

**Boards of directors**  
**Developments in practice**  
**and findings in research**

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**What do boards do?**

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## Role of the board

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- Hire and evaluate management
  - Vote on major operating proposals
  - Vote on major financial decisions
  - Offer expert advice to management
  - Make sure the firm's activities and financial condition are accurately reported to its shareholders
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- Precise role varies across countries
  - Today: Talk about general aspects

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## The Big Picture

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## Separation of Ownership and Control

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The shareholders are owners of the firm

The officers (or executives) control the firm

Especially relevant in large corporations

## Principal-agent problem

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- Principal—shareholders
- Agent—managers
- Principal-agent problem represents the conflict of interest between management and owners.
  
- For example, if shareholders cannot effectively monitor the managers' behavior, then managers may be tempted to use the firm's assets for their own ends, all at the expense of shareholders.

## Addressing the principal-agent problem

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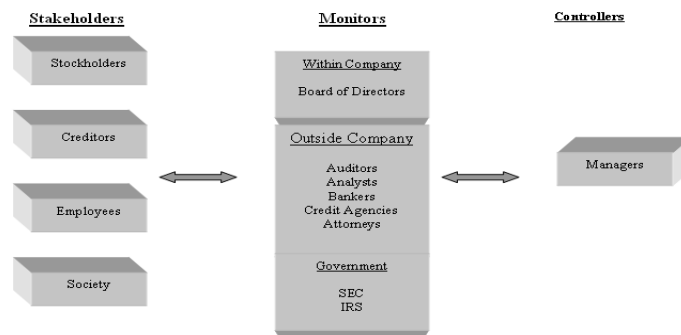
Incentives—aligning executive incentives with shareholder desires.

e.g. stock, restricted stock, and stock options.

Monitoring—setting up mechanisms for monitoring the behavior of managers.

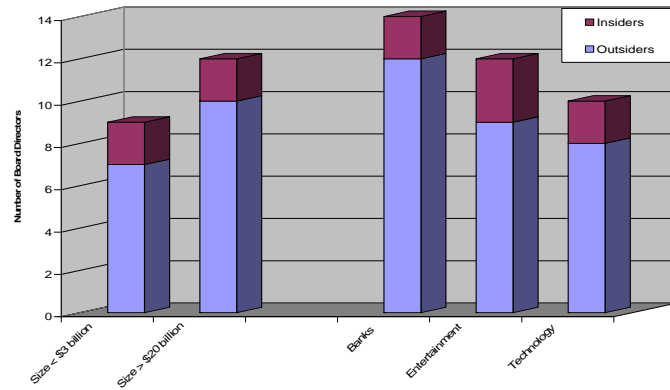
No “solutions” to the principal-agent problem

FIGURE 1.1 SEPARATION OF OWNERSHIP, MONITORING, AND CONTROL



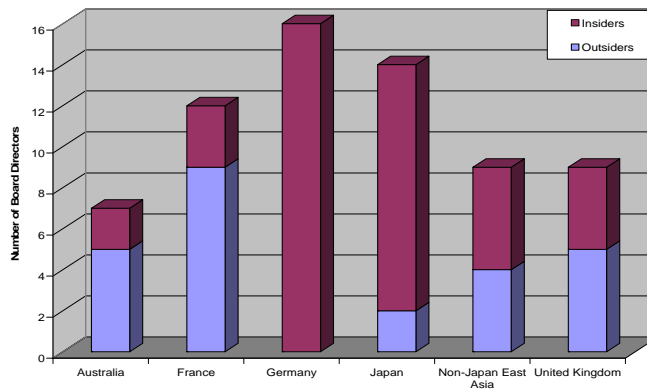
Kim and Nofsinger (2007)

### Average U.S. board size and composition by company size and industry



Source: Board Analyst, 2005

### Average board size and composition around the world, 2004



Source: Kim and Nofsinger (2007)

### An example from Europe: Boards in Switzerland (SMI)



SMI-firms have 9 board members on average

Average age: 59 years

Experience:

82%: leadership background

50%: specialists in the sector

37%: business/finance/audit background

15%: law background

Composition

42%: Foreigners

8%: Women

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### An example from Europe: Boards in Switzerland (SMI)



Composition

23%: CEO = Chairman

81%: Half of the board is independent

Availability: 62% have limited availability

Terms: Median: 2 ½ years

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## **Case Study: Accounting Fraud at WorldCom**

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## **What happened?**

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## What happened?

