Ch. 4 Financial Goals and Governance

Topics

- Corporate governance and the goals for MNEs
- Stockholder wealth maximization model vs. Stakeholder capitalism model
- Corporate governance reform

Managing for Value

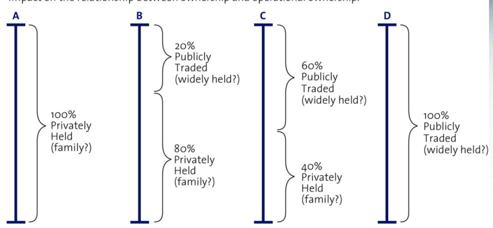
- Like domestic projects, foreign projects involve an investment decision and a financing decision.
  - how much business to conduct in each country
  - how much financing to obtain in each currency
- MNE's financial decisions determine its exposure to the international environment.
- Maximize NPVs of projects → Maximize firm value → Maximize shareholder value

Goals of The MNEs

- Shareholders desire wealth maximization.
- Do managers (i.e. agents) maximize shareholder value?
- What is the major challenge for managers of MNEs?
  - Challenge: Constantly changing worldwide competitive environment
  - Intense competition is caused by global excess capacity.

Who Owns the Business?

Who owns the business—whether its privately held or publicly traded—has a significant impact on the relationship between ownership and operational ownership.



Although most businesses begin their lives as 100% privately held, often by a family, some firms go public gradually. Often selling only 20% equity interest publicly at first, some sell greater and greater equity interests to the public markets, possibly becoming 100% publicly traded.
Recently, however, many firms in the US and UK markets have begun somewhat reversing the process, with private equity funds buying all outstanding shares, taking the firm private once more.

What is the Goal of Management?

- As Trident becomes more deeply committed to multinational operations, a new constraint develops – one that springs from divergent worldwide opinions and practices as to just what the firms' overall goal should be:
  - Shareholder Wealth Maximization Model: Characterized by Anglo-American markets
  - Stakeholder Capitalism Model: Characterized by Continental European and Japanese markets

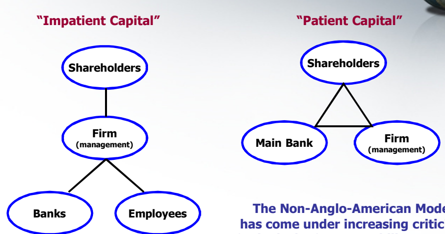
Shareholder Wealth Maximization

- The Anglo-American markets believe that a firm's objective should be to maximize shareholder wealth. A firm should strive to maximize the total return to shareholders (capital gains plus dividends), for a given level of risk
  - These countries include the US, Canada, Australia, United Kingdom.
  - Shareholder believes that markets are efficient and that prices are correct.
  - This view defines risk in a very strict financial sense.
  - Risk is defined as the added risk a firm's shares bring to a diversified portfolio (a fully diversified portfolio represents **systematic risk**).
  - The added firm-specific risk is known as **unsystematic risk**.

Stakeholder Capitalism Model

- The EU, Japan and Latin American countries view that, in addition to shareholders, all of corporation's stakeholders (employees, management, suppliers, local community, local/national government and creditors) need to be considered.
  - 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. The definition of corporate wealth is much broader than just financial wealth; it includes technical, market and human resources as well.
  - Total risk, both operating and financial risk, is important.
  - Doesn't make an issue of market efficiency because long-term loyal shareholders should be more influential than transient shareholders.

Goals of The MNEs



The Anglo-American Model has been frequently criticized as focusing on short-term profitability rather than long-term growth.

The Non-Anglo-American Model has come under increasing criticism for its lack of accountability to equity investors – its shareholders – while focusing on the demands of a group of stakeholders.

Superior Performance of Family Firms

- Many firms are publicly traded but are still heavily influenced or even controlled by families.
- Family businesses on average out-perform nonfamily businesses.
- Why?
  - Longer-term focus
  - Better alignment of management and shareholder interests
  - Stronger focus on the core business of the firm

Corporate Governance

- The single overriding objective of corporate governance in the is the optimization over time of the returns to shareholders.
- The most widely accepted statement of good corporate governance (established by the OECD) focus on the following principles:
  - The rights and equitable treatment of shareholders
  - The role of stakeholders in corporate governance
  - Disclosure and transparency
  - The responsibilities of the board

