CHAPTER 1: FINANCIAL GOALS AND CORPORATE GOVERNANCE

1. Corporate goals: shareholder wealth maximization. Explain the assumptions and objectives of the shareholder wealth maximization model.

The Anglo-American markets are characterized by a philosophy that a firm's objective should follow the *shareholder wealth maximization* (SWM) model. More specifically, the firm should strive to maximize the return to shareholders, as measured by the sum of capital gains and dividends, for a given level of risk. Alternatively, the firm should minimize the risk to shareholders for a given rate of return.

The SWM model assumes as a universal truth that the stock market is efficient. The share price is always correct because it captures all the expectations of return and risk as perceived by investors. It quickly incorporates new information into the share price. Share prices, in turn, are deemed the best allocators of capital in the macro economy.

The SWM model also treats its definition of risk as a universal truth. Risk is defined as the added risk that the firm's shares bring to a diversified portfolio. The total operational risk of the firm can be eliminated through portfolio diversification by the investors. Therefore, this *unsystematic risk*, the risk of the individual security, should not be a prime concern for management unless it increases the prospect of bankruptcy. *Systematic risk*, the risk of the market in general, cannot be eliminated. This reflects risk that the share price will be a function of the stock market.

2. Corporate goals: corporate wealth maximization. Explain the assumptions and objectives of the corporate wealth maximization model.

In contrast to the SWM model, Continental European and Japanese markets are characterized by a philosophy that a corporation's objective should be to maximize *corporate wealth*. Thus a firm should treat shareholders on a par with other corporate interest groups, such as management, labor, the local community, suppliers, creditors, and even the government. The goal is to earn as much as possible in the long run, but to retain enough to increase the corporate wealth for the benefit of all interest groups. This model has also been labeled the *stakeholder capitalism model*.

The definition of *corporate wealth* is much broader than just financial wealth, such as cash marketable securities, and unused credit lines. It includes the firm's technical, market, and human resources. "Consequently, it goes beyond the wealth measured by conventional financial reports to include the firm's market position as well as the knowledge and skill of its employees in technology, manufacturing processes, marketing and administration of the enterprise."

The corporate wealth maximization (CWM) model does not assume that equity markets are either efficient or inefficient. It does not really matter because the firm's financial goals are not exclusively shareholder-oriented. In any case, the model assumes that long-term "loyal" shareholders should influence corporate strategy, not the transient portfolio investor.

The CWM model assumes that *total risk,* that is, operating and financial risk, does count. It is a specific-corporate objective to generate growing earnings and dividends over the long run with as much certainty as possible, given the firm's mission statement and goals. Risk is measured more by product market variability than by short term variation in earnings and share price.

3. Corporate governance. Define the following terms

a. **Corporate governance** – The relationship among stakeholders used to determine and control the strategic direction and performance of an organization is termed *corporate governance*. Corporate governance is, in essence, the method by which an organization establishes order among the various stakeholders to ensure that decisions are made and interests are represented in line with the firm's stated objectives.

b. **The market for corporate control** includes the composition and control of boards of directors as well as takeover strategies and defenses.

c. **Agency theory** – The field of agency theory is the study of how shareholders can motivate management to accept the prescriptions of the SWM model.

d. **Cronyism** – Many of the most prominent firms are owned by families or the government, or by the relatives or friends of top government officials (so-called cronyism). They are often overstaffed because of nepotism and political payoffs. They are often over-financed by banks that are also owned by the same elite group. The emerging market crisis, starting in Asia in 1997 (see Chapter 2), may have shaken this situation considerably, thus leading to more shareholder-friendly behavior.

e. **Stakeholder capitalism** – In contrast to the SWM model, Continental European and Japanese markets are characterized by a philosophy that a corporation's objective should be to maximize *corporate wealth*. Thus a firm should treat shareholders on a par with other corporate interest groups, such as management, labor, the local community, suppliers, creditors, and even the government. The goal is to earn as much as possible in the long run, but to retain enough to increase the corporate wealth for the benefit of all interest groups. This model has also been labeled the *stakeholder capitalism model*.

