CORPORATE GOVERNANCE MATTERS

A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES

DAVID LARCKER
BRIAN TAYAN

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

This page intentionally left blank

Corporate Governance Matters

This page intentionally left blank

Corporate Governance Matters

A Closer Look at Organizational Choices and Their Consequences

David Larcker
Brian Tayan

Vice President, Publisher: Tim Moore
Associate Publisher and Director of Marketing: Amy Neidlinger
Executive Editor: Jeanne Glasser
Editorial Assistant: Pamela Boland
Operations Manager: Gina Kanouse
Senior Marketing Manager: Julie Phifer
Publicity Manager: Laura Czaja
Assistant Marketing Manager: Megan Colvin
Cover Designer: Chuti Prasertsith
Managing Editor: Kristy Hart
Senior Project Editor: Lori Lyons
Copy Editor: Krista Hansing Editorial Services, Inc.
Proofreader: Language Logistics, LLC
Indexer: Angie Martin
Senior Compositor: Gloria Schurick
Manufacturing Buyer: Dan Uhrig

© 2011 by Pearson Education, Inc.
Publishing as FT Press
Upper Saddle River, New Jersey 07458

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.

FT Press offers excellent discounts on this book when ordered in quantity for bulk purchases or special sales. For more information, please contact U.S. Corporate and Government Sales, 1-800-382-3419, corpsales@pearsontechgroup.com. For sales outside the U.S., please contact International Sales at international@pearson.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 April 2011

ISBN-10: 0-13-218026-X
ISBN-13: 978-0-13-218026-9

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educatio[ac]n de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Cataloging-in-Publication Data

Larcker, David F.
Corporate governance matters : a closer look at organizational choices and their consequences / David F. Larcker, Brian Tayan.
p. cm.
ISBN 978-0-13-218026-9 (hardback : alk. paper)
1. Corporate governance. I. Tayan, Brian, 1975- II. Title.
HD2741.L3153 2012
658.4—dc22

2011002152

To Sally, Sarah, and Daniel,

Jack, Louise, and Brad

This page intentionally left blank

Contents

	Preface	xv
Chapter 1	Introduction to Corporate Governance	1
Chapter 2	International Corporate Governance	23
Chapter 3	Board of Directors: Duties and Liability	67
Chapter 4	Board of Directors: Selection, Compensation, and Removal	93
Chapter 5	Board of Directors: Structure and Consequences	127
Chapter 6	Organizational Strategy, Business Models, and Risk Management	169
Chapter 7	Labor Market for Executives and CEO Succession Planning	203
Chapter 8	Executive Compensation and Incentives	237
Chapter 9	Executive Equity Ownership	287
Chapter 10	Financial Reporting and External Audit	325
Chapter 11	The Market for Corporate Control	361
Chapter 12	Institutional Shareholders and Activist Investors	393
Chapter 13	Corporate Governance Ratings	433
Chapter 14	Summary and Conclusions	459
	Index	467

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 and Thomas Friel (Heidrick & Struggles), H. Ross Brown (Egon Zehnder), and David Lord (Executive Search Information Services) provided real-world insight into CEO succession planning, the executive recruitment process, and the labor market for directors. Alan Jagolinzer (University of Colorado), Brendan Sheehan (Cross Border USA), and Lois Cartwright (Merrill Lynch) assisted in our understanding of executive hedging and pledging and the behavioral implications of executive equity ownership. Jack Zwingli (GovernanceMetrics International) explained professional models to detect financial manipulation through the combination of accounting and corporate governance data. Abe Friedman (BlackRock) 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 the Stanford Graduate School of Business for his support of the Corporate Governance Research Program. We would also like to thank David Chun (Equilar) and Thomas Quinn (FactSet TrueCourse) for providing some of the data used in the book.

We are grateful to Christopher Armstrong, Maria Correia, Ian Gow, Allan McCall, Gaizka Ormazabal, Daniel Taylor, and Anastasia Zakolyukina 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.

Finally, we are grateful to the high-quality support provided by Jeanne Glasser, Lori Lyons, Krista Hansing, and others at Pearson. We would like to thank Stephen Kobrin for encouraging us to write this book.

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/

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 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.

1

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).[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]

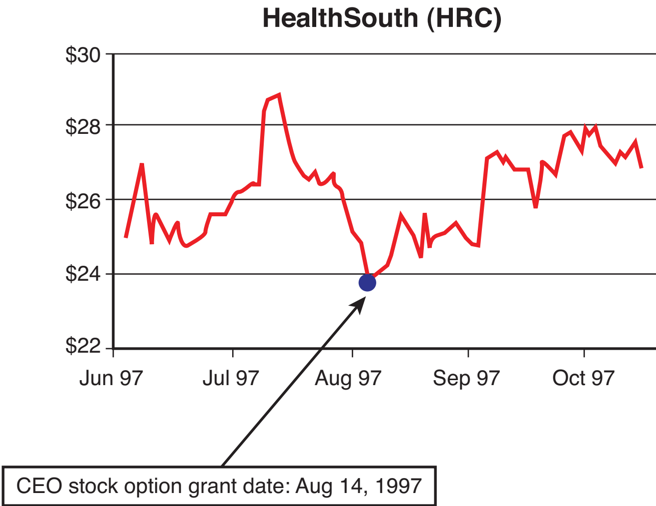
What was the external auditor (Ernst & Young) doing?

- 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, 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.[13] 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.[14] 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.[15] 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.[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).

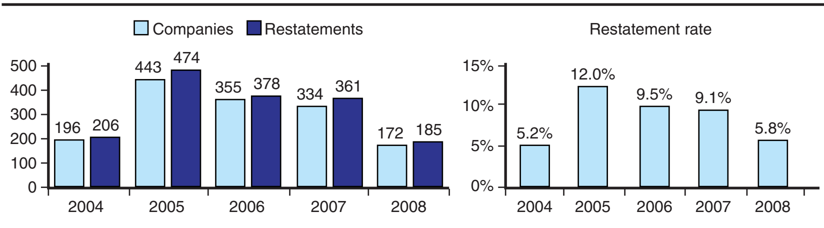
Evidence of Self-Interested Behavior

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.[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.[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.[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).

