Governance and Value

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Corporate Governance

- How well investors are protected from expropriation by managers or controlling shareholders

Corporate Governance

- Why does it matter?
  - Nature of the relationship between corporate governance and corporate value

Shareholder Rights & Corporate Performance

- Gompers, Ishii and Metrick (2003)
  - Classic article
  - Create a governance index as a proxy for the strength of shareholder rights and corporate governance practices
  - Study the empirical relationship between their index and corporate performance
- 1,500 firms in the 1990s

Governance Provisions

- Investor Responsibility Research Center (IRRC)
  - Lists corporate governance provisions for individual firms
  - 24 unique provisions that measure corporate governance
  - Charter provisions, bylaw provisions, firm-level rules and state takeover laws

Governance Index

- The GIM index adds one point for every provision that restricts shareholder rights
  - Maximum value for the index is 24
- Decile rankings of companies
  - “Dictatorship portfolio”
    - Highest management, lowest shareholder power
  - “Democracy portfolio”
    - Lowest management, strongest shareholder rights

Governance and Returns

- A $1 investment in the (value-weighted) Dictatorship Portfolio on September 1, 1990, would have grown to $3.39 by December 31, 1999
- A $1 investment in the Democracy Portfolio would have grown to $7.07 over the same period
- Annualized returns
  - 14.0 percent for the Dictatorship Portfolio
  - 23.3 percent for the Democracy Portfolio
  - A difference of more than 9 percentage points per year

Governance and Operating Performance

- Also “find some significant evidence that more democratic firms have better operating performance”
- Three operational measures
  - net profit margin (income divided by sales),
  - the return on equity (income divided by book equity), and
  - one-year sales growth

Managerial Entrenchment & Corporate Performance

- Bebchuk, Cohen & Ferrell (BCF)
  - Also start with the twenty-four governance provisions from the Investor Responsibility Research Center
  - Which ones are correlated with firm value and stockholder returns?

Bebchuk, Cohen & Ferrell (2005)

Managerial Entrenchment

- BCF focus on *entrenchment*
  - Arrangements that protect incumbents from removal
- Entrenchment and the ensuing insulation *might* harm shareholders by removing the disciplinary threat of removal
- Devise an entrenchment index (from 0 to 6) based on four “constitutional” and two “takeover readiness” provisions

Bebchuk, Cohen & Ferrell (2005)

Governance and Returns

- “During the 1990-2003 period, buying an equally-weighted portfolio of firms with a 0 entrenchment index score and selling short an equally-weighted portfolio of firms with entrenchment index scores of 5 and 6 would have yielded an average annual abnormal return of approximately 7%.”

Bebchuk, Cohen & Ferrell (2005)

An Application

- $1 of cash is worth between $0.42 and $0.88 in a poorly-governed firm and about twice as much in a well-governed firm
  - Governance measured with GIM and BCF indices and institutional blockholdings
- Excess cash held by poorly governed firms also leads to poor operating performance (lower accounting returns)

Dittmar and Mahrt-Smith (forthcoming)

Governance, Operating Performance and Returns

- A recent study demonstrates a significant positive correlation between GIM and BCF indices and "better contemporaneous and subsequent *operating performance*," but not future stock market performance

Bhagat and Bolton (2006)

Governance and Value

- Governance studies show the *correlation* between good corporate governance practices and higher shareholder value, but *do not demonstrate causality*
- Firms with higher valuation multiples adopt better corporate governance provisions as opposed to the hypothesis that better corporate governance provisions lead to higher valuation multiples

Lehn, Patro and Zhao (2006)

Beyond Poor Governance

Beyond Poor Governance

- When do we cross the line from poor governance to unethical and fraudulent behavior?
  - Meeting/beating analyst expectations
  - Backdating
  - Management buyouts of public companies
  - Empty voting

Meeting/Beating Expectations

- Why Meet Expectations?
  - 86% of CFOs say “builds credibility”
  - 80% believe maintains or increases stock price

Graham, Harvey and Rajgopal (2005)

