Case Studies on

Corporate Governance

Edited by

R. Muthukumar

Icfai Business School Case Development Centre

Icfai Books™

71, Nagarjuna Hills, Punjagutta, Hyderabad – 500082

Icfai Books™
71, Nagarjuna Hills,
Punjagutta, Hyderabad – 500082
Andhra Pradesh, INDIA
Phone: 91 - 40 - 23435387/91, Fax: 91 - 40 - 23435386
e-mail: icfaibooks@icfai.org, ibscdc@icfai.org
Website: www.books.iupindia.org, www.ibscdc.org

© 2009 The Institute of Chartered Financial Analysts of India. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means – electronic, mechanical, photocopying or otherwise – without prior permission in writing from the Icfai University Press.

While every care has been taken to avoid errors and omissions, this publication is being sold on the condition and understanding that the information given in the book is merely for reference and must not be taken as having authority of or being binding in any way on the authors, editors, publishers or sellers.

Icfai Books, IB and the IB logo are trademarks of the Icfai University Press. Any other product or corporate names, that may be registered trademarks, are used in the book only for the purpose of identification and explanation, without any intent to infringe.

Other than the publisher, no individual or organization is permitted to export this book from India.

Case studies are intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.

Copies of individual case studies are available for purchase from *www.ibscdc.org*

ISBN: 978-81-314-2118-5

Editorial Team: Shanul Jain and Lalitha Jaya Prakash

Visualiser and Designer: P. Damodara Siva Prasad

The views and content of this book are solely of the author(s)/editor(s). The author(s)/editor(s) of the book has/have taken all reasonable care to ensure that the contents of the book do not violate any existing copyright or other intellectual property rights of any person in any manner whatsoever. In the event the author(s)/editor(s) has/have been unable to track any source and if any copyright has been inadvertently infringed, please notify the publisher in writing for corrective action.

Case Title	Page No.
Executive Compensation – Microsoft's Risk-return Tradeoff	1
Canon: Fujio Mitarai's "Excellent Global Corporation Plan"	15
The Body Shop: The Ethical Beauty Retailer's Growth Strategies	29
US Bankruptcy Laws: Benefiting Debtors or Creditors?	43
Corporate Governance at Nestlé: The Debate over Combined CEO and Chairman	61
The Oil-for-Food Scandal at UN: Questions of Governance Issues	79
Corporate America and Sarbanes-Oxley Act: The Costs vs Benefits	93
Corporate Governance Problems at Seibu, Japan's Major Private Railway: Board to be Blamed?	113
EADS: The Boardroom Battle at Europe's Aerospace Giant	123
Running a Board: The Reuters' Way	139
Volkswagen's Ferdinand Piëch's Porsche Connections: The Clash of Interests?	147
Porsche's Investment in Volkswagen: Moving Away from 911?	157
Wal-Mart's 'Corporate Citizenship' Initiatives	171
Chapter 11: Bankruptcy as a Strategic Tool?	189
Philanthropy to Corporate Social Responsibility: Coke's Initiatives	203
The Rise of Green Consumerism: Is it a Fad or is it "Sustainable"?	225

OVERVIEW

In today's society, corporate governance is one of the most talked about topics in business. Most academics, business professionals and lay observers would agree that it is defined as the general set of customs, regulations, policies and laws that determine to achieve certain targets for which a firm should be run.

It is clear that corporate governance exists at a complex intersection of law, morality and economic efficiency, considering that issues of executive compensation, financial scandals and shareholder activism are all tied up with it.

Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. Corporate governance raises some of the key issues like how much focus should be given to the interests of directors, shareholders, employees and other stakeholders and how these interests can be expressed, aligned, and reconciled. Other stakeholders include suppliers, customers, banks and other lenders, regulators, the environment, and the community. So, corporate governance examines how corporations are governed and to whom they should be responsible. It is a system of structuring, operating and controlling a company with a view to achieving long-term strategic goals to satisfy stakeholders and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs.

An important aspect of corporate governance is to ensure the accountability of certain individuals in an organisation. The important issues are the role of the board of directors, reaggregation of shareholder power due to concentrated institutional holdings and effects of legislation on corporate governance.