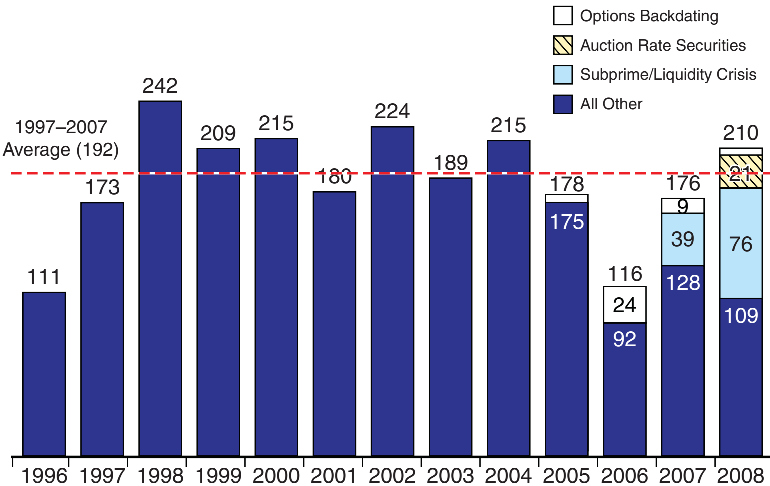


Source: Mark Grothe and Poonam Goyal (2009).

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).

CAF Index™ – Annual Number of Class Action Filings 1996–2008



Source: *Securities Class Action Filings 2008: A Year in Review,* Cornerstone Research.

Figure 1.3 Annual number of class action filings (1996–2008)

- **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*

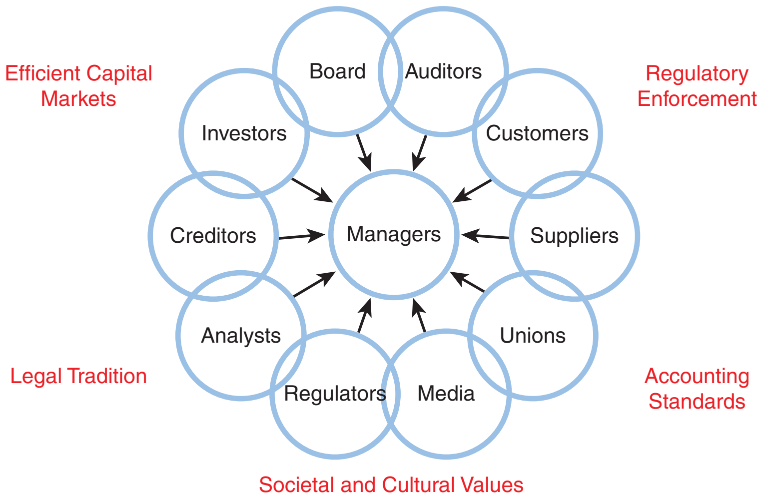
has identified 167 companies that have engaged in backdating.[21] Research suggests that the practice might have been even more pervasive.[22] Bernile and Jarrell (2009) found that the average abnormal stock market return for the first announcement that a company engaged in backdating is –7 percent.[23]

- **"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.[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 **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).



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

Figure 1.4 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 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.[26] 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.[27] 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.[28]

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.[29]

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.[30]

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.[31] 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?

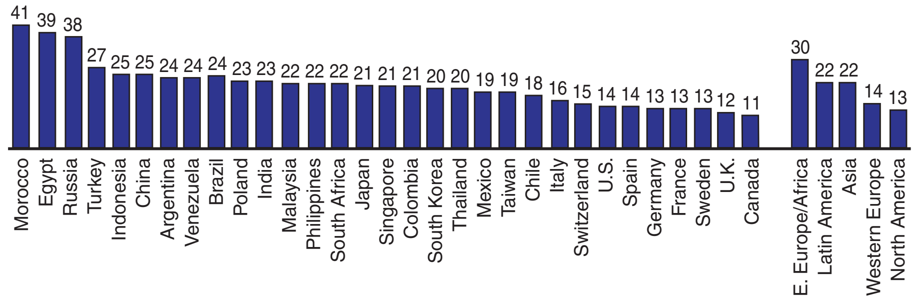
Applying a "one-size-fits-all" approach to governance can lead to incorrect conclusions and is unlikely to substantially improve corporate performance. The standards most often associated with good governance might appear to be good ideas, but when applied universally, they can result in failure as often 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?[32] Personal attributes might influence independence of perspective more than predetermined standards.[33] However, these elements are rarely captured in regulatory requirements.[34]

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).[35] These results imply that investors perceive well-governed companies to be better investments than poorly governed companies.[36] They are also consistent with the idea that governance systems are more important in certain countries than in others.



Source: Paul Coombes and Mark Watson (2002). "Global Investor Opinion Survey 2002: Key Findings." McKinsey & Company.

Figure 1.5 Indicated premiums for good corporate governance, by country.

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).[37] 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.
2. See Aaron Beam and Chris Warner, *HealthSouth: The Wagon to Disaster* (Fairhope, AL: Wagon Publishing, 2009).
3. Lisa Fingeret Roth, "HealthSouth CFO Admits Fraud Charges," FT.com (March 26, 2003). See http://proquest.umi.com/pqdweb?did=318664941&sid=1&Fmt=3&clientId=12498&RQT=309&VName=PQD.
4. HealthSouth Corporation, Form DEF14-A, filed with the Securities and Exchange Commission, May 16, 2002.
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.
6. Chad Terhune and Carrick Mollenkamp, "HealthSouth Officials May Sign Plea Agreements—Moves by Finance Executives Would Likely Help Build Criminal Case Against CEO," *Wall Street Journal* (March 26, 2003, Eastern edition): A.14.
7. Carrick Mollenkamp, "Some of Scrushy's Lawyers Ask Others on Team for Money Back," *Wall Street Journal* (December 17, 2003, Eastern edition): A.16.
8. HealthSouth Corporation, Form DEF14-A.

9. Dan Ackman, "CEO Compensation for Life?" Forbes.com (April 25, 2002). Accessed November 16, 2010. www.forbes.com/2002/04/25/0425ceotenure.html.

10. HealthSouth Corporation, Form DEF14-A. See also Jonathan Weil and Cassell Bryan-Low, "Questioning the Books: Audit Committee Met Only Once During 2001," *Wall Street Journal* (March 21, 2003, Eastern edition): A.2.

11. HealthSouth Corporation, Form DEF14-A.

12. Ken Brown and Robert Frank, "Analyst's Bullishness on HealthSouth's Stock Didn't Waver," *Wall Street Journal* (April 4, 2003, Eastern edition): C.1.

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.

15. Gary Becker, *The Economic Approach to Human Behavior* (Chicago: University of Chicago Press, 1976).

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.

