WEAK CORPORATE GOVERNANCE AND $1.5 TRILLION OF INVESTMENT LOSSES

Hugh Grove*, Maclyn Clouse**

*Accounting Professor, School of Accountancy, University of Denver, USA
**Finance Professor, Reiman School of Finance, University of Denver, USA

Abstract

Weak corporate governance facilitated over $1.5 trillion in investment losses in the 21st Century in just 17 primarily U.S. public companies. Sir David Tweedy, the former chair of the International Accounting Standards Board, has commented: “The scandals that we have seen in recent years are often attributed to accounting although, in fact, I think the U.S. cases are corporate governance scandals involving fraud” (Tweedy, 2007). Thirteen prominent U.S. business leaders from industry, asset management firms, and an activist investment firm secretly worked for one year to develop corporate governance principles that would become a pathway for the future. The importance of implementing good corporate governance principles, as developed by this committee in 2016, is stressed by these $1.5 trillion of investment losses. This paper has developed lessons learned from these scandals which reinforce these corporate governance principles as a pathway to avoid such malpractices in the future. Attention should be particularly paid to the violations of two critical principles which amassed the majority of these investment losses: Principle I. Board of Directors - Composition and Internal Governance, especially Composition and Independence and Director Effectiveness, and Principle IV. Public Reporting, especially Transparency and Non-Generally Accepted Accounting Principles.

Keywords: Corporate Governance Principles, Market Capitalization

1. INTRODUCTION

The Chief Executive Officer (CEO) of JPMorgan Chase, Jamie Dimon, called the CEO of Berkshire Hathaway, Warren Buffett, and suggested that they get together and come up with general principles for corporate governance that would become a pathway for the future. 13 prominent U.S. business leaders from industry, asset management firms, and an activist investment firm secretly worked for one year to develop corporate governance principles (Thakker, 2016). They wanted to provide such guidance at a time when fewer entrepreneurs are deciding to sell shares on U.S. public markets (Mathews 2016). These authors said that the resulting document was detailed and tough-minded with commonsense recommendations and guidelines about the roles and responsibilities of boards, companies, and shareholders (Governanceprinciples.org, 2016). A financial press commentator said that these principles may set a new standard in American corporate governance and that the stakes couldn’t be higher as over 90 million Americans own U.S. public companies through their investments in mutual funds, retirement plans, and pensions (Gara, 2016). A corporate governance expert commented on these principles: “I think it shifts the burden of proof onto any corporation that doesn’t comply and I am delighted the signatories are such influential people” (McGregor 2016).

2. CORPORATE GOVERNANCE PRINCIPLES

This paper summarizes these eight corporate governance principles and demonstrates their relevance with related examples of weak corporate governance by just 17 public companies that destroyed more than $1.5 trillion of market capital in the 21st Century. Hopefully, there are memorable corporate governance lessons to be learned from these investment losses, especially for Boards of Directors and auditors as gatekeepers to help protect investors.

3. PRINCIPLE I. BOARD OF DIRECTORS – COMPOSITION AND INTERNAL GOVERNANCE

3.1 Composition and Independence

The principles stated that directors’ loyalty should be to the shareholders and the company and must
not be beholden at the CEO or management. A significant majority of the board should be independent under the New York Stock Exchange (NYSE) rules or similar standards. However, dual class voting has negated this independent board rule if the voting stock, usually owned by top management, has a majority of the votes. Prominent current examples are Facebook, Alphabet (formerly Google), and Alibaba. Thus, the principles also stated that dual class voting is not a best practice.

The principles also stated that all directors must have high integrity and the appropriate competence to represent the interests of all shareholders in achieving long-term success of their company. Concerning appropriate competence, the Financial Crisis Inquiry Commission (2011) was appointed by the U.S. government with the goal of investigating the causes of the financial crisis of 2008-2009. At the end of January 2011, the Commission finished its report and concluded: “the greatest tragedy would be to accept the refrain that no one could have seen this coming and thus find nothing could have been done. If we accept this notion, it will happen again.” The Commission concluded that the financial crisis was an “avoidable” disaster caused by widespread failures in government regulation, corporate mismanagement and heedless risk-taking by Wall Street. This financial crisis eventually destroyed $1 trillion of global market capitalization.