4. Operational goals. What should be the primary operational goal of a MNE?

The primary operational goal of the MNE is to *maximize consolidated profits, after-tax*. *Consolidated profits* are the profits of all the individual units of the firm originating in many different currencies expressed in the currency of the parent company. Each of multinational's foreign subsidiaries has its own set of traditional financial statements: 1) a statement of income, summarizing the revenues and expenses experienced by the firm over the year; 2) a balance sheet, summarizing the assets employed in generating the unit's revenues, and the financing of those assets; and 3) a statement of cash flows, summarizing those activities of the firm that generate and then use cash flows over the year. These financial statements are expressed initially in the local currency of the unit for tax and reporting purposes to the local government, but must be consolidated with the parent company's financial statements for reporting to shareholders.

5. Knowledge assets. "Knowledge assets" are a firm's intangible assets, the sources and uses of its intellectual talent – its competitive advantage. What are some of the most important "knowledge assets" that create shareholder value?

Knowledge assets are the company's intangible assets, the sources and uses of its intellectual talent – its competitive advantage. Experts argue that there are at least 10 categories of knowledge assets:

1. Innovation	6. Research and product/service development
2. Quality	7. Technology to streamline operations
3. Customer care	8. Brand value
4. Management skill	9. Employee relations
5. Alliances	10. Environmental and community awareness.

6. **Labor unions. In Germany and Scandinavia, among others, labor unions have representation on boards of directors or supervisory boards. How might such union representation be viewed under the shareholder wealth maximization model compared to the corporate wealth maximization model?**

   Labor union representation on boards of directors or supervisory boards would not be welcome in the shareholder wealth maximization model since they would not represent shareholder interests. They would be welcome (and necessary) in the corporate wealth maximization model because they represent one of the most important stakeholder groups.

7. **Interlocking directorates. In an interlocking directorate members of the board of directors of one firm also sit on the board of directors of other firms. How would interlocking directorates be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?**

   Interlocking directorates would be welcome by the SWM model because it would strengthen the power of shareholders. For the same reason it would be unwelcome in the CWM model because it would dilute the influence of non-shareholder stakeholder groups.

8. **Leveraged buyouts. A leveraged buyout is a financial strategy in which a group of investors gain voting control of a firm and then liquidate its assets in order to repay the loans used to purchase the firm's shares. How would leveraged buyouts be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?**

   A leveraged buyout would be acceptable to the SWM model because it could give an immediate profit to shareholders who offer their shares at a premium. It would be unwelcome in the CWM model because it would increase the risk of bankruptcy and not benefit the other stakeholder groups.

9. **High Leverage. How would a high degree of leverage (debt/assets) be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?**

   High leverage would increase the firm's risk and therefore be unwelcome in the CWM model. High leverage could benefit less risk averse shareholders who are diversified in their own portfolios. The firm's beta would increase but so would the possible return.

10. **Conglomerates. Conglomerates are firms that have diversified into unrelated fields. How would a policy of conglomeration be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?**

    Conglomerates are accepted by the CWM model because they could increase the firm's wealth in terms of assets and human resources while reducing operational risk due to diversification. In the SWM model the shareholders are already diversified so the firm's diversification creates no value. Furthermore, shareholders usually prefer a focused firm (also known as a *pure play*).

11. **Risk. How is risk defined in the shareholder wealth maximization model compared to the corporate wealth maximization model?**

    In the shareholder wealth maximization model, risk is defined as the added risk that the firm's shares bring to a diversified portfolio. The total operational risk of the firm can be eliminated through portfolio diversification by the investors. Therefore, this *unsystematic risk*, the risk of the individual security, should not be a prime concern for management unless it increases the prospect of bankruptcy. *Systematic risk*, the risk of the market in general, cannot be eliminated. This reflects risk that the share price will be a function of the stock market.

