UKRAINIAN CORPORATE GOVERNANCE ACADEMY

Value-Based Corporate Governance

Prof. Kevin Kaiser, The Wharton School, University of Pennsylvania

Program overview: How does corporate governance affect a firm's ability to create value? The short answer is, hugely! Poor corporate governance results in management focused on narrowly-defined, short-term objectives to the detriment of the long-term well-being (i.e., value creation) of the organization. Good corporate governance ensures management maintain an orientation toward value creation, meaning a broad perspective on the myriad elements of performance which drive value, and a long-term focus to ensure proper management of the tradeoff between near-term resource allocations (and their short-term benefit) and future resource allocations (and their long-term benefit). While many talk about the importance of long-term focus and sustainability, we will discuss these concepts using the rigour of the principles of finance which translate fuzzy language into more concrete implications and measurements.

The program aims to integrate knowledge from different courses and business disciplines, as value creation requires simultaneous prioritization across all areas of business. A good governance structure will have implications for all aspects of management. As a result, this course will draw upon several business disciplines in addition to finance, though the focus will be on the financial aspects and perspective of corporate governance.

In addition to business disciplines, we will also discuss the principle of governing for value creation within the context of biology and physics. We will develop a view of governance from observations of the evolution of life on Earth over 4 billion years, and then the development and evolution of human culture and economic models over tens of thousands of years.

We will then be in a position to use these observations and theories to assess the recent developments in corporate governance ('recent' here refers to the past 400 years) and draw implications for what sustainable and long-term mean in the context of evolution and the principles of finance.

The program starts with an analysis of the impact of governance on behavior and value creation. This will include defining the relevant financial concepts used to define and measure value creation. With these concepts and tools, we will then be able to assess alternative corporate governance models and practices in evolution as well as in human civilization. Only after clarifying the meaning and relevance of these financial aspects, and of value creation as the objective for the firm in particular, will we then consider specific governance arrangements.

We will naturally discuss the organizational structure of the firm and the role of the Board of Directors and of various other committees. We will analyze their role in specific situations such as the monitoring of the CEO, the setting of incentives and compensation, their assessment and approval of the accounts, their role in risk management, and their role in approving large investment decisions (such as mergers or acquisitions), among others. We will investigate strategies for improving governance, starting with the effect of shareholder activism and the role played by hedge funds. While much discussion is about publicly traded firms, we will see that those best practices are also good for private entrepreneurial firms, non-profit firms, or even governments.

For whom is this relevant?

As this program assesses alternative approaches to corporate governance through the lens of value creation, it is first and foremost a program for those seeking to understand how to develop organization structures, incentives and cultures oriented around delivering long-term success. Professions for whom this is important include all board members or managers of any business independent of ownership structure, as well as investors who seek to invest in and oversee successful organizations, such as those in private equity or activist hedge funds. Besides those investing in or managing organizations, others for whom this content is important include people going to consulting firms, investment banks, accounting firms, or law firms, who advise organizations on these issues. Finally, it is also important for those who invest in publicly traded companies and seek to be able to assess and distinguish value-oriented governance from non-value-oriented (and therefore likely value-destroying) governance, so as to avoid investing in value destroying companies.

Session 1: Corporate Governance from a “Blue Line” Perspective

What is corporate governance? What is the role of corporate governance? To address these and other questions, we require clarity on the objective for the organizations whose corporate governance we are assessing. For example, if the objective is to destroy the organization within a year, the criteria for what constitutes “good” corporate governance may differ significantly from the case where the objective is long-term survival. What differentiates good governance from “ethical” behaviour?

As this course looks at corporate governance from a “financial aspects” perspective, we will begin the program by proposing the objective as value creation. This will then provide the conceptual structure within which we will assess the important elements of corporate governance and their impact in the context of the cases and discussions in the remaining sessions of the program.

Reading: Kaiser and Young, Managing for Value 2.0, *Journal of Applied Corporate Finance*,

- Jensen, Value maximization, stakeholder theory, and the corporate objective function, *Business Ethics Quarterly,* 2002, 235-256
- Henderson and Rose, “Investor “Short-Termism”: Really a Shackle?” (HBS 9-315-084)

Optional: Kaiser and Young, The Blue Line Imperative

Session 2: Deepening the Conceptual Foundation: Evolution & Finance

In order to deepen the conceptual foundations of value and value creation, we will tell the story of evolution and ask what ‘value creation’ means in the context of evolution. We will see how the imperative of value creation drives the governance and organization structure of organisms and how the governance then either supports or undermines the organism’s ability to ‘manage for value creation. We will quickly review the evolution of the human brain and consider the relevance of social co-operation (co-operation across non-chemically connected organisms, e.g., human to human) rather than chemical co-operation (co-operation only across chemically connected organisms, e.g., the various lifeforms such as heart cells, liver cells, bacteria in the microbiome, etc., which comprise a human being and whose co-operation enables the microorganism to live). We will then review the implications of this development of the brain for the development and limitations of the social group in biology. We will put the development of agriculture into this context to see that the human adoption of agriculture required a radical change in governance, which has dominated the human progress for the past 12,000 years. Finally, we will see how the recent adoption of alternative governance structures have challenged the dominance of this twelve-thousand year-old governance model and opened the door to phenomenal value creation.