Citing dramatic breakdowns in corporate governance which included taking on too much risk, the Commission portrayed incompetence with the following examples. Executives at Citigroup (initial market capital destruction of $240 billion) conceded that they paid little attention to mortgage-related risks. Executives at American International Group (initial market cap destruction of $185 billion) were blind to its $79 billion exposure to credit-default swaps. Managers at Merrill Lynch (initial market cap destruction of $200 billion by its parent, Bank of America) were surprised when seemingly secure mortgage investments suddenly suffered huge losses. The banks hid their excessive leverage with derivatives, off-balance-sheet entities, and other accounting tricks. Their speculations were aided by a giant “shadow banking system” in which banks relied heavily on short-term debt. The Commission concluded: “when the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans, and the risky assets all came home to roost” (Chan 2011), especially with the $700 billion bank bailout by the U.S. government’s Troubled Asset Relief Program (TARP).

For example, the Capital Services or banking division of General Electric (GE) was about 40% of GE’s total business and it had the same risk issues. Thus, GE initially lost $200 billion of its market capitalization after the financial crisis started. In 2016, GE divested itself of this division, explaining that the new higher (8%) bank capital requirements of the Dodd-Frank Act were too burdensome for its leveraging strategy. At the time of the financial crisis in 2008, major U.S. banks averaged only 3% capital or stockholders’ equity.

Key research-based corporate governance issues that impacted company performance included board independence, major shareholder control, CEO duality (where the CEO is also the Chairperson of the Board or COB), and a short/long mix of CEO compensation packages (Allemand et.al. 2013). These issues are addressed by these corporate governance principles. For example, Volkswagen had all four of these key corporate governance issues which contributed to its recent scandal. Volkswagen appeared to have rigged their sales growth and profits by designing software to defeat diesel engine emission requirements in order to make its short-term performance and executive compensation goals. After Volkswagen admitted to installing “defeat devices” in more than 11 million diesel engine vehicles worldwide in September 2015, it lost 1/3 of its market cap in one week. By July 2016, Volkswagen’s market cap was down 42%, or $43 billion, which in just one year destroyed the prior three year market capitalization increase of $43.7 billion.

A June 2016 settlement with U.S. Volkswagen car owners and U.S. regulators was for $14.7 billion: $10 billion on 475,000 2.0-liter diesel vehicle buybacks and $4.7 billion to mitigate pollution from such vehicles. Volkswagen still had to reach a deal with U.S. regulators on another possible 85,000 3.0 liter diesel vehicles. However, that $14.7 billion settlement did not include any penalties or lawsuits that might be imposed on Volkswagen (Ewing 2016). In July 2016, the state of New York said Volkswagen was exposed to state penalties of over $500 million and filed a lawsuit with the New York State Supreme Court. The state of Massachusetts joined this New York lawsuit and its attorney general commented: “This is an example of a company that not only engaged in deception and fraud on a brazen scale but covered up that deception. The conduct reflects a corporate culture that had no regard for the law, no respect for the American people, and no regard for the environment or people’s health” (Ewing and Tabuchi, 2016). The New York lawsuit also criticized Volkswagen’s Board for awarding about $70 million in salary and bonuses to the CEO and other management board members in 2015 and said: “Recent actions demonstrate that the company’s culture that incentivizes cheating and denies accountability comes from the very top and, even now, remains unchecked” (Ewing and Tabuchi, 2016).

Concerning board independence, the Volkswagen Board of Directors has major independence problems in addition to its performance-ripping, ethical problems. Nine of the twenty Board members (45%) are or have been Volkswagen executive managers (Minow, 2015). Volkswagen, Germany’s largest company employs nearly 280,000 people in Germany, mainly in the state of Lower Saxony where Volkswagen has its headquarters. The state of Lower Saxony owns 20% of Volkswagen’s common stock. Thus, if the union and local government board members, all with strong, possibly dependent, economic links to Volkswagen, are included, there are now fourteen of the twenty members (70%) who could be non-independent. According to one commentator on Volkswagen’s Board, “Outside views rarely penetrate. It’s an echo chamber” (Stewart, 2015).