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- \$30bn revenues, \$104bn assets, 60,000 employees
- On July 21, 2002, WorldCom files for bankruptcy protection
  
- Between 1999 and 2002: WorldCom had overstated its pre-tax income by at least \$7bn
  
- WorldCom stock collapsed, many employees lost their jobs and most lost their retirement accounts

## Incentives to cook the books

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- Compensation tied to share price, short-term targets
- Empire-Building (Ebbers started washing dishes and became a billionaire)
- Wanted to keep high P/E ratio, needed growth
- High stock price allowed acquisitions, but poorly implemented, management errors in leasing agreements
- Telecom industry after dot.com
- Could not acquire Sprint, only organic growth left

## How could it happen? 1/5

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- Leadership and culture
  - Intra-day fluctuations of share price vs. Long-term value creation
  - Power, carrot&stick
  - Fragmented company
  - Missing outside options
  - No Code of Conduct
  - Culture of „not knowing“

## How could it happen? 2/5

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- Internal control
  - Direct control by management top level
  - No opportunity for (constructive) whistle-blowing (needs independent recipient, anonymity, 0-800-number, ...)

## How could it happen? 3/5

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- Internal audit
  - Responsibility of CFO Scott Sullivan!
  - Today's best practice: Internal audit reports directly to Audit Committee of the board

## How could it happen? 4/5

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- External audit
  - Arthur Andersen did not behave independently
  - Would have needed to report difficulties to the audit committee of the board (and the board would have had to ask)
  - Even the SEC was skeptical

## How could it happen? 5/5

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- Board of directors
  - Fulfilled today's criteria for "independence"
  - Most had experience and expertise in the telecommunications industry
  - Board also had an independent chairman
  
- BUT...

## The WorldCom board

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- Was not truly independent
- Most had been made rich through the purchase of their company by Ebbers' WorldCom
- Served at Ebbers' pleasure
  - "Bernie's Boys"
- Board allowed Ebbers to become involved in businesses with no relevance to WorldCom; gave him personal loans; and was co-opted with special gifts and perquisites (jet plane ownership and transportation) supplied by the company
- Board members had served for a very long time
  - Dependent
  - Started with a small company

## The WorldCom board

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- The numbers reported to the board were “false, but plausible”
- Board behaved passively
- The board members’ complicity contributed to the sustainability of the fraud
- “Detached and dysfunctional” (Richard C. Breeden)

## Potential problems with today’s boards

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- Frequently observed factors
  - For many firms, the board’s chairman is also the firm’s CEO.
  - Some board members may not be independent
  - Directors do not have a significant vested interest in the firm.
  - Some directors may be overextended
  - Some directors do not have the expertise to be a board member
  - Some boards are too large
- Central message today: These are important factors.
- But they don’t get at the heart of what good board governance is

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## Spotlight on Research: Board independence

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## The CEO – board relationship

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- Fact 1: CEOs select their own boards (Mace 1986)
- Klaus Kaldemorgen (2007, DWS Investment GmbH): "The selection process [of board members] is intransparent. One obtains the impression that CEOs select their own board members." (p. 264)

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## Boards and firm performance

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- Most academic work on boards has been empirical:
- Weisbach (1988): Independent boards are more likely to dismiss CEO following poor performance
- Rosenstein and Wyatt (1990): Positive stock price reaction to news of the appointment of an outside director
  
- Fact 2: Most work fails to detect a significant relation between firm performance and board composition: Hermalin and Weisbach (1991), Byrd and Hickman (1992), Mehran (1995)

## The CEO – board relationship again

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- Fact 3: Directors are rewarded by CEOs for loyalty and punished for disloyalty
  - Informal social sanctioning (Westphal and Khanna 2003)
  - Directors who ingratiate themselves are more likely to gain additional board appointments (Westphal and Stern 2006, 2007)
  
- Fact 4: Directors suffer costs from the market following acts of loyalty.
  - They lose directorships after a lawsuit is filed (Fich and Shivdasani 2006) or when an accounting restatement is issued (Srinivasan 2005)