17. Deloitte, "Ten Things about Bankruptcy and Fraud: A Review of Bankruptcy Filings," Deloitte Forensic Center (2008). See www.deloitte.com/view/en_US/us/Services/Financial-Advisory-Services/Forensic-Center/1d42a68c4d101210VgnVCM100000ba42f00aRCRD.htm.

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.

19. Mark Grothe, "The Errors of Their Ways," Yellow Card Trend Report, Glass Lewis & Co. (February 27, 2007).

20. David C. Weiss, "The Foreign Corrupt Practices Act, SEC Disgorgement of Profits, and the Evolving International Bribery Regime: Weighing Proportionality, Retribution, and Deterrence," *Michigan Journal of International Law* 30 (2009): 147. See www.heinonline.org/HOL/Page?handle=hein.journals/mjil30&id=1&size=2&collection=journals&index=journals/mjil.

21. Anonymous, "Perfect Payday: Options Scorecard," Wall Street Journal Online (2007). See http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

22. Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science* 51 (2005): 802–812. Lucian A. Bebchuk, Yaniv Grinstein, and Urs C. Peyer. "Lucky CEOs and Lucky Directors," *Journal of Finance* 65 (2010): 2,363–2,401.

23. Gennaro Bernile and Gregg A. Jarrell, "The Impact of the Options Backdating Scandal on Shareholders," *Journal of Accounting and Economics* 47 (2009): 1–2. Also Accounting Research on Issues of Contemporary Interest (March 2009): 2-26.

24. John Graham, Campbell Harvey, and Shiva Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal* 62 (2006): 27–39.

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."

26. Cadbury Committee, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee, 1992).

27. Deborah Solomon, Carrick Mollenkamp, Peter A. McKay, and Jonathan Weil, "Refco's Debts Started with Several Clients; Bennett Secretly Intervened to Assume Some Obligations; Return of Victor Niederhoffer," *Wall Street Journal* (October 21, 2005, Eastern edition): C1.

28. James R. Hagerty, "Politics & Economics: Fannie Mae Moves Toward Resolution with Restatement," *Wall Street Journal* (December 7, 2006, Eastern edition) A.4. Damian Paletta, "Fannie Sues KPMG for $2 Billion Over Costs of Accounting Issues," *Wall Street Journal* (December 13, 2006, Eastern edition): A.16.

29. A forthcoming study by Larcker, Ormazabal, and Taylor found that the legislative provisions in Schumer and Dodd–Frank are associated with negative stock price returns for affected companies. These results seemed to have little impact on the congressional debate. Similarly, the legislators who drafted the Sarbanes–Oxley Act of 2002 did not take into account research literature. See David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor, "The Market Reaction to Corporate Governance Regulation," *Journal of Financial Economics* (forthcoming); and Roberta Romano, "The Sarbanes–Oxley Act and the Making of Quack Corporate Governance," *Yale Law Review* 114 (2005): 1,521–1,612.

30. Cited in Jeffrey Sonnenfeld, “Good Governance and the Misleading Myths of Bad Metrics,” *Academy of Management Executive* 18 (2001): 108–113.

31. Securities Lawyer’s Deskbook. “Investment Company Act of 1940. Rule 30b1-4,” *The University of Cincinnati College of Law*. See www.law.uc.edu/CCL/InvCoRls/rule30b1-4.html. See also “Report of Proxy Voting, Record Disclosure of Proxy Voting Policies, and Proxy Voting Records by Registered Management Investment Companies,” Securities and Exchange Commission: 17 CFR Parts 239, 249, 270, and 274 Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02. www.sec.gov/rules/final/33-8188.htm.

32. The NYSE acknowledges this risk. See Chapters 3, “Board of Directors: Duties and Liability,” and 5, “Board of Directors: Structure and Consequences,” for a more detailed discussion of board independence.

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.

34. Milton Harris and Artur Ravi, “A Theory of Board Control and Size,” *Review of Financial Studies* 21 (2008): 1,797–1,831.

35. Paul Coombes and Mark Watson, “Global Investor Opinion Survey 2002: Key Findings,” McKinsey & Co. (2002). Accessed November 1, 2010. See www.mckinsey.com/clientservice/organizationleadership/service/corpgovernance/pdf/globalinvestoropinionsurvey2002.pdf.

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.

37. Paul Gompers, Joy Ishii, and Andrew Metrick, “Corporate Governance and Equity Prices,” *Quarterly Journal of Economics* 118 (2003): 107–155.

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.

39. Emphasis added. Nobel Prize Organization, “Oliver E. Williamson—Interview” (2009). See http://nobelprize.org/nobel_prizes/economics/laureates/2009/williamson-telephone.html.

This page intentionally left blank

INDEX

8-K forms, 330
2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, 12

A

A-shares, 51
AAAA (Associated Actors and Artists Association), 411
ABI (Association of British Insurers), 352
abnormal accruals, 339
abuses by executives, checks and balances system, 1-8
academic researchers, 448-453
accountability, board evaluations, 116
Accounting and Governance Risk (AGR) scores, 339
accounting
- audit committee responsibilities, 327
- equity ownership, 292-293
- fraud, decentralized organizations, 337-338
- models for detecting manipulations, 338-341
- standards, influence on governance system, 28-31

accredited investors, 416
accrual accounting, 339
acquirers (company making offer), 362
acquisitions
- antitakeover protections. *See* antitakeover protections
- friendly, 362
- hostile takeovers, 362
- impact on corporate performance, 367-372

Active Advisor (CEO), 220
active investors, 394
activist investors, 13, 394, 406-410
- hedge funds, 416-419
- institutional funds with a social mission, 414-416
- pension funds, 413
- shareholder democracy, 419-424

advantages (corporate strategy), 171
advisory capacity (board of directors), 67
advisory directors, 99
Aetna, changes in CGQ, 447
AFL-CIO (American Federation of Labor and Congress of Industrial Organizations), 411
agencies
- costs, equity ownership, 292
- statistics, 5-6, 8

Aggressor (CEO), 221
AGR (Accounting and Governance Risk) scores, 339
AICPA (American Institute of Certified Public Accountants), 348, 352
AIG (American International Group), governance rating error, 444-445
Airline Pilots Association (ALPA), 411
AirNet Systems
- hedging policies and disclosure, 310-311
- pledging policies and disclosure, 313

ALPA (Airline Pilots Association), 411
American Electric Power, 228
American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), 411