Concerning major shareholder control, Volkswagen family members control a majority of the voting shares and one family member had been
the Chairman of the Board (COB) for over 20 years until early 2015. He even had his fourth wife, a former kindergarten teacher and family governness, elected to the company’s Supervisory Board (Stewart, 2015). There was a unique twist to the well-researched CEO duality problem. After the diesel emission cheating emerged in late 2015 and the CEO was replaced, the Volkswagen family members (with majority voting control) elected the Chief Financial Officer, not the CEO, as the new COB (VOA News, 2015). Such actions further emphasized the Volkswagen Board’s ongoing independence problems, as well as Board entrenchment problems, since there are insufficient outside directors or shareholders to challenge the existing Board of Directors.

In commenting on “one of the biggest corporate scandals of recent years,” one financial analyst summarized corporate governance at Volkswagen: “VW was an organization full of hubris, you know, dominate the world and walk-on-water type of thinking. This has all led to the situation we are in now. It is that hubris, equating to a lack of understanding of the meaning of corporate responsibility at the top—as opposed to easily pointed fingers at the action of a handful of rogue employees— that is most chilling” (Medland, 2016). Similarly, the CEOs and boards of collapsed, fraudulent companies gradually slid into the intent to deceive “as hubris consumed them and they did whatever it took to maintain their unique and revered status in the marketplace” (Jennings, 2006). The Greek term hubris describes a personality quality of extreme or foolish pride or dangerous overconfidence. Hubris often indicates a loss of contact with reality and an overestimation of one’s own competence, accomplishments, or capabilities. On a related note, Volkswagen’s global sales fell 4.7% and U.S. sales fell 13% in early 2016. It should take years for the full scale of this Volkswagen emissions scandal to become apparent (Medland, 2016).

Another example of extreme hubris by top management and failure of corporate governance by its board of directors was ExxonMobil. In November 2015, it was being investigated by the New York attorney general for lying about the risks of climate change. Exxon was aware in the 1970s that carbon dioxide from oil and gas burning could have dire impacts on the earth, and Exxon’s board of directors was fully briefed by Exxon’s own scientists decades ago on such risks. However, Exxon decided to “emphasize the uncertainty in scientific conclusions” and from 1998 to 2005, Exxon contributed almost $16 million to organizations designed to muddy the scientific waters. However, in 2007 Exxon acknowledged that the earth’s warming was caused in large part by carbon dioxide and promised to no longer fund climate change deniers with their “junk science,” as previously facilitated by Exxon’s Board (Egan, 2015).

3.2. Election of Directors

The principles stated that directors should be elected by a majority of the votes cast “for” and “against/withhold”, i.e. abstentions and non-votes, should not be counted for this purpose. Unfortunately, there was no mention of prohibiting staggered board elections which preclude shareholders from replacing the entire board if deemed necessary, say for a large market cap destruction due to fraudulent financial reporting. Many such company examples are provided in this paper.

3.3. Nominating Directors

The principles stated that long-term shareholders should recommend potential directors if they know the individuals well and believe they would be additive to the board. A company is more likely to attract and retain strong directors if the board focuses on big-picture issues and delegates other matters to management.

3.4. Director Compensation and Stock Ownership

The principles stated that a company’s directors should be fairly and equally compensated for board service although lead directors and committee chairs may receive additional compensation. Companies should consider paying a substantial portion (e.g., for some companies as much as 50% or more) of director compensation in stock, performance stock units, or similar equity-like instruments with vesting over the duration of tenure to align with the long-term performance of the company.

3.5 Board Committee Structure and Service

The principles stated that a board should have a well-developed committee structure and should consider the periodic rotation of board leadership roles (i.e., committee chairs and the lead independent director). In contrast, both Bear Stearns and Lehman Brothers had ineffective Risk Management Committees. Bear Stearns’ risk committee only started in January 2007 just 14 months before JP Morgan Chase bailed it out in March 2008. Lehman Brothers’ risk committee was started in 2006 and only had two meetings (one in 2006 and one in 2007) before it went bankrupt in October 2008. The chairman of the risk management committee was 80 and a retired Salomon Brothers investment banker. The other members were 73 (retired chairman of IBM), 77 (private investor and retired Broadway producer), 60 (retired rear admiral of the Navy), and 50 (former CEO of a Spanish language TV station). What were the qualifications of these last three members for serving on Lehman Brothers’ risk management committee (Grove and Patelli, 2013)?!