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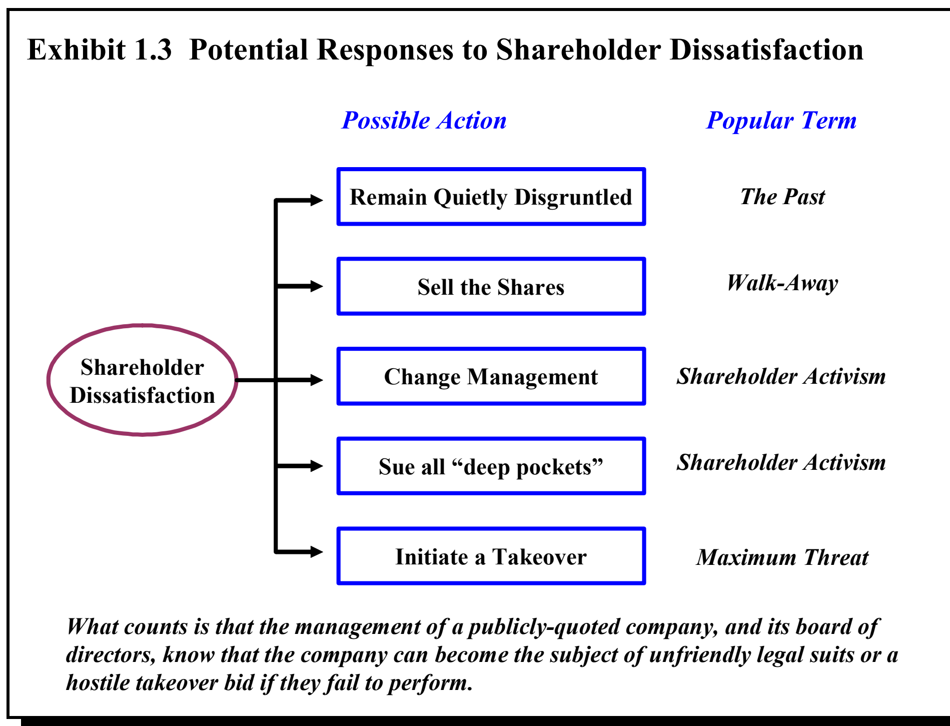
12. Stock options. How would stock options granted to a firm's management and employees be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?

The SWM model makes heavy use of stock options to motivate management (and in some cases other employees). Stock options would not be welcome in the CWM model because they benefit mainly only one stakeholder – management.

13. Shareholder dissatisfaction. If shareholders are dissatisfied with their company what alternative actions can they take?



14. Dual classes of common stock. In many countries it is common for a firm to have two or more classes of common stock with differential voting rights. In the United States the norm is for a firm to have one class of common stock with one-share-one-vote. What are the advantages and disadvantages of each system?

The purpose of having dual classes of stock with differential voting rights is to allow the original owners or entrenched management to maintain control of the firm by preventing takeovers. This insulates poor management (as well as good management). The one-share-one-vote system allows shareholders to get rid of poor management, but also to benefit potentially from an outside takeover at a premium share price.

15. Emerging markets corporate governance failures. It has been claimed that failures in corporate governance have hampered the growth and profitability of some prominent firms located in emerging

markets. What are some typical causes of these failures in corporate governance?

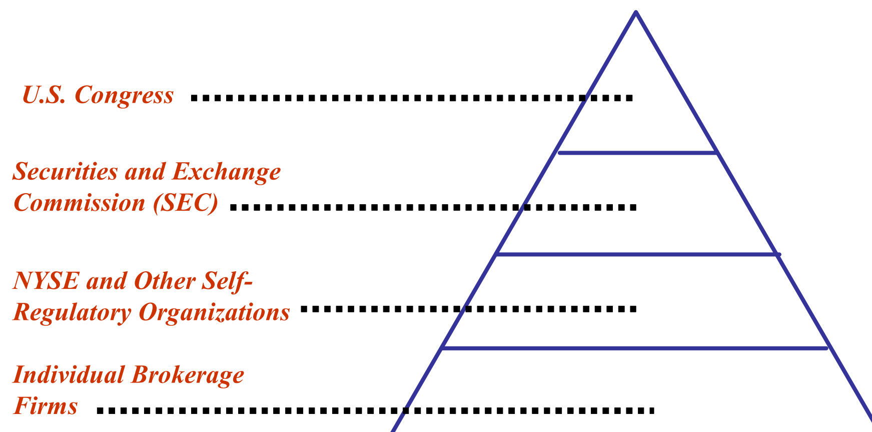
Many of the most prominent firms are owned by families or the government, or by the relatives or friends of top government officials (so-called cronyism). They are often overstaffed because of nepotism and political payoffs. They are often over-financed by banks that are also owned by the same elite group. The emerging market crisis, starting in Asia in 1997 (see Chapter 2), may have shaken this situation considerably, thus leading to more shareholder-friendly behavior.