American Institute of Certified Public Accountants (AICPA), 348, 352
American International Group (AIG), governance rating error, 444-445
Ameriprise Financial, 268
Amgen, 276
Analog Devices, 104
Anglo-Saxon model of governance, 38
annual bonuses, executive compensation, 241
annual incentives, executive compensation, 262-264
annual salaries, executive compensation, 241
antitakeover defenses, 363
antitakeover protections, 363, 373
- dual-class stocks, 374, 382-384
- poison pills, 374-379
- rank by level of protectiveness, 384-386
- staggered boards, 375, 379-380
- state of incorporation, 380-382

assets under management (AUM), 180
Associated Actors and Artists Association (AAAA), 411
Association of British Insurers (ABI), 352
audit committees, 72
- financial reporting quality, 329-330
- responsibilities, 326-329

audits. *See* external audits; quality audits
AUM (assets under management), 180
average employee, pay inequity, 257-259

B

B-shares, 51
Bank of America, 134
Bankers, as members of board of directors, 147-148
bankruptcy statistics, 5
BASF versus Engelhard Corporation, 371-372
behavior (executives), relationship to equity ownership, 287
- accounting manipulation, 292-293
- agency costs, 292
- CEOs, 287-288
- equity sales and hedging, 298-299
- firm performance, 288-291
- hedging, 306-312
- insider trading, 300-302
- manipulation of equity grants, 294-298
- pledging shares, 312-314
- repricing/exchange offers, 314-317
- Rule 10b5-1, 302-306
- target ownership plans, 291-292

benchmarking executive compensation, 247-250
benefits, executive compensation, 245, 268-269
best practices, 13-14
- Cadbury Committee Code of Best Practices, 10
- governance reform, 39-40
- insufficient testing, 460-461

bidders, 362
Big Four (audit industry), 345-347
black swans (unpredictable events), 188
blackout period, 301
BlackRock, 394
blockholders, 395-398
board classification, 379-380
board committees, 72-76
board evaluation, directors, 115-117
board of directors, 66-67
- board observers, 100-101
- Cadbury Committee Code of Best Practices, 40
- compensation, 108-117
- disclosure requirements for qualifications, 103-105
- duration of director terms, 76-77
- elections, 77-79
- executive compensation, 240-247
- independence, 69
- legal duties. *See* legal duties
- market for directors, 93-102
- operations, 70-76
- recruitment process, 105-107
- removal of directors, 79, 117-121
- responsibilities
  - *business model development, 175-180*
  - *identification of KPIs, 180-186*
  - *organizational strategy, 170-172*
  - *risk management, 186-198*
  - *strategic guidance of company, 169*
  - *strategy implementation, 173-175*

structure, 127-128, 160-161
bankers, 147-148
busy directors, 151-154
chairman of the board, 129, 133, 136
diversity, 157-158
employee representation, 149-151
female directors, 158-160
financial experts, 148
independent committees, 146-147
independent directors, 142-145
interlocked boards, 154-155
lead independent directors, 136-139
outside directors, 139-142
politically connected directors, 149
size, 155-156
Toyota, 47
Bombay Stock Exchange, 54
Bostock, Roy, 386
Bovespa (São Paulo Stock Exchange), 55
Brazil, governance structure, 55-56
British model of governance, 38
broker nonvotes, shareholder democracy, 421
Buffett, Warren, 402
bullet-dodging options, 298
burn rate in equity-based compensation, 405
business judgment rule, 84
business model development, 175-180
busy directors
board of directors, 151-154
interlocked boards, 154-155

C

Cadbury Committee Code of Best Practices, 10, 40-42
***The Cadbury Report* (1992), 39-40**
Calhoun, David, 205
capital market efficiency
Brazil, 55
influence on governance system, 24-27
Capitulator (CEO), 221
cash from operations, 263
causal business model, 174
CD&A (Compensation Discussion & Analysis), 240, 274
CEOs. *See also* executives
active, market for directors, 97-98
compensation. *See* compensation, executives
equity ownership, 287-288
labor market, 203-213
models for succession, 213-218
outgoing, 107
separation from the chairman of the board, 132-136
severance agreements, 228, 230
succession-planning process, 218-230
turnover, 208
CGQ (Corporate Governance Quotient), 437-439
chaebol structure (South Korea), 49
chairman of the board, 70, 129-136
charter provisions, 375
checks and balances system, 1-8
Chesapeake Energy, 314
China, governance structure, 51-53
China National Petroleum Corp. (CNPC), 53
CII (Confederation of Indian Industries), 53
Cisco Systems, 75
Citadel Broadcasting, 315
Citigroup, 246
civil-code tradition, Germany, 44
claims and payments, D&O insurance, 87
class action lawsuits, 6
classified boards, 76, 375-380
Clause 49 (India), 53
clawbacks, 245-247
CNPC (China National Petroleum Corp.), 53
Coca-Cola Company, 112
***Code of Best Practices* (Cadbury Committee), 10, 40-42**
codetermination, 34
commercial bankers, 147
committee fees, 109
Committee of Sponsoring Organizations (COSO) framework, 190-192
committees
board, 72-76
independent, 146-147
common shares, 55
Companies Act 1985, 39
Companies Act 2006, 83
Company Law of the People's Republic of China, 52

compensation
committee fees, 73, 109
components of, 240-247
directors, 108-117
equity-based, 405-406
executives, 238
benefits and perquisites, 268-269
components of, 240-247
consultants, 250-252
determining level of, 247-250
incentives, 260-266
levels of, 252-254
package structure, 259
pay for performance contracts, 269-274
pay inequity, 254-259
reform efforts, 274-278
risk disclosure, 267-268
shareholder say-on-pay, 276
United States, 38
incentives, 365-367
lead independent directors, 110
nonexecutive chairmen, 110
reform, 43
Compensation Discussion & Analysis (CD&A), 240, 274
***Competitive Strategy*, 172**
compliance risk, 189
comply or explain practice, United Kingdom, 42
components of compensation, 240-247
composition, board evaluations, 116
Confederation of Indian Industries (CII), 53
consultants, 250-252
contested elections, 78
context, governance systems, 464-465
contracts, executive compensation, 245-246
control activities (COSO risk management framework), 191
controls, Cadbury Committee Code of Best Practices, 42
conventionally independent directors, 144
corporate control, 361-365
acquisitions, 367-386
corporate governance
defined, 8-9
standards, 10-13
Corporate Governance Code
Germany, 44
India, 53
Corporate Governance Quotient (CGQ), 437-439
Corporate Governance Rules (NYSE), 36
The Corporate Library, 12
corporate strategy
aspects, 171
business model development, 175-180
identification of key performance measures, 180-186
identification of mission, 170-172
implementation process, 173-175
risk management, 186-193
corporations
chaebol structure (South Korea), 49
Chinese model of governance, 51
COSO (Committee of Sponsoring Organizations) framework, 190-192
cost, performance measures, 183
country-specific accounting standards, 29
Covidien, 104
credit ratings, 434-437
credit-rating agencies, 434
creditworthiness, 434
Crimson Exploration, 301
CRM (customer resource management), 175
culture
influence on governance system, 32-35
risk, 191
cumulative pay consideration, executive compensation reform, 277
cumulative voting procedures, 77-78
customer resource management (CRM), 175