3.6. Director Tenure and Retirement Age

The principles stated that some boards have rules about maximum length of service and mandatory retirement age for directors. Others have such rules but permit exceptions or have no such rules. Whatever the case, companies should clearly articulate their approach on term limits and retirement age. Ken Bertsch, the executive director of the Council of Institutional Investors (2016), endorsed these corporate governance principles by saying corporate governance has now entered the mainstream. However, he said the principles should have gone further on some issues, like specifics on director tenure, staggered board elections, and
retirement age. A corporate lawyer agreed and said the principles missed an opportunity to offer more specifics here to help directors make sensitive decisions on retirements. For example, Berkshire Hathaway’s 2016 proxy filing showed that five of the 12 directors were older than 80 years old (Kerber, 2016). “Male, pale, and stale” boards have become a touchy subject, especially with demands for more women and minorities to be represented. For example, Bear Stearns and Lehman Brothers had a majority of their directors over 60 years old (85% and 91%, respectively). Both had directors over 70 years old (23% and 55%, respectively) as well as directors over 80 years old (15% and 18%, respectively). Concerning women and minorities, Bear Stearns had none and Lehman Brothers had one of each. For the new board of Valeant Pharmaceuticals International (market cap destruction of $82 billion in just the past year), there is only one female and eight of the 11 board members will be 60 years or older in 2016 with three in their seventies (Rapopart and McNish, 2016).

3.7. Director Effectiveness

The principles stated that boards should have a robust process to evaluate themselves on a regular basis and should have the fortitude to replace ineffective directors. However, even after the bankruptcies of Lehman Brothers and Enron and the bailout of Bear Stearns, many of their former directors continued to serve on other boards: six from Lehman Brothers, seven from Enron, and six from Bear Stearns. Such circumstances emphasized the “old boy network” where Wall Street does not simply view prior bad conduct as a problem (Davidoff 2011). Concerning all the exotic financial instruments developed by Wall Street banks that significantly contributed to the 2008 financial crisis, the former Chairman of the Federal Reserve Bank, Paul Volker, has commented that the last real innovation of Wall Street banks was the Automatic Teller Machine (ATM) which was actually developed by a Nebraska bank!

Different circumstances occurred at Valeant, possibly to head off terminations, where there were unexpected resignations and/or retirements of key executives and/or board members: Valeant’s CEO, Chief Financial Officer (CFO), Audit Committee Chair, and 9 of 11 Valeant board members, as well as administrative leave for Valeant’s corporate controller (Rapopart and McNish, 2016). Valeant did acknowledge corporate governance problems when it issued an 8-K Report to the Securities and Exchange Commission (SEC) in March 2016 as it responded to revenue recognition issues raised by a blogger and short seller in October 2015. Valeant concluded that one or more material weaknesses existed in its internal control over financial reporting and disclosures which were then acknowledged to be ineffective. Valeant also determined that the “tone at the top” of the organization with its short-term performance-based environment, based upon achieving challenging targets, may have been contributing factors to the Company’s improper revenue recognition. Valeant did warn that such deficient controls may cause 2015 executive compensation to be lowered (Valeant 8-K Report, 2016).

The failure of corporate governance by Valeant’s board of directors was summarized by a corporate governance and information technology consultant: “Where were the information and corporate governance checks and balances? Why did it take a report by an activist short seller to reveal this massive alleged fraud? Simply put, had solid information and corporation governance discipline and technologies been in place, a thoughtful outside or independent director would have been able to discover this information long before the short seller’s report and taken action to remediate the resulting governance lapses.” He further argued that proactive corporate governance is much more efficient, as well as capital preserving than reactive forensic analysis as a discovery function of fraudulent practices. Davis concluded that “What happened at Valeant can be described as an epic corporate governance failure” and predicted that subsequent forensic analysis will find that the high integrity management touted in Valeant investor presentations will be shown to have been a sham. “The net result is that an independent board with the requisite resources could have identified and headed off the behaviors that caused this debacle” (Davis, 2016).