16. **Emerging markets corporate governance improvements. In recent years emerging market MNEs have improved their corporate governance policies and become more shareholder-friendly. What do you think is driving this phenomenon?**

A number of large multinationals resident outside the Anglo-American countries have had to tap global equity and debt markets to maintain a competitive cost and availability of capital. Since they need to attract international portfolio investors, their behavior has become more shareholder-friendly than before. Some of these firms have even converted to the one-share-one-vote system in response to shareholder demands.

17. **Corporate Regulatory Pyramid n the Unites States. Describe the four tiers of regulators of U.S. securities markets.**

Exhibit 1.4 The Corporate Regulatory Pyramid in the United States



Source: ***Your Market: Straight Talk For Investors*, New York Stock Exchange with Time, Inc. Custom Publishing, July 2002, p. 15.**

MINI-CASE: CORPORATE GOVERNANCE AT BRASIL TELECOM

1. What do you believe a government expects to gain from privatizing major sectors like telecommunications?

Privatization is often conducted in pursuit of both political and economic goals. Politically, the recent trend globally has been toward market-based economies, in which government ownership is to be minimized. Economically, privatization is considered by many emerging market countries as a significant way of raising capital and building globally competitive institutions and industries.

In the case of Brasil and the telecommunications sector, the privatization auction raised an enormous amount of capital, as well as attracting foreign owners with world class experience in that specific industry. The hope was that owners like Telecom Italia would provide capital, technology, and managerial expertise to take the Brazilian telecom industry forward into the 21st century.

2. Why would two major investors like CVC/Opportunity and Telecom Italia create a partnership to gain control of a firm and then be unable to agree on the firm's future strategy?

As is often the case with joint ventures and strategic alliances, the initial motivations for the partnership are not the same as the long-term strategies of the individual players. Alone, either of the two parties could not have obtained the capital or political links necessary to take control. However, CVC/Opportunity is primarily interested in building the profitability of BT itself over time, whereas Telecom Italia sees BT as only one element of a much larger and complex strategy for telecommunications industry penetration in Latin America as a whole.

3. If you were in management at Brasil Telecom, how would the fighting between your owners alter your ability to do your job? What could you do to 'manage your owners'?

The tendency among most larger firms is for management to either make all major decisions or guide ownership's interest in those decisions. BT's management, if it were to focus its attention on a daily basis on the disagreements among its owners, would find itself standing still. 'Managing owners' is a difficult and dangerous process of management. In the case of Brasil Telecom, it appeared from the very beginning that Telecom Italia would not be a long-term owner, and most of management had therefore sided with CVC/Opportunity for expedient reasons.

Management will typically try to ignore it to whatever degree possible, and prevent ownership's divided input from entering daily management and leadership. Unfortunately, for major strategic and capital decisions such as the rate at which BT is to fulfill infrastructure obligations, the owners must be involved.

4. If you were a minority investor in Brasil Telecom, holding some of the publicly-traded shares, what rights do you believe you should have in the ownership-control debate?

Minority shareholder rights is a very controversial subject in global business today. Many countries have enacted complex laws to protect minority shareholders. (For example, in many countries like France a corporate raider may not acquire more than 30% ownership of the publicly traded shares without making a public tender offer to all remaining shareholders.) Most minority shareholders will realize that they will not have any real voice in the future direction of the firm. In this case, minority investors are increasingly passive owners. The debate, can, however, become increasingly complex as foreign ownership like Telecom Italia starts appearing to abuse the rights of domestic investors – minority investors and major investors – adding fuel to the fire of public debate.