In corporations, the shareholder delegates decision rights to the manager to act in the principal's best interests. This separation of ownership from control implies a loss of effective control by shareholders over managerial decisions. Partly, as a result of this separation between the two parties, a system of corporate governance controls is implemented to assist in aligning the incentives of managers with those of shareholders.

The board of directors often play a key role in corporate governance. It is their responsibility to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives, and to ensure accountability of the organisation to its owners and authorities. Similarly, the company secretary, known as a corporate secretary in the US and often referred to as a chartered secretary if qualified by the Institute of Chartered Secretaries and Administrators (ICSA), is a high ranking professional who is trained to uphold the highest standards of corporate governance, effective operations, compliance and administration.

All parties to corporate governance have an interest, whether direct or indirect, in the effective performance of the organisation. Directors, workers and management receive salaries, benefits and reputation, while shareholders receive capital return, customers receive goods and services and suppliers receive compensation for their goods or services. In return, these individuals provide value in the form of natural, human, social and other forms of capital.

Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate the model periodically for its effectiveness. Generally accepted principles of corporate governance include:

- Rights and equitable treatment of shareholders
- Interests of other stakeholders
- Roles and Responsibilities of the Board: It needs to be of sufficient size and have an appropriate level of commitment to fulfil its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors. The key roles of chairperson and CEO should not be held by the same person
- Disclosure and Transparency: Organisations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability.

Issues involving corporate governance principles include:

- Internal controls and the independence of the entity's auditors
- Oversight and management of risk
- Oversight of the preparation of the entity's financial statements
- Review of the compensation arrangements for the chief executive officer and other senior executives
- The resources made available to directors in carrying out their duties
- The way in which individuals are nominated for positions on the board
- Dividend policy.

Though corporate governance has a long history, there has been renewed interest in its practices in modern corporations since 2001, particularly due to the high-profile collapse of a number of large US firms.

Though the history of corporate governance goes back to early 19th century, it got debated since the mid-20th century. Since mid-1980s, corporate governance has attracted a great deal of attention. The initial impetus was given by anglo-american

codes of corporate governance like the Cadbury Code (1992) in the UK, the principles and recommendations of the American Law Institute (1984) and the Treadway Commission in the US. These stimulated other countries to adopt these codes for their companies.

After World War II, as the US expanded through the emergence of multinational corporations, the establishment of the managerial class was witnessed. According to Harvard Business School management profs. Jay Lorsch and Elizabeth MacIver, many large corporations had dominant control over business affairs without sufficient accountability or monitoring by their board of directors.

Since then, corporate governance has been the subject of significant debate around the globe. The efforts to reform it have been driven, in part, by the needs and desires of shareowners to exercise their rights of ownership and to increase the value of their shares, therefore, wealth. Over the past three decades, corporate directors' duties have expanded greatly beyond their traditional legal responsibility of duty of loyalty to the corporation and its shareowners. Many years ago, worldwide, individual investors like wealthy businessmen were shareowners, buyers and sellers of corporation stocks. They often had a vested, personal and emotional interest in the corporations whose shares they owned. The rise of the institutional investor has brought with it some increase of professional diligence which has tended to improve regulation of the stock market.

In the first half of the 1990s, the issue of corporate governance in the US received considerable attention due to the wave of CEO dismissals (IBM, Kodak and Honeywell) by their boards.

In 1997, the East Asian Financial Crisis saw the economies of Thailand, Indonesia, South Korea, Malaysia and the Philippines severely affected by the exit of foreign capital after property assets collapsed. Some industry experts expressed their view that the lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies. Even the World Bank alarmed those countries, that for sustainable development, corporate governance has to be good.

