

SARBANES-OXLEY: ONE YEAR LATER

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WAS THERE A CRISIS?

- LITTLE DEBATE:
 - Chronic Accounting Restatements
 - Governance Deficiencies
 - Agency Issues
- HOW TO FIX THE PROBLEM?
 - Sarbanes-Oxley?

CORPORATE GOVERNANCE

- What is it?
- “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”

The Journal of Finance, Shleifer and Vishny [1997, page 737].

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance",

OECD April 1999.

GOVERNANCE: A NEW FIELD

- Too broad in many discussions:
 - All inclusive
 - Open ended
 - Any implications for policy?
- Here consider two aspects of Governance:
 - Board Structure; and
 - Agency Relationships

THE CRISIS OF CONFIDENCE

- Accounting Restatements:
 - 59 Public Company Restatements in 1997
 - 240 by 2002, plus the \$ scale
 - Causes?
 - Governance Deficiencies
 - Agency Issues
- Extreme Governance Failures
 - WorldCom, Enron

Restatements

- Ongoing but reached new levels
- Causes:
 - 1. Accounting judgements
 - 2. SEC investigation resolution
 - 3. Fraud
 - 4. Inter-period adjustments
 - 5. For comparability after restructuring
 - 6. To reflect legal settlements

Effects of Restatements

- Overall, not too surprising: **NEGATIVE!**
- What additional insights?
 - Biggest effect (lose 1/3) when CEO departs
 - Even negative effects when “neutral”
 - Only “legal settlement” cases positive
 - Effect for competitors
- The linkage to top executives: **Governance**

Restatements and Governance

- Biggest negative reaction to restatement
- What is the “signal?”
- Managerial and governance deficiencies
- Focus on Governance for two reasons:
 - Board Structure
 - Agency problems
- Boards and Agency relationships

BOARDS

- Failures: distressing number of examples:
 - W.R. Grace
 - WorldCom
 - Enron
- Insiders versus Outsiders
- Dual Office Holding
- Self Dealing:
 - Adelphia

Quick “Solutions”: The Need for Caution

- The complexity of governance
- Insiders and outsiders
 - Knowledge and objectivity
- Dual office Holding
 - The “star”
- Look at both
- Insights from research

Insiders versus Outsiders

- Outsiders: the benefit of objectivity
- Insiders: the knowledge advantage
- Affiliated: intermediate, but conflicted?
- Extremes often not functional:
 - All insiders & affiliates: W.R. Grace & Co.
 - Mostly outsiders: Coca Cola 1997-1999
- Insights from research

Dual Office Holding

- “CEO their own Boss”
- Checks and balances?
- Why so common?
- Examples:
 - Negative: Adelphia, Tyco
 - Positive: Coca Cola (1982-1997), GE
- Insight: Tobin’s Q Ratio

TOBIN'S Q RATIO

- Emerging findings on Dual Office Holding and Tobin's Q
- When Tobin's $Q > 1$: Positive
- When Tobin's $Q < 1$: negative
- From Concept to Metric
- Other evidence on Tobin's Q:
 - Capital expenditure announcements