D

D&O (directors' and officers') insurance
board of directors, 86-88
claims and payments, 87
Datalink Corporation, 303
decentralization, internal controls, 337-338
defense mechanisms, poison pills, 49
deferred payout provisions, 245-247
defining corporate governance, 8-10
democracy, shareholders, 419
broker nonvotes, 421
majority voting, 420

proxy access, 422-423
proxy voting, 424
detecting accounting manipulations, models, 338-341
accrual accounting, 339
AGR scores, 339
linguistic-based analysis, 340
determinants (corporate governance systems), 8
dimension, performance measures, 183
director indemnification, 86-88
directors
advisory, 99
busy, 151-154
compensation, 108-117
disclosure requirements for qualifications, 103-105
female, 158-160
independent, 142-145
lead independent, 136-139
mandatory retirement age, 128
market for, 93-102
observer, 99-101
outside, 139-142
politically connected, 149
recruitment process, 105-107
removal of, 117-121
Directors' Remuneration Report Regulations, 43
disclosure
10b5-1 plans, 303-304
board of directors, 83-84
Brazilian board members, 55
compensation consultants, 251-252
Dodd–Frank Financial Reform Act of 2010, 37
executive compensation and risk, 267-268
hedging, 310-311
pledging shares, 313-314
requirements for director qualifications, 103-105
discount to fair value, exchange offers, 315
dismissals, 353
Disney case, 85
diverse directors, 101
diversification, 363
board of directors, 157-158
executive portfolio, 298-299
Dodd–Frank Financial Reform Act of 2010, 37, 79
Dodd–Frank Wall Street Reform and Consumer Protection Act (2010), 12
Doyle, David, 308
dual-class stocks, 374, 382-384
dual-class structure, 77
duration, board of directors' terms, 76-77
duties
audit committee, 326-329
board of directors, 67-68
business model development, 175-180
candor, 81
care, 80
identification of KPIs, 180-186
loyalty, 81
organizational strategy, 170-172
risk management, 186-198
strategic guidance of the company, 169
strategy implementation, 173-175

E

economic value added (EVA), 113
EFAA (European Federation of Accountants and Auditors), 353
elections, board of directors, 77-79
empire building, 365
empirical tests, 16-18
employee representation, board of directors, 149-151
employee stock ownership plans (ESOPs), 150
enforcement actions (SEC), 86
enforcement
regulations, 31-32
securities laws, 85-86
state corporate law, 84-85
Engelhard Corporation versus BASF, 371-372
enterprise resource programs (ERPs), 175
environment
corporate strategy, 171
factors influencing governance system, 23-35
equal to fair value, exchange offers, 315
equity grants, 294-298
equity ownership (executives), 287
accounting manipulation, 292-293
agency costs, 292
CEOs, 287-288
equity sales and hedging, 298-299
firm performance, 288-291

hedging, 306-312
insider trading, 300-302
manipulation of equity grants, 294-298
pledging shares, 312-314
repricing/exchange offers, 314-317
Rule 10b5-1, 302-306
target ownership plans, 291-292
equity sales, 298-299
equity-based compensation plans, 405-406
ERPs (enterprise resource programs), 175
errors, financial restatements, 330
ESOPs (employee stock ownership plans), 150
European Federation of Accountants and Auditors (EFAA), 353
EVA (economic value added), 113
evaluations
board of directors, 115-117
designing, 116
event identification (COSO risk management framework), 191
event studies, 18
evidence of self-interested behaviors, 5
excessive risk taking, 266
exchange offers, equity ownership, 314-317
Excite, 100
executive directors
Brazil, 55
Cadbury Committee Code of Best Practices, 41
executive sessions, 71, 136
executives
checks and balances system, 1-8
compensation. *See* compensation, executives
equity ownership. *See* equity ownership (executives)
portfolio diversification, 298-299
exercise backdating options, 298
expanded constituency, 82
expense recognition errors, financial restatements, 331-333
expertise, market for directors, 99
expressed opinion, external audits, 343
external auditors
CFO as, 350-352
fraud, 344-345
external audits, 325-326, 341-343
assessment of internal controls, 342
audit preparation, 341
communication with audit committee, 343
expressed opinion, 343
fraud evaluation, 342
review of estimates and disclosures, 341
external candidates, CEO succession model, 213
external succession (CEOs) versus internal, 214
ExxonMobil, 246

F

factors, governance system influences, 23-24
accounting standards, 28-31
capital market efficiency, 24-27
country's legal tradition, 27-28
enforcement of regulations, 31-32
societal and cultural values, 32-35
families, shareholders, 398-399
family-controlled business groups, 25
Fannie Mae, 11
FASB (Financial Accounting Standards Board), 35, 327
FCPA (Foreign Corrupt Practices Act) violations, 7
FEE (Fédération des Experts Comptable Européens), 353
female directors, 158-160
fiduciary duties, board of directors, 80-83
Fifth Third Bancorp, Risk and Compliance Committee, 75
Financial Accounting Standards Board (FASB), 35, 327
financial experts, 148, 326
financial KPIs, 181
financial reporting, 325-326
audit committee, 326-330
audit quality, 345-354
external audits, 325-326, 341-343
financial restatements, 330-337
models for detecting accounting manipulations, 338-341
financial restatements, 330-337
Krispy Kreme Doughnuts, 335-336
statistics, 5
financial risk, 189
Financial Services Authority (Japan), 49
financial synergies, 363

firm performance
relationship to corporate governance, 14-18
relationship to equity ownership, 288-291
focus on functions of governance, 461-462
Ford, William, Jr., 219
Foreign Corrupt Practices Act, 7, 328
Form 8-K, 330
founders, shareholders, 398-399
fraud
decentralized organizations, 337-338
external auditors, 344-345
evaluations, 342
freerider problem, 395
friendly acquisitions, 362
functions of governance, 461-462