Reading: There is no specific reading for this session as there is no short article which covers the wide range of topics which blend together to form the story we will tell in this session.

Background reading: "What is Life? How Chemistry becomes Biology," by Andy Pross

- "SuperCooperators: Altruism, Evolution, and Why We Need Each Other to Succeed," by Martin Novak with Roger Highfield
- "Thinking Big: How the Evolution of Social Life Shaped the Human Mind," by Robin Dunbar, Clive Gamble, et al.
- "Behave: The Biology of Humans at Our Best and Worst," by Robert Sapolsky

Session 3: Executive Compensation: Intrinsic and Extrinsic motivators to align with long-term health

One of the main jobs of the board is to set executive compensation policies. What are the foundations for the compensation policies we observe? What is the economic reason for paying executives with stocks and options?
What are the side-effects of providing high-powered incentive packages? We have certainly heard a lot about the failures of highly paid executives - how is this linked to the pay structure?

Readings:

- Case study for this session: ***WL Gore*** (INSEAD case)
- O'Byrne, Measuring and Improving Pay for Performance: Board Oversight of Executive Pay, *The Handbook of Board Governance*, 2016
- The controversy over executive compensation, Journal of Applied Corporate Finance, Nov 2003, 108-111
- Kaiser and Young, The Perils of Indicator-Driven Management, 2016
- Graham, Harvey, Rajgopal, The Economic Implications of Corporate Financial Reporting, 2005

Session 4: Corporate Governance: Activism by Hedge Funds

What does a governance activist investor do? How does an activist operate and why? Should management listen to an activist? What do activists know better than management – after all they are outsiders?!

The goals are to highlight what activists do and how they approach a target; to understand what management and the Board can learn from activists, if anything; how and whether a firm should defend (has the right and can defend) itself against an activist investor; and get an understanding of how profitable activism is for the activist investor as well as for the other shareholders and the company.

Readings:

- Case study for this session: ***Apple: Corporate Governance and Stock Buyback***
- The Long Term Effects of Hedge Fund Activism, *Columbia Law Review*, June 2015

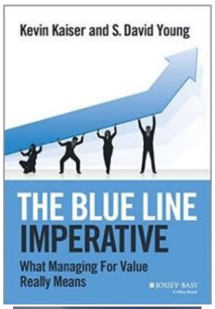
Optional:

- Returns to Shareholder Activism: Evidence from a clinical study of the Hermes UK Focus Fund. Becht et al (2006)
- Survey by Brav, Jiang, and Kim, 2009, Hedge Fund Activism: A Review; http://faculty.fuqua.duke.edu/~brav/HF_Activism_Review.pdf
- Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors. Klein and Zur (2009)
- Hedge Funds and governance targets: Long-term results. William W. Bratton. Working paper. http://ssrn.com/abstract=1677517

Outline

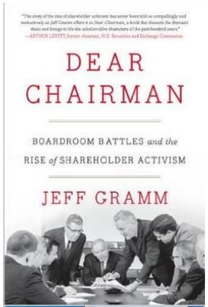
1:00pm – 2:30pm	Session 1: Corporate Governance from a Blue Line Perspective
2:30pm – 2:45pm	Break
2:45pm – 4:15pm	Session 2: Deepening the Conceptual Foundation: Evolution and Finance
4:15pm – 4:30pm	Break
4:30pm – 6:00pm	Session 3: Compensation Structures: Intrinsic and Extrinsic Motivators
6:00pm – 6:15pm	Break
6:15pm – 7:45pm	Session 4: Corporate Governance and Shareholder Activism
7:45pm – 8:00pm	Wrap-up

Recommended Readings:

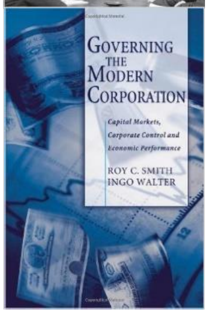


[The Blue Line Imperative, by Kaiser and Young, 2013]

[A Real Look at Real World Corporate Governance, by Larcker, Tayan and Gutman, 2013]



[Dear Chairman: Boardroom Battles and the Rise of Shareholder Activism, by Jeff Gramm, 2016]



[Governing the Modern Corporation, by Smith and Walter, 2006]

Updates on Governance can be found on the webpage of the Institute of Directors (those exist in several countries) as well as the ECGI *http://www.ecgi.org/codes/all_codes.php*.

Warren Buffett's letters to Berkshire Hathaway shareholders, 1977-2016 (http://www.berkshirehathaway.com/letters/letters.html)