Chapter 2

Financial Goals and Corporate Governance
The Multinational Enterprise (MNE)

- A multinational enterprise (MNE) is defined as one that has operating subsidiaries, branches or affiliates located in foreign countries.
- The ownership of some MNEs is so dispersed internationally that they are known as transnational corporations.
- The transnationals are usually managed from a global perspective rather than from the perspective of any single country.
Multinational Business Finance

• While multinational business finance emphasizes MNEs, purely domestic firms also often have significant international activities:
  – Import & export of products, components and services
  – Licensing of foreign firms to conduct their foreign business
  – Exposure to foreign competition in the domestic market
  – Indirect exposure to international risks through relationships with customers and suppliers
Global Financial Management

• There are significant differences between international and domestic financial management:
  – Cultural issues
  – Corporate governance issues
  – Foreign exchange risks
  – Political Risk
  – Modification of domestic finance theories
  – Modification of domestic financial instruments
The Goal of Management

• Maximization of shareholders’ wealth is the dominant goal of management in the Anglo-American world.

• In the rest of the world, this perspective still holds true (although to a lesser extent in some countries).

• In Anglo-American markets, this goal is realistic; in many other countries it is not.
The Goal of Management

- There are basic differences in corporate and investor philosophies globally.
- In this context, the universal truths of finance become culturally determined norms.
Shareholder Wealth Maximization

- In a Shareholder Wealth Maximization model (SWM), a 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 level of risk to shareholders for a given rate of return.
Shareholder Wealth Maximization

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

• The SWM model also treats its definition of risk as a universal truth.
• Risk is defined as the added risk that a firm’s shares bring to a diversified portfolio.
• Therefore the unsystematic, or operational risk, should not be of concern to investors (unless bankruptcy becomes a concern) because it can be diversified.
• Systematic, or market, risk cannot however be eliminated.
Shareholder Wealth Maximization

- *Agency theory* is the study of how shareholders can motivate management to accept the prescriptions of the SWM model.

- Liberal use of stock options should encourage management to think more like shareholders.

- If management deviates too extensively from SWM objectives, the board of directors should replace them.

- If the board of directors is too weak (or not at “arms-length”) the discipline of the capital markets could effect the same outcome through a takeover.

- This outcome is made more possible in Anglo-American markets due to the one-share one-vote rule.
Shareholder Wealth Maximization

• Long-term value maximization can conflict with short-term value maximization as a result of compensation systems focused on quarterly or near-term results.
• Short-term actions taken by management that are destructive over the long-term have been labeled impatient capitalism.
• This point of debate is often referred to a firm’s investment horizon (how long it takes for a firm’s actions, investments and operations to result in earnings).
Shareholder Wealth Maximization

• In contrast to *impatient capitalism* is *patient capitalism*.
• This focuses on long-term SWM.
• Many investors, such as Warren Buffet, have focused on mainstream firms that grow slowly and steadily, rather than latching on to high-growth but risky sectors.
Corporate Wealth Maximization

- 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 (the CWM model).

- In this context, 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.

- This model, also called the stakeholder capitalism model focuses on earning as much as possible in the long-run while retaining enough to increase the corporate wealth for the benefit of all interest groups.
Corporate Wealth Maximization

- The definition of corporate wealth is much broader than just financial wealth (cash, marketable securities and lines of credit).
- Corporate wealth includes technical, market and human resources.
- This measure goes beyond financial reports to include the firm’s market position, employee knowledge base and skill sets, manufacturing processes, technological proficiencies, marketing and administration capabilities.
Corporate Wealth Maximization

• The CWM model does not assume that equity markets are either efficient or inefficient.
• In fact, market efficiency does not matter as the firm’s financial goals are not exclusively shareholder-oriented.
• This model assumes that long-term “loyal” shareholders should influence corporate strategy, not transient portfolio investors.
Corporate Wealth Maximization

- The CWM model assumes that total risk, operating and financial risk, does count.
- In the CWM model, it is a 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.
Corporate Wealth Maximization

• Although the CWM model avoids the impatient capitalism as seen in the SWM, it has its own flaw in that management is tasked with meeting the demands of multiple stakeholders.

• This leaves management without a clear signal about the tradeoffs, which management tries to influence through written and oral disclosures and complex compensation systems.
Corporate Wealth Maximization

• In contrast to the CWM model, the SWM model requires a single goal of value maximization.
• While both forms of wealth maximization have their strengths and weaknesses, two trends in recent years have led to a focus on the SWM model.
  – As non Anglo-American markets privatize their industries the SWM model becomes more important in the overall effort to attract foreign capital
  – Many analysts believe that shareholder-based MNEs are increasingly dominating their global industry segments
Failures in Corporate Governance

- There are clear examples of the failure of Corporate Governance in the United States:
  - Enron – lack of full disclosure of off-B/S debt
  - WorldCom – capitalizing costs that should have been expensed
  - Global Crossing – hiding its overinvestment in operating losses
  - Adelphia – management looting of the firm
Failures in Corporate Governance

• In each case, prestigious auditing firms missed the violations or minimized them, presumably because of lucrative consulting relationships or other conflicts of interest.
• In addition, security analysts urged investors to buy the shares of firms they knew to be highly risky (or even close to bankruptcy).
• Top executives themselves were responsible for mismanagement and still received overly generous compensation while destroying their firms.
Regulation of Corporate Governance

• The corporate regulatory “pyramid” in the United States is as follows:
  – US Congress
  – Securities and Exchange Commission (SEC)
  – New York Stock Exchange (NYSE)
  – Individual Brokerage Firms
The Sarbanes-Oxley Act

- This act was passed by the US Congress, and signed by President George W. Bush during 2002 and has three major requirements:
  - CEOs of publicly traded companies must vouch for the veracity of published financial statements
  - Corporate boards must have audit committees drawn from independent directors
  - Companies can no longer make loans to corporate directors
- Penalties have been spelled out for various levels of failure.
- Most of its terms are appropriate for the US situation, but some terms do conflict with practices in other countries.
Governance, Rights, and the Future

- Clearly, there has been substantial reflection on business in the early days of the 21st century.
- Issues such as sustainable development, environmentalism and corporate social responsibility are emerging as concerns for society, and of course management as businesses look toward the future.