G

G-Index (governance index), 450
GAAP (generally accepted accounting principles), 29
GAAS (Generally Accepted Auditing Standards), 348
GAO (General Accounting Office), 353
General Mills, Public Responsibility Committee, 76
General Motors, 134
Gephardt, Richard, 219
Germany, governance structure, 44-46
Glass Lewis, 401
GMI (GovernanceMetrics International), 441
golden parachutes, 228-230
good faith (board of directors), 84
governance committees, 73
governance index (G-Index), 450
governance ratings. *See* ratings
Governance Risk Indicators (GRiD), 439-440
GovernanceMetrics International (GMI), 441
Greenberg, Hank, 445
The Greenbury Report (1995), 39
GRiD (Governance Risk Indicators), 439-440
groupthink, 157
guidelines, stock ownership, 245

H

H-shares, 51
The Hampel Report (1998), 39
harmonization, accounting standards, 29-30
HealthSouth Corp., breakdown in corporate governance, 1-3
hedge funds, 416-419
hedging
equity ownership, 298-299, 306-312
transactions, 311
Heinz Company, 192-193
herding behavior, 365-366
The Higgs Report (2003), 40
high water marks, 417
Hill, Bonnie, 138
Hockaday, Irvine, Jr., 152
Hofstede model of cultural dimensions, 33
Hofstede, Geert, 33
Home Depot
lead independent director, 138
severance agreements, 229
Hopeful Savior (CEO), 221
horse race, CEO succession model, 216-217
hostile takeovers, 362
hot money, 417
hubris, 365-366

I

IAB (International Advisory Board), 47
IASB (International Accounting Standards Board), 29, 327
IBEW (International Brotherhood of Electrical Workers), 411
Icahn, Carl, 386
identification of mission, organizational strategy, 170-172
IDW (Institut der Wirtschaftsprüfer), 353
IFRS (International Financial Reporting Standard), 29
illegal insider trading, 300
implementation process, organizational strategy, 173-175
incentives. *See* compensation
incorporated states, 380-382
indemnification, board of directors, 86-88

independence, board of directors, 69
independent chairman, 132-133
independent committees, 146-147
independent directors, 142-145
India, governance structure, 53-55
indirect influence of shareholders, 395
individual structures, national governance, 35
  Brazil, 55-56
  China, 51-53
  Germany, 44-46
  India, 53-55
  Japan, 46-49
  Russia, 57-59
  South Korea, 49-51
  United Kingdom, 38-44
  United States, 35-38
individualism (cultural attribute), 33
information and communication (COSO risk management framework), 191
information gap, 133, 139
inside-outside model, CEO succession model, 217-218
insider trading
  equity ownership, 300-302
  Rule 10b5-1, 302-305
  trading window, 301
Institut der Wirtschaftsprüfer (IDW), 353
institutional funds with a social mission, 414-416
institutional shareholders, 393
  activist investors, 406-410, 413-424
  blockholders, 395-398
  founders and families, 398-399
  proxy advisory firms, 401-404
  proxy voting, 399-401
  roles, 393-395
  shareholder proposal, 407
insufficient testing, 460-461
insurance, D&O (directors' and officers'), 86-88
interlocked boards, 154-155
internal control monitoring, 328
internal controls
  assessment of external audits, 342
  decentralized organizations, 337-338
internal environment consideration (COSO risk management framework), 191
internal succession (CEOs) versus external, 214
International Accounting Board (IAB), 327
International Accounting Standards Board (IASB), 29
International Accounting Standards Committee, 29
International Advisory Board (IAB), 47
International Brotherhood of Electrical Workers (IBEW), 411
International Brotherhood of Teamsters, 411
international corporate governance
  factors influencing system, 23-24
    accounting standards, 28-31
    capital market efficiency, 24-27
    country's legal tradition, 27-28
    enforcement of regulations, 31-32
    societal and cultural values, 32-35
  individual structures. *See* individual structures, national governance
International Financial Reporting Standard (IFRS), 29
interpretation
  empirical testing, 16-18
  performance measures, 183
Intuit, 100
Investment and Finance Committee (Cisco Systems), 75
investment bankers, as members of board of directors, 148
Investor AB, 25
investors
  accredited, 416
  active, 394, 406-410, 413-424
  passive, 394
ISS/RiskMetrics, 399-401

J–K

Japan, governance structure, 46-49
Jeffries, Michael, 255

keiretsu, 46
Kerr, Sir John, 138
key performance indicators (KPIs), 180-186
Kilts, James, 205
King Report (1994), 83
King Report II (2001), 83
King Report III (2009), 83
Knight, Phil, 214

KPIs (key performance indicators), 180-186
Krispy Kreme Doughnuts, 335-336
Kroger, 249-250
Kumarmangalam Birla Committee, 53

L

labor market for CEOs, 203-206
 newly appointed CEOs, 211-213
 pool of talent, 206-207
 turnover rate, 208-211
LBO (leveraged buyout), 362
lead independent directors, 136-139
 compensation, 110
 Home Depot, 138
 Royal Dutch Shell, 138
lean manufacturing, 184
legal duties, board of directors, 79
 D&O insurance, 86-88
 director indemnification, 86-88
 disclosure obligations under securities laws, 83-84
 enforcement of securities laws, 85-86
 enforcement of state corporate law, 84-85
 fiduciary duties, 80-83
legal tradition, influence on governance system, 27-28
Lehman Brothers, 140
levels of compensation, 252-254
leveraged buyout (LBO), 362
liabilities, board of directors, 67-68
Lilly, 267
limits on compensation, 277
linguistic-based analysis, 340
Lockheed Martin, 170
long-term incentives, executive compensation, 264-266
long-term orientation (cultural attribute), 33

M

majority voting
 procedures, 77
 shareholder democracy, 420
management board, 44
management entrenchment, 256, 373
mandatory retirement age, 128
manipulation of accounts
 equity ownership, 292-293
 models for detection, 338-341
manipulation of equity grants, 294-298
Manne, Henry, 362
market for corporate control, 361-365
 acquisitions, 367
  antitakeover protections, 373-386
  value in a takeover, 370-372
  who gets acquired, 367-368
market for directors, 93-95
 active CEOs, 97-98
 diverse directors, 101
 international experience, 98-99
 professional directors, 102
 special expertise, 99
market for labor (CEOs), 203-206
 newly appointed CEOs, 211-213
 pool of talent, 206-207
 turnover rate, 208-211
market standard of performance, 24
market-to-book value, 17
markets (corporate strategy), 171
Marshall, Ric, 443
masculinity (cultural attribute), 33
material information (SEC filings), 84
Maytag, 443
McAdam, Lowell, 216
McClendon, Aubrey, 314
McDATA Corporation, 304
McKesson, 246
Merck & Co. Research Committee, 75
mergers, 363
 compensation incentives, 367
 empire building, 365
 herding behavior, 366
 hubris, 366
Microsoft versus Yahoo!, 385
Miller, James, 119
Ministry of Justice (Japan), 48
misclassification errors, financial restatements, 331-333
mission identification, organizational strategy, 170-172
monitoring
 COSO risk management framework, 191
 internal controls, 328
Moog, 267
moral salience, 4
Mulally, Alan, 219
Murthy, N. R. Narayana, 53