4. PRINCIPLE II. BOARD OF DIRECTORS’ RESPONSIBILITIES

4.1. Director Communication with Third Parties

The principles stated that robust communication of a board’s thinking to the company’s shareholders is important. Companies may wish to designate certain directors to communicate directly with shareholders on governance and key shareholder issues, such as CEO compensation. Directors should speak with the media about the company only if authorized by the board and in accordance with company policy. Regulation FD (Fair Disclosure), adopted by the SEC in 2000, should be followed to avoid any insider trading issues. It prohibits selective disclosure by requiring public companies to disclose material information through broadly accessible channels, primarily the SEC EDGAR filings, press releases, and quarterly earnings calls. However, in early 2013, Netflix’s CEO posted monthly usage numbers on his personal Facebook page. The SEC ruled that a company may use social media to communicate with investors without violating Regulation FD as long as the company had adequately informed the market that material information would be disclosed in this manner (Sandler, 2013).

4.2. Critical Activities of the Board; Setting Agenda

The principles stated that a board should be continually educated on the company and its industry and use outside experts and advisors when appropriate, such as for cybercrime. The board should meet in executive session without the CEO or other members of management. The board or appropriate board committee should discuss and approve the CEO’s compensation. The audit committee should focus on whether the company’s financial statements would be prepared or disclosed in a materially different manner if the external auditor were solely responsible for their preparation.
This audit committee principle was initially recommended in a 2002 SEC roundtable by Warren Buffett, who was then a member of the Coca-Cola audit committee (Gibson Dunn, 2016). Boards, audit committees, and external auditors should all function as gatekeepers to help protect investors from investment losses, such as the more than $1.5 trillion by just 17 public companies discussed here.

5. PRINCIPLE III. SHAREHOLDER RIGHTS

5.1. Proxy Access

The principles stated that a shareholder (or group of up to 20 shareholders) who has continuously held a minimum of 3% of the company’s outstanding shares for three years is eligible to include on the company’s proxy statement nominees for a minimum of 20% of the company’s board seats.

5.2. Dual Class Voting

The principles stated that dual class voting is not a best practice. If a company has dual class voting, which sometimes is intended to protect the company from short-term behavior, the company should consider having specific sunset provisions based upon time or a triggering event, which eliminate dual class voting. As previously discussed, several major public companies, such as Alphabet, Facebook, and Alibaba, have dual class voting where the founders and related parties have a majority of the voting stock. Thus, they are excluded from U.S. stock exchanges’ requirement to have a majority of independent directors.

5.3. Written Consent

The principles stated that where written consent and special meeting provisions are adopted, there should be a reasonable minimum amount of outstanding shares required in order to prevent a small minority of shareholders from being able to abuse the rights or waste corporate time and resources.

6. PRINCIPLE IV. PUBLIC REPORTING

6.1. Transparency

The principles stated that transparency around quarterly and annual financial statement results is important. Lack of such transparency has facilitated numerous financial reporting frauds. The use of off-balance sheet entities hid liabilities of $25 billion at Enron, $20 billion at Parmalat (“Europe’s Enron”), and $10 billion at Satyam (“Asia’s Enron”) and destroyed market capitalization of $78 billion, $5 billion, and $13 billion, respectively. Similarly, Lehman Brothers ($32 billion market cap destruction) used repurchase agreements to hide $40 to $50 billion of loans off its books by instead showing them as sales of the loan collateral in its last three 2008 quarterly reports before filing for bankruptcy in October 2008. Lehman’s filing is generally acknowledged as the “tipping point” of the 2008 financial crisis. Howard Schilit, the forensic accountant, summarized this transparency problem: “The difference between a loan and a sale of an asset should be clear to any auditor (and board member) on the planet. Yet Ernst & Young let this behavior slip by without comment” (Schilit, 2010).

