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PART A : ARTICLE

Reflections on corporate governance: Views of Warren Buffett, Bengt Holstrom , Parl Paulman, and Sanjeev Bikhchandani

It is instructive to learn about the views of four eminent persons on corporate governance, viz., Bengt Holstrom , Paul Polman, and Sanjeev Bhikchandani.

Warren Buffett

In his Letter to Shareholders in the annual report of Berkshire Hathaway Limited for the year 2019, Warren Buffett reflected on boards of directors. Based on his experience of serving on the boards of 21 publicly limited companies during the last 62 years, he made the following insightful observations.

1. Over the years, many new rules and regulations relating to board composition and duties have been introduced. The key challenge for the board, however, is still the same: find a talented, honest, and devoted CEO. As Buffett put it, "The bedrock challenge for directors, nevertheless, remains constant: Find and retain a talented CEO possessing integrity, for sure – who will be *devoted* to the company for his/her business lifetime. Often, that task is hard. When directors get it right, though, they need to do little else. But when they mess it up, …."
2. Audit committees now work harder than before. Yet, they are not a match for managers who wish to manage the bottom line. Executives who manipulate the numbers are often prompted by ego rather than a desire for financial gain.
3. Compensation committees now depend more heavily on consultants than in the past. As a result, compensation arrangements have become overly complicated.
4. A *very* important mandated improvement in corporate goverance has been the regularly – scheduled "executive session" of directors without the CEO. Prior to this change, frank discussions of a CEOs skills, acquisitions, and compensation were rare.
5. Acquisition proposals are a particularly vexing problem for board members. As Buffett put it, "The legal orchestration for making deals has been refined and expanded (a word aptly describing attendant costs as well). But I have yet to see a CEO who craves an acquisition bring in an informed and articulate critic to argue against it. And yes include me one among the guilty."
6. Over the years, board "independence" has received greater emphasis. However, an important aspect of this topic has been glossed over. As Buffett put it, "One key point relating to this topic, though, is almost invariably overlooked: Director compensation has now soared to a level that inevitably makes pay a subconscious factor affecting the behavior of many non- wealthy members ."No wonder when seeking directors,

CEOs look for friendly souls.   Buffett added, “Despite the illogic of it all, the director for whom fees are important- indeed craved – is almost universally classified as ‘independent’ while many directors possessing fortunes very substantially linked to the welfare of the corporation are deemed lacking in independence.”

7. Women are under- represented on corporate boards.

Bengt Holstrom

Here are the views of Bengt Holstrom, a Nobel Laureate in Economics, on corporate governance.

1. Corporate governance has been evolving over time, adapting itself to corporate and social needs and public opinion.
2. Friedman’s 1970 argument for maximizing profits - for which read “shareholder value” - finds partial expression in the way companies have responded to current social concerns.
3. Calls for wholesale change in corporate governance are premature.
4. In the 1970s the prevailing doctrine was “stakeholder value.” Shareholder value maximization became the new motto in the war of successful hostile takeovers and restructuring. Lucrative option contracts were designed for executives. While they worked well initially because there was too much to restructure, their poor design eventually led to scandals and eroded trust. Today we are seeing a return to stakeholder value again with a difference from the 1970s. The new regime may be called “stakeholder plus regime” The plus refers to the rise of ESG as an increasingly important element of corporate governance.
5. The 1980s switch to shareholder value invigorated the economy, generating broad benefits along with some undesirable consequences.
6. Today’s ESG movement has provided a call to action against major social threats. It remains to be seen how corporations can translate social pressures into effective actions.
7. Friedman argued that since shareholders have a residual claim - and other stakeholders have a fixed claim - corporate managers who represent them will make choices that consider the total benefits and costs to all stakeholders. If a decision hurts an employee, she will leave . As Bengt Holmstrom says, “In idealized conditions, if parties can bargain and contract costlessly, the outcome will be efficient in the sense that the preferences and exit options of all stakeholders have been considered. **This central insight is Coase’s and it underpins Friedman’s logic.”**
8. It is crucial that managers work to maximize firm value. As Holmstrom says, “If corporate managers become indifferent to or are prevented from trying to maximize investors’ wealth, the system breaks down, including the benefits and assurances it offers non-investor stakeholders.”

