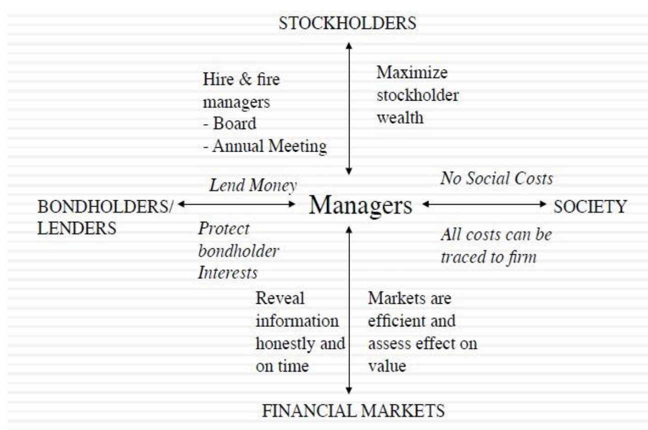
ULTIMATE CORPORATE OBJECTIVE

- The ultimate objective in corporate decision making is to maximise firm value or maximise asset value
- A narrower objective is to maximise the stock price i.e maximise equity value
  - Stock prices are frequently updated (unlike other performance measures)
  - If market is efficient (which we assume is the case) the share price should reflect the quality of decision making
- **Maximising profit is <u>not</u> optimal because:**
  - Profit numbers (unlike cash flows) are subject to manipulation
  - Managers (CEOs) may focus on short-term gains or performance objectives which may hurt long-term value eg. cut investments and dividends to improve short term cash flows

WHAT ADDS VALUE?

- some decisions have the potential to add more value than others
  - "Value comes mainly from the asset side of the balance sheet"---i.e investment decisions can add more value than financing/payout decisions
  - Eg. Microsoft has a market capitalization of about USD361 billion .
    - Most of that comes from product development, brand name and world wide customer base.
    - Their financing strategy is very simple: no debt and finance most of investment by retained earnings
    - Their payout ratio is very simple: pay no dividends until 2003. Since then their dividends have been increasing reflecting the drying up of profitable investment opportunities

BROADER CORPORATE OBJECTIVE



AGENCY PROBLEM AND OTHER ISSUES

- Agency Problem:
  - results from the separation of ownership and control
  - Managers not acting in the best interest of shareholders
  - Bondholders suffer at the expense of shareholders
- Disclosures:
  - Firms delay release of bad news or provide misleading information
- Market Efficiency:
  - Market is not efficient in processing the information ie. can over or underreact to information

CORPORATE GOVERNANCE AND CONTROL

- Corporate governance and control aims at disciplining managers to ensure they act in the best interest of the shareholders and work towards achieving the corporate objective
- In theory, shareholders can discipline managers by:
  - Going to annual meeting
  - Voting for the board of directors

- In practice, these disciplinary mechanisms do not work very well
  - Shareholders do not go to annual meeting and if they do are unlikely to bring up any confrontational issues
  - Board of directors are well paid and busy, they are picked by CEO and don't have a lot of equity stakes in the company
- **Internal** Governance and Control:
  - Well-designed incentives and compensation packages for managers: performance based bonus, embedded stocks and stock options
  - Requirements for board of directors
    - Outside vs. inside directors: majority of directors are outsiders (or independent)
    - Audit and Remuneration committee: directors are exclusively independent
    - The Chairman is independent
  - Investors can "vote with their feet" which means sell the shares in the company
- **External** Governance and Control:
  - Standards for accounting and **disclosure** to investors
  - **Regulations** (e.g. SOX in the U.S. and CLERP 9 in Australia)
  - Industry **watchdogs** (e.g. ASIC, ACCC, ATO, and RBA).
  - Monitoring from **lenders** and/or banks
  - The market for **corporate control**:
    - the company can be taken over if the manager is not performing (Note:

related to Topic 9) **CORPORATE SOCIAL RESPONSIBILITY**

- Corporate financial decision making can have social implications:
  - **Social costs**:
    - Environmental cost (pollution, health impact)
    - Quality of life cost (traffic, congestion, safety)
  - **Social benefits**:
    - Creating employment
    - Improve infrastructure in some cases