In the early 2000s, the massive bankruptcies (frauds and scandals) of Enron and Worldcom as well as lesser corporate debacles, such as Adelphia Communications, AOL, Arthur Andersen, Global Crossing, Tyco and more recently, Fannie Mae and Freddie Mac, led to increased shareholder and governmental interest in corporate governance. The Enron collapse is an example of misleading financial reporting. The company concealed huge losses by creating illusions that a third party was

contractually obliged to pay the amount of any losses. However, the third party was an entity in which Enron had a substantial economic stake. In discussions of accounting practices with Arthur Andersen, the partner in charge of auditing, views inevitably led to the client prevailing. This is reflected in the passage of the Sarbanes-Oxley Act of 2002. In 2002, the US Federal Government passed the Sarbanes-Oxley Act, intending to restore public confidence in corporate governance.

Corporate Governance Models around the World:

Although the US model of corporate governance is the most notorious, there is a considerable variation in corporate governance models around the world. There are many different models of corporate governance around the world. These differ according to the variety of capitalism in which they are embedded. The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model that one finds in Continental Europe and Japan also recognises the interests of workers, managers, suppliers, customers and the community. Both models have distinct competitive advantages, but in different ways. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model facilitates incremental innovation and quality competition. However, there are important differences between the US' recent approach to governance issues and what has happened in the UK.

In the US, a corporation is governed by a board of directors, which has the authority to choose a CEO. The CEO has broad power to manage the corporation's day-to-day activities, but needs to get board endorsement for certain major decisions, like choosing/recruiting his/her immediate subordinates, raising capital and acquiring another company. Other duties of the board may include policy setting, decision-making, monitoring management's performance or corporate control.

The board of directors is nominally selected by and responsible to the shareholders, but the bylaws of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board. Usually, members of the boards of directors are CEOs of other corporations.

The UK has pioneered a flexible model of regulation of corporate governance, known as the 'comply or explain' code of governance. This code lists a dozen of recommended practices, such as the separation of CEO and chairman of the board, the introduction of a minimum number of non-executives directors, independent directors, the formation and composition of remuneration, audit and nomination committees. Publicly listed companies in the UK were required to either comply with those principles or otherwise, to explain in their annual reports why they did

not do so. The monitoring of those explanations is left to shareholders themselves. The tenet of the code is that one size does not fit all in matters of corporate governance and that instead of a statuatory regime like the Sarbanes-Oxley Act in the US, it is best to leave some flexibility to companies so that they can make choices most suitable to their circumstances. If they have good reasons to deviate from the sound rule, they should be able to convincingly explain those to their shareholders. The code has been in place since 1993 and has had drastic effects on the way firms are governed in the UK.

Non Anglo-American Model

In East Asian countries, family-owned companies dominate. According to earlier studies, the top wealthy families in East Asian countries dominated listed corporate assets. In countries such as Pakistan, Indonesia and the Philippines, the top families controlled over 50% of publicly-owned corporations through a system of family cross-holdings, thus dominating the capital markets. Family-owned companies also dominate the Latin model of corporate governance, that is companies in Mexico, Italy, Spain, France (to a certain extent), Brazil, Argentina and other countries in South America.

Corporate governance principles and codes have been developed in different countries and issued from stock exchanges, corporations, institutional investors or associations (institutes) of directors and managers with the support of governments and international organisations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes linked to stock exchange listing requirements may have a coercive effect. For example, companies quoted on the London and Toronto Stock Exchanges formally need not follow the recommendations of their respective national codes. However, they must disclose whether they follow the recommendations in those documents and where not, they should provide explanations concerning divergent practices. Such disclosure requirements exert a significant pressure on listed companies for compliance.

In some countries, the guidelines are issued by associations of directors, corporate managers and individual companies, which tend to be wholly voluntary. For example, The GM Board Guidelines reflect the company's efforts to improve its own governance capacity. Such documents, however, may have a wider multiplying effect prompting other companies to adopt similar documents and standards of best practice.

One of the most influential guidelines has been the 1999 OECD principles of corporate governance. This was revised in 2004. The OECD remains a proponent of corporate governance principles throughout the world.