9. The dominance of joint stock companies is because shareholders have a relative unity of interest. Of the different stakeholders of the corporation, shareholders are by far the most homogeneous group.
10. Changing capitalism is utterly unwarranted at this stage. Improvements can be made to corporate governance at the margin, without massive structural change. As Holmstrom says, “I think there is a need for better information so you know what changes are socially good or bad.”
11. Corporate governance has historically shifted in response to stakeholder concerns and corporations have indeed found it value-maximizing to do so. Based on this logic we can predict that corporations will respond to the ESG-concerns.
12. The regulatory system is highly imperfect. The main force of change will come from four main groups : consumers , public opinion, regulators, and institutional investors. For a broader public engagement, we need robust ESG measures. Given the advances in AI, we seem to be on the right track.
13. Nevertheless, I believe that **wealth maximization and the Coasian mechanism are fundamental to a successful economy.**
14. **It is interesting to note that the most valuable companies today are those who ignore the market and downplay quarterly earnings. Steve Jobs never talked to investors. Larry Page and Sergey Brin focused squarely on building the best search engine. Warren Buffet never talks to institutional investors.**

Parl Polman

Paul Polman, a former chairman of Unilever, has this to say on corporate governance;

1. My father gave me a little porcelain plaque that said in Dutch : “An economist is someone who doesn't know what he doesn't know.”

2. Milton Friedman developed his perspective in a different time and in the U.S. The system we inherited from that era undoubtedly did a tremendous job in lifting more people out of poverty than at any time in human history.

3. The reality, however, is that the way our economic system has provided growth is simply not sustainable. In the last four decades, we have done more damage to our planet than in the entire history of the planet.

4. Just as Franklin Roosevelt allowed the U.S. to embark on a period of prosperity, we now desperately need another new deal.

5. Many of the things that Bengst said will work for responsible companies with responsible leaders and responsible governments. However, we do not have enough such responsible institutions. Collectively, the numbers do not add up.

6. “No long-lived company has decided itself just to maximizing shareholder value. Lord Lever did not found Unilever to maximize his own wealth. He wanted to invent

products that solved hygiene problems..He believed in something that was called shared prosperity."

7. Today, business has another reason to address social reasons. For the first time, financial markets have become responsive to ESG concerns. During COVID more ESG funds were founded because fund managers saw an opportunity in them, and not because they were persuaded of the ESG themselves.
8. We must upgrade our corporate governance, leadership, and moral codes. If we can also influence governments in the right directions, then we have a wonderful world to live in.
9. For Unilever, it was not profit per se that was paramount. It was the long term cumulative growth of the company that mattered. When I became the CEO, I stopped quarterly reporting and moved the compensation system to the long term for everyone.
10. Jeff Bezoz got interested in climate change only when 8000 employees threatened to walk out.

Sanjeev Bikhchandani

As Sanjeev Bikhchandani, co-founder, Info Edge, says good governance is inside the founders' heads. No amount of oversight by investors, boards, audit committee, or auditors can ensure a company is well governed if the founders are not committed to this objective.

There are some simple principles of good governance for companies and founders to follow- tell the truth, comply with the law, listen to your board and to your auditors, treat minority shareholders well, be transparent and disclose all material information to all the relevant stakeholders, give bad news early and good news only after it is confirmed, make sure your significant accounting policies (revenue recognition, expense booking, inventory etc.) are within the boundaries of prudent, reasonable, truthful and fair accounting principles.

It is very hard to get good independent directors for company boards given the fiduciary responsibilities and the potential liabilities. There is very little upside for good people to accept board positions. They will only do if they are completely convinced that the company is impeccably governed.