## An example of a model

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- CEOs care about competence of boards because CEO compensation is tied to firm performance
- CEOs want boards to be loyal, i.e., grant them private benefits, sometimes even if they are bad for the firm and thus costly for boards
- Loyalty with rewards is non-contractible and must be self-enforcing

That is, a distinction between formal (de iure) and actual (de facto) independence of directors. Based on Wagner (2007)

## Results

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- 1. There is a tradeoff between loyalty and competence: Loyalty is not feasible for too competent boards
- 2. A CEO may prefer an incompetent board when the shareholders would prefer a competent board
  - Reason: Board competence helps identify negative NPV projects, which makes obtaining board loyalty more costly

I'll take 50% efficiency if I can get 100% loyalty  
Samuel Goldwyn (MGM)

## Results for research aficionados

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- Comparative statics for board competence as the dependent variable
  - New predictions while existing papers have few predictions (only for complexity of the environment)
- Additional implications
  - Efficient loyalty is more easily sustainable with competent directors; implications for voting procedures, term limits,...

## Other theoretical models of boards

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- Central insight: Boards are endogenous
- Very important for empirical work
  - Hermalin and Weisbach (1998): CEO and board negotiate, many predictions
  - Harris and Raviv (2005): Optimal boards employ larger number of outsiders when managers' private benefits are high and the cost of monitoring is low
  - Coles et al. (2006): Boards are bigger in complex environments
  - Adams and Ferreira (2007): Friendly boards can lead CEO to reveal more information
  - Song and Thakor (2006): CEO controls the board's screening information and may also prefer a less competent board
- Boone et al. (2006) find some empirical support for most of these theories

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## Modern, progressive boards

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## Different types of boards

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- The passive board
- The certifying board
- The engaging board
- The intervening board
- The operating board

Adapted from Nadler (2004)

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## Key success factors

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- Group dynamics
- Information architecture
- Focus on the key issues

## Group dynamics

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- Dialogue is the lifeblood of boards
- One or two directors as facilitators
- Lead director
  - Especially important when CEO = Chairman
  - Example: Tyco, explicit division of responsibilities (after scandals)
- Executive sessions
  - Can be powerful, but also very destructive
  - Communication with management
- Board evaluation
- Unwanted directors
  
- Research: Economics has very little to say yet, interdisciplinary work is important

## Best-practice board development

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- Hard to present blueprints
- Some ideas
  - Ongoing new elections of a given percentage of the board
  - Retreats
  - Board self-assessment
  - Analysis of other boards
  - Active communication of management needs to the board
- Key: Balancing firm development and board development

## Information flows

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- Board briefing
  - Simplify and get to the fundamentals
  - Cash flow
  - What is driving margins?
- Management letter
- Employee surveys
- Director outreach
- Reports from committees

## Board Committees

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- Most common sub-committees include:
  - Audit committee (96% of SMI companies)
  - Compensation committee (57% of SMI companies)
  - Nomination committee (46% of SMI companies)
- Other sub-committees may include:
  - Executive committee
  - Finance committee
  - Community relations committee
  - Corporate governance committee
  - Stock options committee

## Substantive issues

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- Too often, discussions of key matters such as strategy, succession, and external trends are squeezed in around the edges
- Comp of the CEO?
  - Academia has a lot to say about this
  - Second-best can be much better than third-best
- Understand the strategy?
- External trends?
- Sources of growth?
- Right approach to diagnosing financial health? Meta-level
- Right CEO? Leadership gene pool?

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## Concluding remarks

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## Thank you

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## Background: Alexander F. Wagner

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- Austrian, born 1975
- 1998 and 2000: Degrees in Economics and Law from the Johannes Kepler University of Linz
- 2001: Ph.D. in Economics, sub auspiciis Praesidentis, JKU Linz
- 2005: Ph.D., Harvard University
- Since October 2005: Assistant Professor of Finance und Financial Markets at the University of Zurich (Swiss Finance Institute) and Research Associate at the Kennedy School of Government at Harvard University
- Research focus: Corporate finance and governance, applied microeconomics
- Professional experience:
  - Economic advisor for a US private equity firm and numerous other companies and governmental agencies
  - Lehman Brothers