has identified 167 companies that have engaged in backdat-
ing.\textsuperscript{21} Research suggests that the practice might have been even more pervasive.\textsuperscript{22} Bernile and Jarrell (2009) found that the average abnormal stock market return for the first announcement that a company engaged in backdating is –7 percent.\textsuperscript{23}

- **“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.\textsuperscript{24} 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.

**Defining Corporate Governance**

We define \textbf{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 1.4).
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. According to the authors, 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 non-audit 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 British government “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. Key recommendations included separating the chairman 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, corporate failures stemming from deficient governance systems continue. In 2005, Refco, a large U.S.-based foreign exchange and commodity broker, filed for bankruptcy after revealing that it had hidden $430 million in loans made to its CEO. The disclosure came just two months after the firm raised $583 million in an initial public offering. That same year, mortgage guarantor Fannie Mae announced that it had overstated earnings by $6.3 billion because it had misapplied more than 20 accounting standards relating to loans, investment securities, and derivatives. Insufficient capital levels eventually led the company to seek conservatorship by the U.S. government.

In 2009, Sen. Charles Schumer of New York proposed new legislation to stem the tide of governance collapses. Known as the Shareholder’s Bill of Rights, the legislation stipulated that companies adopt procedural changes designed to give shareholders greater influence over director elections and compensation. Requirements included a shift toward annual elections for all directors (thereby disallowing staggered or classified boards), a standard of majority voting for director elections (instead of plurality voting) in which directors in uncontested elections must resign if they do not receive a majority vote, the right for
certain institutional shareholders to directly nominate board candidates on the company proxy (proxy access), the separation of the chairman and CEO roles, and the right for shareholders to have an advisory vote on executive compensation (say-on-pay). The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act subsequently adopted several of these recommendations, including proxy access and say-on-pay. The interesting question is whether this legislation is a product of political expediency or actually is based on rigorous theory and empirical research.  

Several third-party organizations, such as The Corporate Library and Risk Metrics Group/Institutional Shareholder Services (ISS), attempt to protect investors from inadequate corporate governance by publishing governance ratings on individual companies. These rating agencies use alphanumeric or numeric systems that rank companies according to a set of criteria that they believe measure governance effectiveness. Companies with high ratings are considered less risky and most likely to grow shareholder value. Companies with low ratings are considered more risky and have the highest potential for failure or fraud. However, the accuracy and predictive power of these ratings has not been clearly demonstrated. Critics allege that ratings encourage a “check-the-box” approach to governance that overlooks important context. The potential shortcomings of these ratings were spotlighted in the case of HealthSouth. Before evidence of earnings manipulation was brought to light, the company had a RiskMetrics/ISS rating that placed it in the top 35 percent of Standard & Poor’s 500 companies and the top 8 percent of its industry peers.

Changes in the business environment further complicate attempts to identify uniform standards of governance. Some recent trends include the increased prominence of private equity, activist investors, and proxy advisory firms in the governance space.

- **Private equity**—Private equity firms implement governance systems that are considerably different from those at most public companies. Publicly owned companies must demonstrate independence at the board level, but private equity–owned companies operate with very low levels of independence (almost everyone on the board has a relationship to the company and has a vested interest in its operations). Private equity
companies also offer extremely high compensation to senior executives, a practice that is criticized among public companies but one that is strictly tied to the creation of economic value. Should public companies adopt certain aspects from the private equity model of governance? Would this produce more or less shareholder value?

- **Activist investors**—Institutional investors, hedge funds, and pension funds have become considerably more active in attempting to influence management and the board through the annual proxy voting process. Are the interests of these parties consistent with those of individual shareholders? Does public debate between these parties reflect a movement toward improved dialogue about corporate objectives and strategy? Or does it constitute an unnecessary intrusion by activists who have their own self-interested agendas?

- **Proxy advisory firms**—Recent SEC rules require that mutual funds disclose how they vote their annual proxies. These rules have coincided with increased media attention on the voting process, which was previously considered a formality of little interest. Has the disclosure of voting improved corporate governance? At the same time, these rules have stimulated demand for commercial firms—such as RiskMetrics/ISS and Glass Lewis—to provide recommendations on how to vote on proxy proposals. What is the impact of shareholders relying on third parties to inform their voting decisions? Are the recommendations of these firms consistent with good governance?