$$"Q" = \frac{\text{Capital Value of Firm}}{\text{Replacement Cost of Assets}}$$

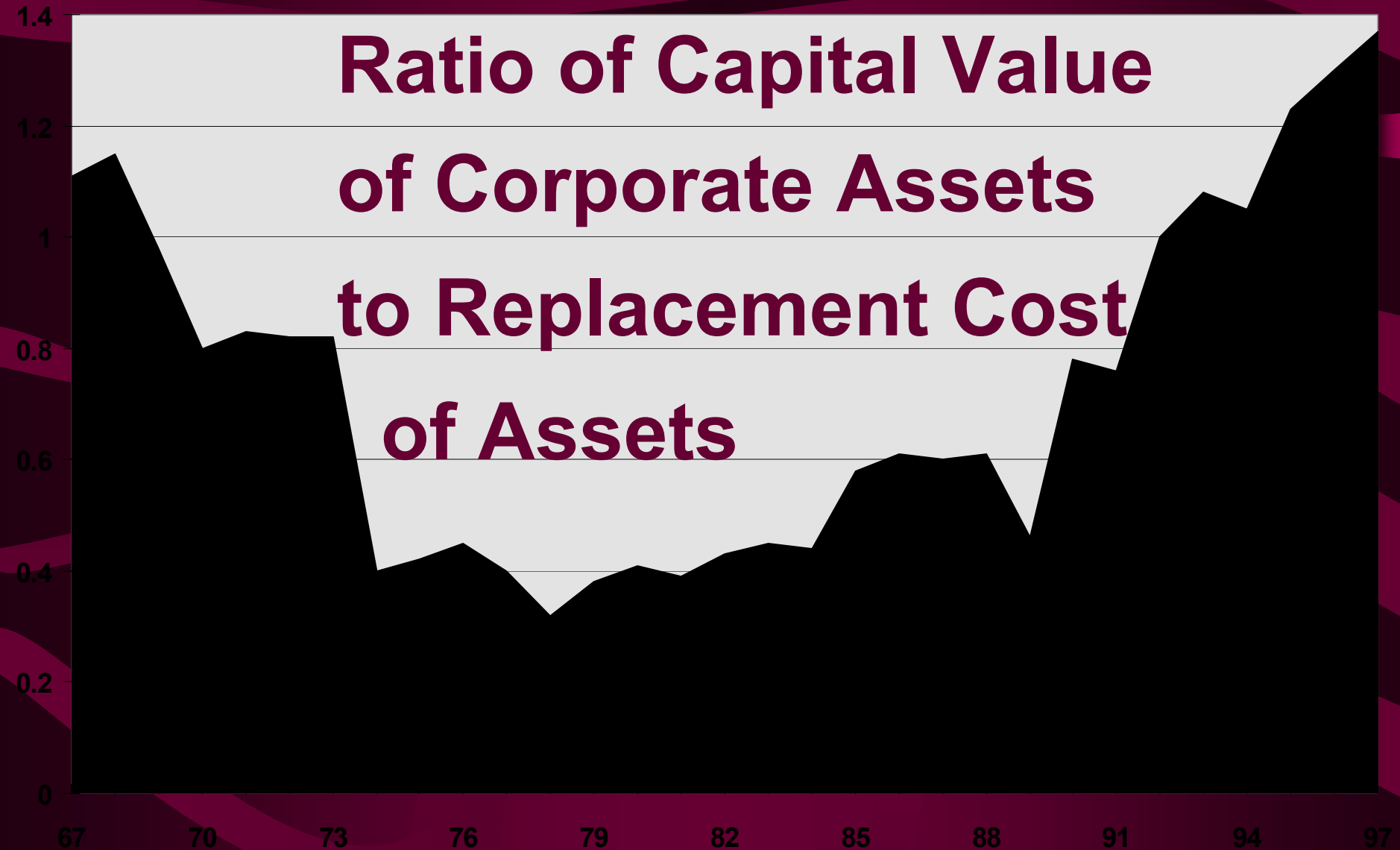
$$"Q" = \frac{\text{TMV} = S + D}{\text{Replacement Cost of Assets}}$$

- **Neat Concept**
- **But how applicable?**



'Q' Ratio Over 1967 - 1997

Ratio of Capital Value
of Corporate Assets
to Replacement Cost
of Assets



Data: Federal Reserve Board
Dean Witter Reynolds Inc. Estimate

EST.

Principals and their Agents

- 1. Owners
- 2. Lenders
- 3. Stockholders
- 4. PBGC-pension employees
- Managers
- Borrowers
- Board members
- Trust-pension executives

Agency: Monitoring, Costs, Aligning

- The first two agency relationships are very familiar:
 - Stock options
 - unintended consequences (Disney, AOL)
 - Indentures and innovations such as:
 - “Put” Bonds to address “event risk” (Marriott)
- But the agency relationships #3 & #4 are newly prominent

Stockholders and Board Members

- Can this Agency relationship exist?
 - Yes! WorldCom
- Stockholders elected representatives
- Nomination procedure
- The “ultimate” Governance problem
- NYSE’s own Governance issues

Pension Trusts

- Just as there may be some light at the end of the tunnel...
- A major new agency relationship emerges
- Pits employees against employees
- Underfunding makes this VERY important
- ERISA and the PBGC
- The airline industry

Is There Still a Crisis of Confidence?

- Has Sarbanes-Oxley accomplished its goals of improving corporate governance standards and the quality of financial information provided?
 - Yes:
 - It is taken seriously, real sanctions
 - No:
 - Few companies sanctioned

Yes, S-O is Working

- This is taken very seriously by most executives
- Definitive sanctions
- Enables prompt action and sanctions
 - HealthSouth
- Formalizes responsibility
- Effective SEC “enforcement tool”

No: S-O is not working

- HealthSouth only company where action taken
- Delayed filings may not be certified:
 - Footstar: no reports filed since summer 2002
 - Quest: restatements for pre S-O periods
 - Gemstar: restatements now certified
- Sheer volume requires “spot checks”
- Unintended consequences

Conclusion

- The U.S. financial markets have experienced a crisis of confidence
- Most severe since the 1930s
- Governance deficiencies and Restatements
- S-O sought to rectify problems and is moving us in the right direction
- Integrity of “institutional infrastructure” needs to be restored to end the crisis