Figure 3: Percentage of Firms Missing Analysts' Expectations over Time

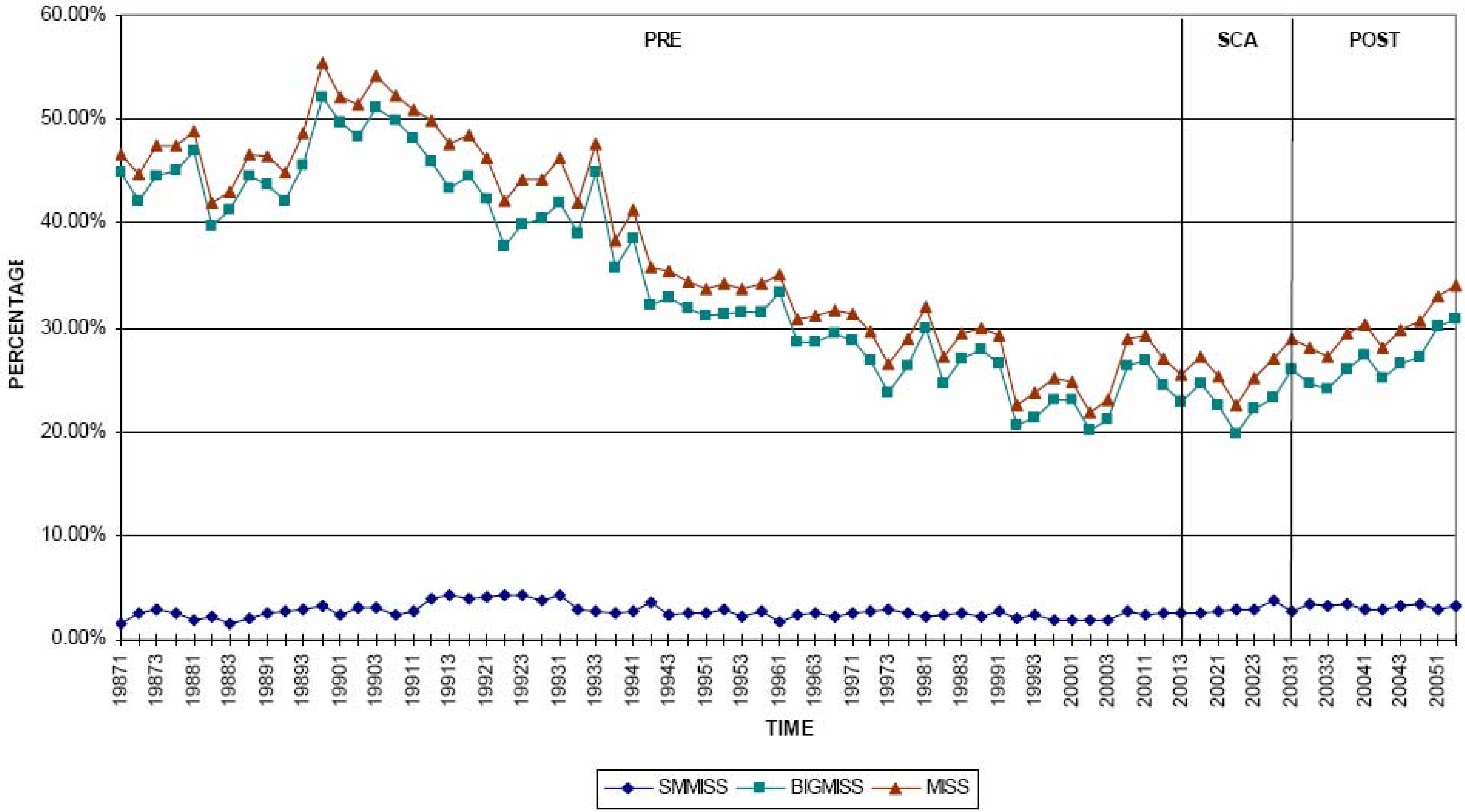


Figure 3 presents the percentage of firms meeting or beating analysts' expectations over time. SMMISS refers to a firm that misses expectations by a cent per share or less, where expectations are defined as the last forecast for the quarter made at least three days prior to the release of the earnings announcement for that quarter. BIGMISS refers to a firm that misses expectations by more than a cent per share.

Koh, Matsumoto and Rajgopal (2006)

Meeting/Beating Expectations

- Tools
  - Accrual-based earnings management (Dhaliwal *et al.* 2004)
  - Real economic actions (Roychowddhury 2006)
  - Earnings expectations management (Bartov *et al.* 2002)

Bartov and Cohen (2006)

Post-SOX?

- No longer a stock market premium to meeting or just beating analysts’ estimates

Koh, Matsumoto and Rajgopal (2006)

Post-SOX?

- The frequency of just meeting/beating earnings expectations is lower
- The use of expectations management and accrual management has declined, but the use of real earnings management has not changed