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

It is highly unlikely that a single set of best practices exists for all firms, despite the attempts of some to impose uniform standards. Governance is a complex and dynamic system that involves the interaction of a diverse set of constituents, all of whom play a role in monitoring executive behavior. Because of this complexity, it is difficult to assess the impact of a single component. Focusing an analysis on one or two mechanisms without considering the broader context can be a prescription for failure. For example, is it sufficient to insist that a
company separate the chairman and CEO positions without considering who the CEO is and other structural, cultural, and governance features of the company?

Applying a “one-size-fits-all” approach to governance can lead to incorrect conclusions and is unlikely to substantially improve corporate performance. The standards most often associated with good governance might appear to be good ideas, but when applied universally, they can result in failure as often as success. For example, consider the idea of board independence. Is a board consisting primarily of independent directors superior to a board comprised entirely of internal directors? How should individual attributes such as their business acumen, professional background, ethical standards of responsibility, level of engagement, relationship with the CEO, and reliance on director fees to maintain their standard of living factor into our analysis? Personal attributes might influence independence of perspective more than predetermined standards. However, these elements are rarely captured in regulatory requirements.

In governance, context matters. A set of governance mechanisms that works well in one setting might prove disastrous in another. This situation becomes apparent when considering international governance systems. For example, Germany requires labor union representation on many corporate boards. How effective would such a system be in the United States? Japanese boards have few outside directors, and many of those who are outside directors come from banks that provide capital to the firm or key customers and suppliers. What would be the impact on Japanese companies if they were required to adopt the independence standards of the United States? These are difficult questions, but ones that investors must consider when deciding where to allocate their investment dollars.

Relationship between Corporate Governance and Firm Performance

According to a 2002 survey by McKinsey & Company, nearly 80 percent of institutional investors responded that they would pay a premium for a well-governed company. The size of the premium varied
by market, ranging from 11 percent for a company in Canada to around 40 percent for a company in Morocco, Egypt, or Russia (see Figure 1.5). These results imply that investors perceive well-governed companies to be better investments than poorly governed companies. They are also consistent with the idea that governance systems are more important in certain countries than in others.

As we will see throughout this book, many studies link measures of corporate governance with firm operating and stock price performance. Perhaps the most widely cited study was done by Gompers, Ishii, and Metrick (2003). They found that companies that employ “shareholder-friendly” governance features significantly outperform companies that employ “shareholder unfriendly” governance features. This is an important research study, but as we will see in Chapter 13, these results are not completely definitive. Currently, researchers have not produced a reliable litmus test that measures overall governance quality.

The purpose of this book is to provide the basis for constructive debate among executives, directors, investors, regulators, and other constituents that have an important stake in the success of corporations. This book focuses on corporate governance from an organizational instead of purely legal perspective, with an emphasis on exploring the
relationships between control mechanisms and their impact on mitigating agency costs and improving shareholder and stakeholder outcomes.

Each chapter examines a specific component of corporate governance and summarizes what is known and what remains unknown about the topic. We have taken an agnostic approach, with no agenda other than to “get the story straight.” In each chapter, we provide an overview of the specific topic, a synthesis of the relevant research, and concrete examples that illustrate key points.38 Sometimes the evidence is inconclusive (see the following sidebar). We hope that the combination of materials will help you arrive at intelligent insights. In particular, we hope to benefit the individuals who participate in corporate governance processes so that they can make informed decisions that benefit the organizations they serve.

**Interpreting Empirical Research**

Oliver Williamson, winner of the 2009 Nobel Prize in Economics, observed the following:

“I have no doubt that the economics of governance is influential in significant measure because it does speak to real-world phenomena and invites empirical testing .... All feasible forms of organizations are flawed, and ... we need to understand the trade-offs that are going on, the factors that are responsible for using one form of governance rather than another, and the strengths and weaknesses that are associated with each of them.”39

Still, the interpretation of empirical tests (academic, consulting, or other) requires some understanding of their limitations:

1. The results cited in **empirical tests** are typically average results generated from the statistical analysis of large samples of firms. Large samples enable a researcher to identify trends that are generally prevalent across companies. However, they do not tell us what we can expect to find at a specific company. Case or field studies can help answer firm-specific questions, but their results are difficult to generalize because they are based on only a handful of firms that may not be typical of the general population of firms.
2. Empirical tests can identify associations between variables, but they do not demonstrate causality. This is a recurring problem in nonexperimental social science. If we observe a negative stock price return when a company adopts a governance change, it does not tell us that the change caused the stock price decline. It is possible that another (exogenous) factor might have been the cause. Ideally, we would control for this by observing what would have happened had another action been taken (the counterfactual outcome); however, this is impossible to observe. In corporate governance, we do not have the luxury of controlled samples. Still, empirical results are superior to guesswork or intuition.