An example of intentionally opaque, complex financial reporting and disclosure came from Enron's related party transactions with its Special Purpose Entities to hide $25 billion of liabilities off its books. The billionaire short seller, Jim Chanos, who was among the first to short Enron, said, “We read the disclosures over and over again and we just didn’t understand it—and we read footnotes for a living” (Grove et al. 2004). Similarly, in his 2003 CEO letter to shareholders, Warren Buffett observed the Enron SPE disclosures were just not understandable. Also, an A.G.Edwards energy analyst said he had never seen such complicated disclosures and it was hard to follow the movement of money. Joe Naccio, the CEO of Qwest ($65 billion of market cap destruction), had a disclosure guideline to which the board acquiesced: “Never disclose anything that would cause the stock price to go down” (Grove and Cook 2005). Also, HealthSouth ($50 billion of market cap destruction) and its board did not disclose the reductions in bad debt estimates which helped make its quarterly numbers before it collapsed in 2003.

The former SEC Chief Accountant, Lynn Turner (2011) said that there was a direct line from the implosion of Enron to the fall of Lehman Brothers which was an inability for investors to get sound financial information necessary for making sound investment decisions, especially citing problems with the mark-to-market standards for financial instruments and derivatives. Enron did follow these standards but hid the resulting holding gains in a non-disclosed other revenue account. Accordingly, Enron’s CEO, Jeff Skilling, boasted that he could add “a gazillion dollars” to Enron’s bottom line anytime he wanted (Grove et. al. 2004). Neither Lehman Brothers nor Bear Stearns followed these standards as both used their own valuation models, as opposed to market values, for these assets. For example, when JPMorgan Chase bailed out Bear Stearns in March 2008, Bear’s balance sheet showed $11.9 billion of stockholders equity. Just three months later, JPMorgan Chase determined that the actual stockholders’ equity was only $2.6 billion, a 78% reduction, due to non-recognized holding losses on Bear’s financial instruments and derivatives (Yale et. al. 2013).

6.2. Earnings Guidance

The principles stated that a company should not feel obligated to provide earnings guidance and should determine whether providing earnings guidance for the company’s shareholders does more harm than good. If a company does provide earnings guidance, it should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.

Some well-known U.S. public companies, like Alphabet, Berkshire Hathaway, and Facebook, do not provide any earnings guidance. Larry Fink, the CEO of BlackRock and one of the 13 authors of these corporate governance principles, recently sent a letter to CEOs of major U.S. public companies, urging them not to provide any quarterly earnings
guidance. Warren Buffett, another one of the 13 authors, said: “We don’t manage to try to get any given number from quarter to quarter. We never make a forecast on earnings. We don’t give out earnings guidance. We think it’s silly. Guidance can lead to a lot of malpractice. I’ve seen guidance produce some bad results...There are ways to move earnings toward the end of a quarter, and sometimes even after the end of a quarter” and earnings guidance has already fallen in 2016 to its lowest level since 2000 from 80% to 40% per a Merrill Lynch study (Ro, 2016).

6.3. Long-Term Goals

The principles stated that as appropriate, long-term goals should be disclosed and explained in a specific and measurable way. The damages of just focusing upon short-term goals, especially for executive compensation, have been discussed here with various fraudulent financial reporting examples from Enron, WorldCom, Tyco, Qwest, HealthSouth, Valeant, Satyam, and Parmalat.

6.4. Long-Term Strategic View

The principles stated that a company should take a long-term strategic view, as though the company was private, and explain clearly to shareholders how material decisions and actions are consistent with that view. In contrast, the 2008 banking and financial crisis reflected short-term risk taking with inappropriate capital structures. In response to an email about the issue of why Bear Stearns was saved and Lehman Brothers let go into bankruptcy, Lynn Turner, the former Chief Accountant of the SEC replied in 2011: “Both were highly risky with very, very arrogant CEOs and chairmen. Neither had a great board but Bear Stearns may have had better connections on their board and in this instance, Lehman Brothers being second was fatal. Both depended too much on very short term financing, including overnight commercial paper or repurchase agreements—very ill advised and highly risky strategy for any company left alone with very little capital.” Similarly, when asked about Rabobank’s role in the Bear Stearns crisis when it refused to renew $2.5 billion in short-term loans coming due in two weeks, Bert Heemskerk, Rabobank’s chairman, said: “It is not true that Rabobank helped to bring down Bear Stearns. No, Bear Stearns had set up their balance sheet totally the wrong way.” Asked if he understood that when one bank stops refinancing, others will follow, he responded: “And rightly so” (Heemskerk, 2008).