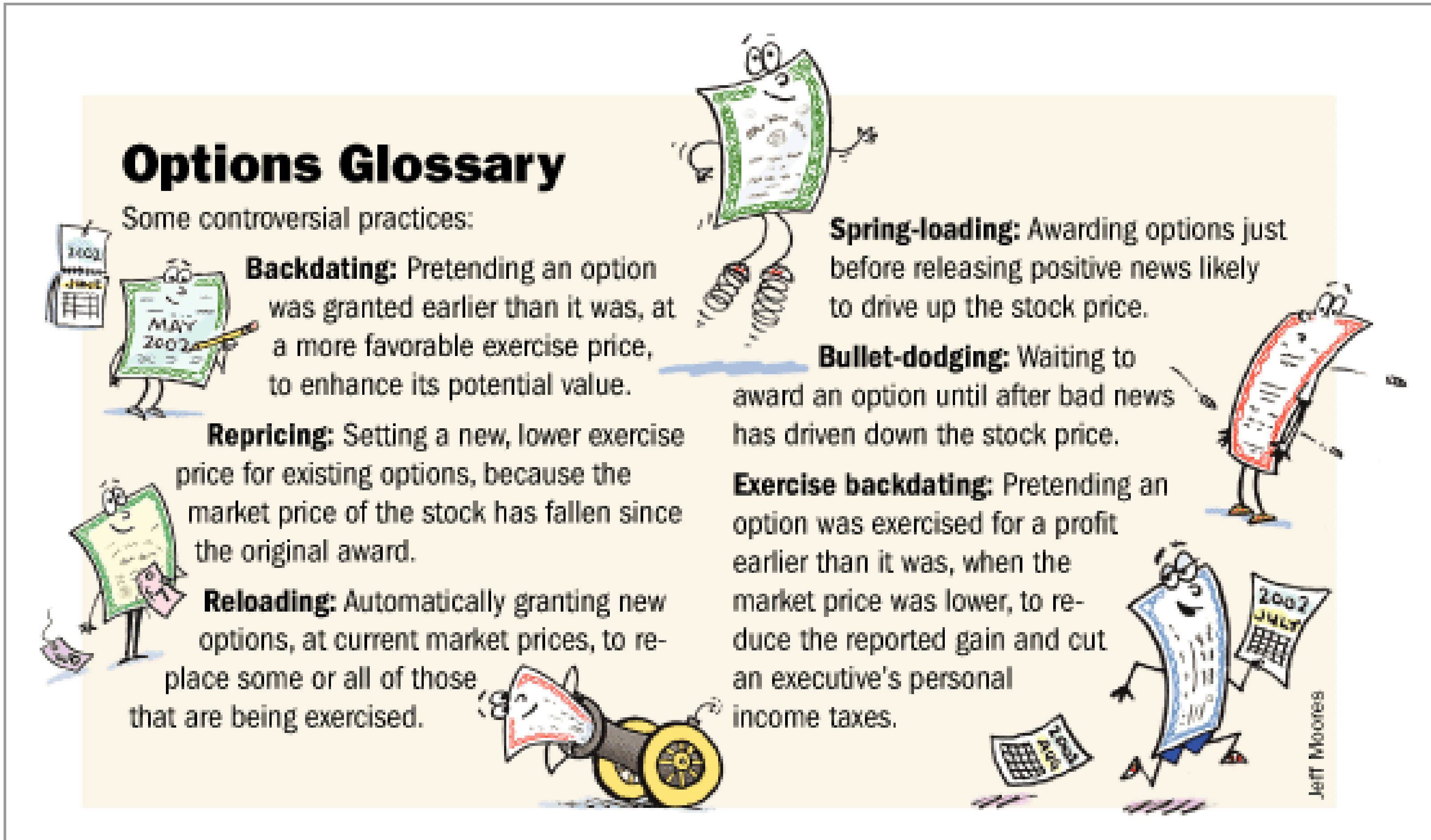
Bartov and Cohen (2006)

Real Earnings Management

- 80% would reduce discretionary spending, R&D, maintenance, advertising
- 55.3% would delay starting a new project even if it entailed a small sacrifice in value
- 78% of survey respondents would sacrifice long-term value to smooth earnings

Graham, Harvey and Rajgopal (2005)

Backdating



Options Glossary

Some controversial practices:

Backdating: Pretending an option was granted earlier than it was, at a more favorable exercise price, to enhance its potential value.

Repricing: Setting a new, lower exercise price for existing options, because the market price of the stock has fallen since the original award.

Reloading: Automatically granting new options, at current market prices, to replace some or all of those that are being exercised.

Spring-loading: Awarding options just before releasing positive news likely to drive up the stock price.

Bullet-dodging: Waiting to award an option until after bad news has driven down the stock price.

Exercise backdating: Pretending an option was exercised for a profit earlier than it was, when the market price was lower, to reduce the reported gain and cut an executive's personal income taxes.

The Wall Street Journal, December 27, 2005.

Backdating

- Could options have been granted randomly just before a run-up in share prices?
  - Yermack (1997)
  - Lie (2005)
  - Lie and Herndon (forthcoming)

See: Erik Lie, “Backdating.” Available online.

Backdating and Shareholders

- How do disclosures of backdating affect shareholder value?
- Shareholders of the 110 companies on the Wall Street Journal list suffered abnormal stock price declines of 20 to 50 percent ($100 to over $250 billion in losses)

Bernile, Jarrell and Mulcahey (2006).

Some Winners

- Whitebox Advisors, a $1.8 billion Minneapolis hedge fund, did their own options backdating study
- Whitebox Advisors shorted the shares of about 80 companies they suspected of backdating and also bought the bonds of some of them

Nocera (September 23, 2006)

And Some Losers…

- "Some companies are not sure when they actually issued the options after they backdated"

Scott Taub, SEC Deputy Chief Accountant

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