3. The performance metrics that governance researchers typically use fall into two broad categories: operating metrics and stock price metrics. Operating metrics (such as return on assets and operating cash flow) are somewhat backward looking but are generally considered to provide insight into value changes within the firm. Stock price metrics are typically based on abnormal or excess returns (the so-called alpha, calculated as observed returns minus the expected returns, given the risk of the stock). Assuming reasonably efficient markets, excess returns provide a measure of change in economic value for shareholders. The researcher must determine which metric is better for evaluating the question at hand. The choice will depend on whether the market should be able to anticipate the impact of interest.

4. Another metric that is commonly used in governance research is the ratio of market-to-book value (sometimes referred to as Tobin’s Q or simply Q). Q is based on the theory that a firm with superior performance will trade in the market at a valuation that is higher than the accounting value of its net assets. While this may be true, we view Q to be an ambiguous measure of firm performance and inferior to traditional operating metrics and excess stock price returns.
5. We sometimes refer to **event studies**. Event studies measure the stock market’s reaction to news or events. These studies have validity only to the extent that the reader believes that markets are at least partly efficient. Even if so, event studies cannot easily control for confounding events (such as other news released by the company during the measurement period). Moreover, event studies require the researcher to make important risk adjustments when computing excess stock returns. Although several risk adjustments have become “accepted,” their computation is complex, and it is difficult to know whether the researcher made them properly.

### Endnotes

1. Some material in this chapter is adapted from David F. Larcker and Brian Tayan, “Models of Corporate Governance: Who’s the Fairest of Them All?” Stanford GSB Case No. CG 11, January 15, 2008. See https://gsbapps.stanford.edu/cases/detail1.asp?Document_ID=3054. Copyright 2008 by the Board of Trustees of the Leland Stanford Junior University. All rights reserved. Used with permission from the Stanford University Graduate School of Business.


5. In re: HealthSouth Corporation Bondholder Litigation. United States District Court Northern District of Alabama Southern Division. Master File No. CV-03-BE-1500-S.


8. HealthSouth Corporation, Form DEF14-A.


11. HealthSouth Corporation, Form DEF14-A.


13. This issue was the basis of the classic discussion in Adolph Berle and Gardiner Means, The Modern Corporation and Private Property (New York: Harcourt, Brace, and World, 1932).

14. The phrase rent extraction is another commonly used term for agency costs and refers to economic costs taken out of the system without any corresponding contribution in productivity.


16. For example, a study by Boivie, Lange, McDonald, and Westphal found that CEOs who strongly identify with their company are less likely to accept expensive perquisites or make other decisions that are at odds with shareholder interests. Source: Steven Boivie, Donald Lange, Michael L. McDonald, and James D. Westphal, “Me or We: The Effects of CEO Organizational Identification of Agency Costs,” Academy of Management Proceedings (2009): 1-6.


18. Enforcement actions are measured as the number of Accounting and Auditing Enforcement Releases (AAER) by the SEC. The SEC issues an AAER for alleged violations of SEC and federal rules. Academic researchers have used AAER as a proxy for severe fraud because most companies that commit financial statement fraud receive SEC enforcement actions.


25. The cost–benefit assessment of a governance system also depends on whether the company operates under a shareholder-centric or stakeholder-centric model. The fundamentally different orientation of these models makes it difficult for an outside observer to compare their effectiveness. For example, a decision to maximize shareholder value might come at the cost of the employee and environmental objectives of stakeholders, but comparing these costs is not easy. We discuss this more in Chapter 2, “International Corporate Governance.”


33. Sonnenfeld has written, “At least as important are the human dynamics of boards as social systems where leadership character, individual values, decision-making processes, conflict management, and strategic thinking will truly differentiate a firm’s governance.” Jeffrey Sonnenfeld, “Good Governance and the Misleading Myths of Bad Metrics,” *Academy of Management Executive* 18 (2004): 108–113.


36. This is what investors say they would do when asked in a formal survey. However, this study does not provide evidence that investors actually take governance into account when making investment decisions.


38. We are not attempting to provide a complete and comprehensive review of the research literature. Our goal is to select specific papers that provide a fair reflection of general research results.

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