**From Sanjeev Bikhchandani, "The Buck Starts with Founders", The Economic Times, April 25 2022*

Part B: SNIPPETS

Impact Bonds

Impact bonds is an outcome- based finance mechanism in which social impact investors and global philanthropic funds participate. The impact bonds work as follows:

1. Risk investors provide upfront capital to an NGO /service provider to deliver a programme with well defined measurable outcomes.
2. An independent evaluator assesses the results.
3. The funders/ donors repay the investors if the outcomes are achieved.
4. The risk investor receives a small return on their investment.

Corporate managers use the following measures for risk (in order of decreasing popularity) : probability of not covering investment costs, standard deviation of expected cash flow, and beta.

Risk Hedging Techniques in Practice

The most common methods for hedging financial risk in practice are as follows (in order of diminishing popularity): forwards, swaps, options, and futures. The choice of forwards and swaps over futures and options suggests that there is a preference for risk- hedging through the banking system rather than the capital market as well as a preference for customised risk-hedging instruments that meet the specific hedging of the company over standard hedging instruments.

Agency Costs of Overvalued Equity

Very few business leaders, Warren Buffett being one of them, have recognised the pitfalls of overvalued equity. Michael Jensen, the father of modern agency theory, earlier regarded markets as potent forces to help control agency costs. Looking at the behaviour of markets and corporates in the late 1990s and early 2000s, Jensen realised how securities markets can sometimes create and exacerbate conflicts of interest between managers and owners rather than resolve them.

Overvaluation of equity triggers organisational forces that are difficult to control and lead to value destruction. An overvalued equity means that the market has unrealistically optimistic view of future earnings. Managers know that the firm will be punished by the capital market, if they miss analysts' inflated earnings' forecasts. So, the only way for managers to meet those expectations is to cook their books. As Jensen noted in 2005, "Indeed 'earnings management' has been considered an integral part of every top manager's job for at least the last two decades. But when managers smooth earnings to meet market projections, they are not creating value for the firm; they are both lying and making poor decisions that destroy

value.” He further added, “Once we as managers start lying in the earnings management game, it is nearly impossible to stop because the game cascades forward.”

Enron is a classic example of this phenomenon. At its peak, Enron’s market value was $70 billion, though in Jensen’s assessment it was worth only $30 billion. As Jensen observed, “It was a good, viable business; the company was a major innovator. But senior managers’ efforts to defend the $40 billion of excess valuation (which was a mistake that was going to go away anyway) effectively destroyed the $30 billion core value.” (In 2000, WIPRO ... 230,000 crore 2007.. 96,00cr).

While the market for corporate control solved many of the problems of undervalued equity in the 1970s and 1980s through takeovers, it could not (and perhaps it cannot) solve the agency problems of overvalued equity.

So corporate boards and business educators have a responsibility. Corporate boards should take discourage target- based budget and compensation systems that dilute integrity by rewarding gaming, lying, and value destruction in their organisations.

It behoves upon business educators teaching students about the desirability of maximising intrinsic value to distinguishing the same from maximising current stock price and caution them about the dangers of overvaluation.

Here are some rules to tell whether a firm’s stock is overvalued: (1) When managers think that it is impossible for them to achieve the performance required to justify the current price of their equity. (2) When managers cook the book or engage in fraudulent behaviour to artificially support their firm’s stock price.

PART C : WIT AND WISDOM

HUMOUR

Promise

Henry told his three children that if they would not smoke till they became 21 years old, he would give them $1000 on their 21st birthday. Cathy, who was 17, said “Yes.” John, who was 15, said, “I will think over it.” Michael, who was 10 years old, said “I wish you had given this offer earlier.”

Girl Friend/Jacket

A young man purchased a red jacket from a shop. Next day he came to the shop to exchange the red jacket with a black jacket because his girl friend didn’t like the red colour. After a week he came back to exchange the black jacket with the original red jacket. The shop keeper asked, “Has your girl friend changed her mind?” “No,” replied the young man, “I have changed the girl friend.”

WISDOM

.Count reminiscences like money . : Carl Sandburg.

You have freedom of choice but not freedom from choice. :Wendell Jones.