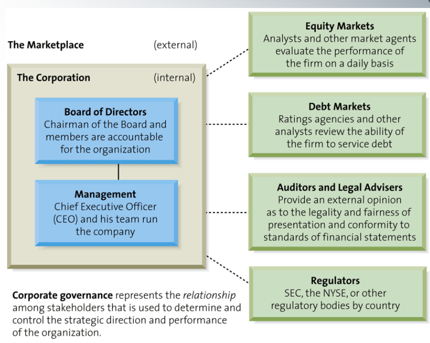
Corporate Governance

- The origins of the need for a corporate governance process arise from the separation of ownership from management, and from the varying views by culture of who the stakeholders are and of what significance.
- A governance regime (system) is a function of;
  1. Financial market development
  2. The degree of separation between management and ownership
  3. The concept of disclosure and transparency

Corporate Governance

- The relationship among stakeholders used to determine and control the strategic direction and performance of an organization is termed **corporate governance.**
- The corporate governance of the organization is therefore the way in which order and process is established to ensure that decisions are made and interests are represented – for all stakeholders – properly.

Structure of Corporate Governance



Corporate Governance

- Does good governance matter?
  - Certainly, as in the case of Enron, many of the improprieties were overlooked as long as the company's share price continued to rise.
  - However, after the fall of Enron, and the substantial losses sustained by investors, employees and society as a whole, many would say that corporate governance matters a lot.
  - Good governance is measured on the basis of accounting standards, the perceived legal standards in a country, and the number of Anglo-American board members.

Corporate Governance Reform

- Sarbanes Oxley (SOX) has four major requirements:
  - Signature Clause – CEOs and CFOs must vouch for accuracy of the published financial statements.
  - Firm audit and compensation committees must be comprised of independent/outside directors.
  - Loans by the firm to corporate officers and directors are prohibited.
  - Internal controls must be tested for protection against financial fraud.

Corporate Governance Reform

- Board Structure and Compensation
  - Some suggest that U.S. corporate boards should be more like European boards (e.g. Germany's two-tiered system).
  - Research suggests that compensation for board members is not a significant problem.
- Transparency, Accounting and Auditing
  - U.S accounting practices are rule-based and can be abused by smart accountants.
  - European accounting practices are conceptually-based.
- Minority shareholder rights are still an issue.

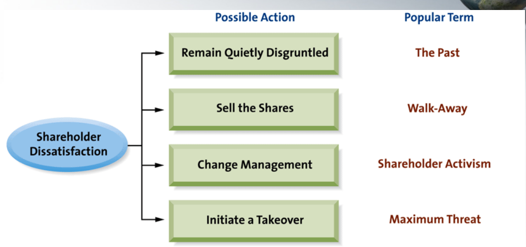
Conflicts Against the MNE Goal

- Agency costs are normally larger for MNEs than for purely domestic firms.
  - The sheer size of the MNE.
  - The scattering of distant subsidiaries.
  - The culture of foreign managers.
  - Subsidiary value versus overall MNE value.
- The magnitude of agency costs can vary with the management style of the MNE.

Impact of Corporate Control

- Various forms of corporate control can reduce agency costs.
  - Pay for performance
  - Internal monitoring system
  - Market for corporate control
  - Specialist monitoring / Auditors
  - Product Market
  - Lawsuit
- As MNE managers attempt to maximize their firm's value, they may be confronted with various constraints.
  - Environmental constraints
  - Regulatory constraints
  - Ethical constraints

Potential Responses to Shareholder Dissatisfaction



What counts is that the management of a publicly quoted company, and its board of directors, know that the company can become the subject of a hostile takeover bid if they fail to perform. The growth of equity and hedge funds in the United States and elsewhere in recent years has strengthened this threat as leveraged buyouts are once again common.

Summary

- The MNE must determine for itself the proper balance between three common operational objectives:
  - Maximization of consolidated after-tax income
  - Minimization of the firm's effective global tax burden
  - Correct positioning of the firm's income, cash flows, and available funds as to country and currency
- As MNEs become more dependant on global capital markets for financing, they may need to modify their policies of corporate governance.
- A trend exists for firms resident in non-Anglo-American markets to move toward being more "stockholder friendly" while Anglo-American markets are moving toward being more "stakeholder friendly".

Summary

- Shareholders who are dissatisfied with their firm's performance typically have four choices: remain quietly disgruntled; sell their shares; change management; or initiate a takeover.
- The recent failures in corporate governance in the United States have spawned a flurry of government and private initiatives to prevent the same kind of failures in the future.
- The United States has already reacted; passing the Sarbanes-Oxley act in 2002.