Based on the work of the OECD, other international organisations, private sector associations and more than 20 national corporate governance codes, the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has produced voluntary 'Guidance on Good Practices in Corporate Governance Disclosure'. This internationally agreed benchmark consists of more than 50 distinct disclosure items across five broad categories: auditing, board and management structure and process, corporate responsibility and compliance, financial transparency and information disclosure, and ownership structure and exercise of control rights. The World Business Council for Sustainable Development (WBCSD) has worked on corporate governance, particularly on accountability and reporting, and in 2004, created an Issue Management Tool: strategic challenges for business in the use of corporate responsibility codes, standards and frameworks.

In its 'Global Investor Opinion Survey' of above 200 institutional investors in 2000 and 2002, McKinsey found that 80% of the respondents would pay a premium for well-governed companies. According to the survey, a well-governed company was defined as one that had as many as outside directors, who had no management ties, undertook formal evaluation of its directors and was responsive to investors' requests for information on governance issues.

Other studies have linked broad perceptions of the quality of companies to superior share price performance. In a study of 5-year cumulative returns of *Fortune* magazine's survey of 'most admired firms', Antunovich, et al., found that those 'most admired' had an average return of 125%, whilst the 'least admired' firms returned 80%. In a separate study, *BusinessWeek* enlisted institutional investors and 'experts' to assist in differentiating between boards with good and bad governance and found that companies with the highest rankings had the highest financial returns.

However, the importance of CG became dramatically clear in 2002, as a series of corporate meltdowns, frauds and other catastrophes led to the destruction of shareholder's wealth worth billions of dollars, job losses in thousands, criminal investigations on dozens of executives and record breaking bankruptcy filings. All of a sudden, everyone was interested in corporate governance. Massive new legislation, Sarbanes-Oxley Act and SEC also had tightened their regulations. NASDAQ has proposed new listing standards that would require companies to improve their corporate governance. But even then, in the past few years, the world witnessed demise of previously successful companies like Parmalat with Calisto Tanzi and Swissair with Philippe Bruggisser. Japan also had its share of corporate scandals with Mitsubishi Motors under CEO Katsuhiko Kawasoe and Seibu Railway under Yoshiaki Tsutsumi.

If we observe the patterns of all these people, the role of the CEOs in these corporate collapses had a huge portion. All have shown poor corporate governance judgment and deliberate greed. According to some experts, eradicating CEO authority and shifting the balance of power towards the board may seem the right response to similar corporate scandals. Reality, however, requires a more sophisticated solution. A workable balance between the board and the CEO will be different for every company and mostly depends on its competitive context.

Defining the board's roles and responsibilities by following a set standard of prescriptions does not always make sense. Instead, the CEO and the board should consider the specific circumstances of their company and identify which types of decisions are vital – these are the ones that the board needs to address. The important thing a board can expect from a CEO is a sound strategic plan. The plan should emphasise both longer-term, 'top-line' performance and shorter-term 'bottom line'. This is a balancing act – not a trade-off – and the CEO must discuss the right balance with the board. The CEO can facilitate the strategy discussion among the board by mapping the various activities for each business area.

The understanding of corporate governance has changed now. Earlier, corporate governance was perceived as a system that ensured that the manager (the CEOs and their team) does not take decisions for private gains and does not expropriate shareholders' wealth. It is now perceived as a system that ensures optimal utilisation of resources for the benefit of shareholders while meeting societal expectations.[1] For example, strategy audit and Corporate Social Responsibility (CSR) are elements of a corporate governance system.

Corporate financial reporting and financial audit support the corporate governance system. They are of immense importance to analysts and investors. Therefore, there is a need to further strengthen corporate financial reporting and financial audit. In March 2008, International Federation of Accountants (IFAC) released its report entitled 'Financial reporting value chain – current perspectives and direction'. The report observes that the three key areas of the financial reporting supply chain – corporate governance, the process of preparing financial reports and the audit of financial reports – have clearly improved in the last 5 years. However, the financial reports are no more useful to them.

This book focuses on the three most significant players in the corporate governance process: shareholders, managers and directors. Together, these forces shape a corporation's focus, its direction, productivity and competitiveness, and ultimately, its viability and legitimacy.

---

[1] Asish K. Bhattacharya, "Corporate Governance and Audit ACCOUNTANCY", *Business Standard*, June 2nd 2008