N

NACD (National Association of Corporate Directors), 169, 329
named executive officers (NEOs), 254-257

Nardelli, Robert, 138
National Association of Corporate Directors (NACD), 169, 329
National Stock Exchange of India, 54
NEOs (named executive officers), 254-257
net present value (NPV), 264
New York Stock Exchange (NYSE), 36, 69
newly appointed CEOs, 211-213
Nike, 214-215
Nivel 1 market (Brazil), 56
Nivel 2 market (Brazil), 56
nominating committees, 73
nonexecutive chairmen, 110
nonexecutive directors, 139-142
  Brazil, 55
  Cadbury Committee Code of Best Practices, 41
  Lehman Brothers, 140
nonfinancial KPIs, 181
nonshareholder constituency, 82
Northrop Grumman, 262-264
Novo Mercado market, 56
NPV (net present value), 264
NYSE (New York Stock Exchange), 36, 69

O

objective setting (COSO risk management framework), 191
objectivity, performance measures, 183
observer directors, 99-101
OECD (Organization for Economic Cooperation and Development), 67
Office of Risk Management (Heinz Company), 192
“one-size-fits-all” approach to governance, 14
operating metrics, 17
operational risk, 189
operations, board of directors, 70-76
opinion shopping, 353
Organization for Economic Cooperation and Development (OECD), 67
organizational strategy, 169
  business model development, 175-180
  identification of key performance measures, 180-186
  identification of mission, 170-172
  implementation process, 173-175
  risk management, 186-193
organizational variables, impact on governance quality, 462-464
outgoing CEOs, 107
outliers (unpredictable events), 188
outside directors, 139-142
oversight
  organizational strategy. *See* organizational strategy
  risk management, 193-198
oversight capacity, board of directors, 68
Ovitz, Michael, 69
ownership guidelines, 113-115

P

PA-SB 1310 (Pennsylvania Senate Bill), 381
package structure, executive compensation, 259
Parker, Mark, 215
participants (corporate governance systems), 8
Passive Aggressor (CEO), 221
passive investors, 394
pay for failure, 229
pay for performance
  equity-based compensation, 405
  executive compensation contracts, 269-274
pay inequity
  average employee, 257-259
  executive compensation, 254-257
PCAOB (Public Company Accounting Oversight Board), 348
peer groups, 247
Pennsylvania Senate Bill (PA-SB 1310), 381
pension funds, 410-413
pension-adjusted operating margin, 263
Perez, William, 214
performance
  CEO turnover, 208-211
  impact of acquisitions, 367-372
  market standards, 24
  measures, 180-186
  metrics, 17
  relationship to equity ownership, 288-291
  shares, 244
performance-vested stock options, 243
perquisites, executive compensation, 245, 268-269

pledging shares, 312-314
plurality of votes, 77
poison pills, 49, 374-379
policies
  hedging, 310-311
  pledging shares, 313-314
politically connected directors, 149
poor pay practice in equity-based compensation, 406
portfolio diversification, 298-299
Power Blocker (CEO), 221
power distance (cultural attribute), 33
precision, performance measures, 183
predictability, governance ratings, 442-448
preferred shares, 55
premium stock options, 242
premium to fair value, exchange offers, 315
prepaid-variable forward (PVF) contracts, 307-308
presiding directors, 136
Principles of Corporate Governance (OECD), 67
principles-based accounting systems, 29-30
private equity, 205, 364-365
private equity firms, 12
private lawsuits, 86
private pension funds, 411
professional directors, 102
protection, antitakeover, 373
  dual-class stocks, 374, 382-384
  poison pills, 374-379
  rank by level of protectiveness, 384-386
  staggered boards, 375-380
  state of incorporation, 380-382
provisions
  Dodd–Frank Financial Reform Act of 2010, 37
  Sarbanes–Oxley Act of 2002, 37
proxy access
  Dodd–Frank Financial Reform Act of 2010, 37
  shareholder democracy, 422-423
proxy advisory firms, 13, 401-404
proxy contests, 363
proxy disclosure, 274
proxy voting
  institutional shareholders, 399-401
  shareholder democracy, 424
Public Company Accounting Oversight Board (PCAOB), 348
public pension funds, 410
Public Responsibility Committee (General Mills), 76
public-traded options, 310
PVF (prepaid-variable forward) contracts, 307-308

Q–R

Q (market-to-book value), 17
qualifications, board of directors members, 103-105
qualified opinions, 343
quality accounting, 327
quality audits, 345
  external auditor as CFO, 350-352
  impact of Sarbanes-Oxley Act of 2002, 348-350
  rotation of auditors, 352-354
  structure of audit industry, 345-348
quality financial reporting, 329-330
Qwest, 300, 308

ratcheting effect, executive compensation, 248
ratings, 433
  academic researchers, 448-453
  credit ratings, 434-437
  GMI (GovernanceMetrics International), 441
  RiskMetrics/ISS, 437-440
  TCL (The Corporate Library), 441-442
  testing predictability, 442-448
  third-party ratings, 433-434
  viability, 453-454
recruitment process, directors, 105-107
Refco, 11
reform
  chaebol structure, 50
  compensation, 43
  executive compensation, 274-278
  governance, 39-40
  Indian governance standards, 53
Regulation N-SX (SEC), 401
Regulation S–K (SEC), 103
regulations, influence on governance system, 31-32
removal of directors, 117-121
  board of directors, 79
  resignations, 118-120
reports, Cadbury Committee Code of Best Practices, 42

repricing offers, equity ownership, 314-317
reputational risk, 189
Research Committee (Merck & Co.), 75
research evidence, factors influencing governance systems
accounting standards, 28-31
capital market efficiency, 24-27
country's legal tradition, 27-28
enforcement of regulations, 31-32
societal and cultural values, 32-35
resignations, directors, 118-120
resources (corporate strategy), 171
responsibilities
audit committee, 326-329
board of directors. *See* board of directors, responsibilities
restatements, financial, 330, 334-337
restricted stock, 244
restriction of payouts, compensation reform, 278
retention approaches, 291
revenue recognition errors, financial restatements, 331-333
Revised Combined Code of Best Practices, 40-42
right of codetermination, 149
risk, 188
assessment (COSO risk management framework), 191
culture, 191
disclosure on executive compensation, 267-268
management, 186
COSO framework, 190-192
Heinz Company, 192-193
oversight by board of directors, 193-198
risk, 188
succession, 225-226
types of risk, 189-190
response (COSO risk management framework), 191
Risk and Compliance Committee (Fifth Third Bancorp), 75
Risk Council (Heinz Company), 192
Risk Metrics/Institutional Shareholder Services (ISS), 12, 399
burn rate in equity-based compensation, 405
equity-based compensation plans, 405-406
pay for performance in equity-based compensation, 405
poor pay practice in equity-based compensation, 406
ratings, 437-440
shareholder value transfer in equity-based compensation, 405
roles
corporation in society, 33
shareholders, 393-395
rotation of auditors, 352-354
Rowe, John W., 447
Royal Dutch Shell, 138
Rule 10b5-1, 302-306
rules-based accounting systems, 29
Russia, governance structure, 57-59

S

Safeway, 249-250
salaries, executive compensation, 241
Sanderson, Robert (Fair Isaac), 118
São Paulo Stock Exchange (Bovespa), 55
Sarbanes–Oxley Act of 2002 (SOX), 11, 37, 70, 128, 146, 348-350
say-on-pay
compensation reform, 43
Dodd–Frank Financial Reform Act of 2010, 37
shareholders, 274-276
scheduled option grants, 295
Schumer, Sen. Charles, 11
scope (corporate strategy), 171
Scrushy, Richard, 1
SEBI (Securities and Exchange Board of India), 53
SEC (Securities and Exchange Commission), 35
Regulation N-SX, 401
Regulation S–K, 103
Securities and Exchange Board of India (SEBI), 53
securities laws
disclosure, 83-84
legal enforcement, 85-86
securities regulation, influence on governance system, 31-32
Seidenberg, Ivan, 216
self-interested executives, 4-8
sensitivity, performance measures, 183
SERPs (supplemental executive retirement plans), 239

Service Employees International Union, 411
severance agreements, 228-230
Shareholder's Bill of Rights, 11
shareholder-centric view, 33
shareholders, 393
activist investors, 406-410, 413-424
blockholders, 395-398
founders and families, 398-399
management decisions based on accounting statements, 28
proxy advisory firms, 401-404
proxy voting, 399-401
roles, 393-395
say-on-pay, 274-276
shares
Chinese companies, 51
executive compensation, 244
pledging, 312-314
short sales, 310
short-term incentives, executive compensation, 260-262
short-term trading, 310
Side A (D&O insurance policies), 87
Side B (D&O insurance policies), 87
Side C (D&O insurance policies), 87
Smith, Weston L., 2
socially independent directors, 144
socially responsible investors, 414-416
societal values, influence on governance system, 32-35
South Korea, governance structure, 49-51
SOX (Sarbanes–Oxley Act of 2002), 11, 37, 70, 128, 146, 348-350
specialized board committees, 74-76
spring-loading options, 298
SPX Corporation, 113
staggered boards, 76, 375-380
standardization of governance systems, 464-465
standards
accounting, 28-31
audit committee responsibilities, 328
corporate governance, 12-13
governance reform, 39-40
independent directors, 143-145
standing orders, 311
state corporate law, 84-85
state laws, 381
state of incorporation, 380-382
statistical data analysis, 175-177
statistics
agency problems, 5-8
bankruptcy, 5
class action lawsuits, 6
FCPA violations, 7
financial restatement, 5
massaged earnings, 8
stock option backdating, 7
stock market, acquisitions assessment, 367
value in a takeover, 370-372
who gets acquired, 367-368
stock options
backdating, 7, 295-297
executive compensation, 241
performance-vested, 243
premium, 242
stock ownership, 245
stock price metrics, 17
***Strategic Management*, 172**
strategy development, 169
business model development, 175-180
identification of key performance measures, 180-186
identification of mission, 170-172
implementation process, 173-175
risk management, 186-193
structure
audit industry, 345-348
board of directors. *See* board of directors, structure
corporate governance system, 9
executive compensation packages, 259
individual international systems. *See* individual structures, national governance
succession models (CEOs), 213
external candidates, 213
horse race, 216-217
inside-outside model, 217-218
promotion of candidate to president or COO, 215-216
succession process (CEOs), 218
evaluation of boards, 223-225, 230
external searches, 226-228
outgoing CEO behaviors, 220-222
risk management, 225-226
supermajority provisions, 379
supervisory boards, 44
supplemental executive retirement plans (SERPs), 239
supply and demand, 205

T

takeovers, hostile, 362
talent pool (CEOs), 206-207
target (company subject to offer), 362
target awards, 260
target ownership plans, 291-292
TARP (Troubled Asset Relief Program), 132
Tata Group, 54
tax accounting errors, financial restatements, 331-333
Taylor, Alexander, III, 308
TCL (The Corporate Library), 441-442
tender offers, 363
terms, boards of directors, 76-77
testing practices, 460-461
testing predictability, governance ratings, 442-448
The Corporate Library (TCL), 441-442
third-party ratings, 433-434
Thornton, John, 219
tin parachutes, 386
Tobin's Q, 17
tokenism, 159
Too Big to Fail, 197
total quality management (TQM), 184
total shareholder returns (TSR), 173
tournament theory, 256
Toyota, 47
TQM (total quality management), 184
trading by insiders, 300-302
trading window, 301
transparency standards, 328
Troubled Asset Relief Program (TARP), 132
TSR (total shareholder returns), 173
The Turnbull Report (1999), 40
turnover rates (CEOs), 208-211
two-tiered board structure, 44

U–V

UAW (United Auto Workers), 411
UBS, 247
uncertainty avoidance (cultural attribute), 33
United Brotherhood of Carpenters and Joiners of America, 411
United Kingdom, governance structure, 38-44
United States, governance structure, 35-38
unpredictable events (black swans), 188
unqualified opinions, 343
unscheduled option grants, 295

values (societal and cultural), influence on governance system, 32-35
values statements, 170
verifiability, performance measures, 183
viability, governance ratings, 453-454

W–Z

Wallenberg family, 25
warranted equity value (WEV), 263
wedge, 382
WEV (warranted equity value), 263
Williamson, Oliver, 16
Write Express, 251
written consents, board of directors, 70

Yahoo! versus Microsoft, 385
Yang, Jerry, 386
Yukos to Gazprom, 58

zero-cost collars, 307-308