6.5. Explanations of Mergers and Acquisitions and Capital Expenditures

The principles stated that companies should explain when and why they are undertaking material mergers or acquisitions or major capital commitments. Tyco ($163 billion of market cap destruction) and its board did not do so as they used improper merger accounting practices to distort their financial statements (Badawi, 2008). AOL used a revenue synergy argument (cross selling to each other’s customers) to sell its $110 billion acquisition of Time Warner. Such synergies never materialized and AOL had to impair its $60 billion goodwill from this deal by a record $54 billion, reflecting a 90% stock price drop and market cap destruction of $200 billion. The two companies have since separated.

6.6. Non-GAAP Measures Excluding Equity Compensation

The principles stated that while it is acceptable in certain circumstances to use non-GAAP measures to explain and clarify results for shareholders, such measures should be sensible and should not be used to obscure GAAP results. It is important to note that all compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings. This last guidance is a “heads-up” to the technology industry which has been excluding such equity compensation for non-GAAP measures even after the GAAP requirement came into existence several years ago (after ten years of successful lobbying against it by this industry). For example, Facebook has been doing so every quarter since it went public in 2012. In its January 2016 8-K Report (required by the SEC for using non-GAAP metrics), it increased its 2015 GAAP net income of $3,688 million to non-GAAP net income of $5,970 million, a 62% increase by excluding stock equity compensation of $2,282 million. The 2014 GAAP net income was similarly increased by 52%.

The blogger, Benzinga Pro, said 90% of S&P 500 companies now use non-GAAP metrics (up from 72% in 2009) and more than 60% have been excluding GAAP expenses from their non-GAAP earnings as far back as 2001 (Duggan, 2016). In 2015, S&P 500 companies’ GAAP earnings were $787 billion but increased by $256 billion (33%) to $1.04 trillion, using non-GAAP measures per S&P Dow Jones Indices’ estimates. The biggest S&P 500 industry offenders in turning GAAP income or loss into higher non-GAAP income were energy ($48 billion loss into $45 billion income), technology ($176 billion income into $218 billion), health-care ($104 billion income into $157 billion) and materials ($13 billion income into $30 billion). Using non-GAAP metrics, the S&P 500 companies’ average price/earnings ratio then fell from over 21 times to less than 17 times, about a 20% difference for performance and investment valuation purposes. Sometimes a non-GAAP number makes sense, such as a non-recurring cost of worker layoffs or a lawsuit settlement, but companies have had a history of treating ordinary expenses as extraordinary or non-recurring when business conditions worsen (Lahart, 2016). Favorite strategies to create non-GAAP profits from GAAP losses have been to exclude restructuring and acquisition costs, stock-based compensation, and write-downs of impaired assets. Such non-GAAP metrics have been called “fantasy math” and “phony-baloney financial reports” in the financial press (Morgenson, 2016).

The SEC is finally updating its Regulation G guidance for non-GAAP metrics as an SEC accountant recently said: “The point is, now the company has created a measure that no longer reflects its business model. We’re going to take exception to that practice” (Dugan, 2016). On May 17, 2016, the SEC staff updated its interpretive
From the following analysis of Valeant’s use of non-GAAP metrics in its required 8-K Reports to the SEC, Valeant appears to have violated all four key examples from the SEC’s updated guidance for using non-GAAP financial measures. For 2014, Valeant used many creative strategies to improve its Consolidated Net Income of $708 million by a factor of 6.55 in reaching a Pro-Forma Consolidated Adjusted EBITDA of $4.639 billion, compared to the average 33% improvement for S&P 500 companies. For 2015, Valeant toned down its non-GAAP metrics, going to an adjusted non-GAAP net income in 2015 from a pro-forma adjusted EBITDA in 2014, especially eliminating 2014 anticipated synergies from anticipated acquisitions of $267 million, probably after being spotlighted by blogger and short seller research reports. However, in 2015, Valeant still turned a GAAP net loss of $300 million into adjusted non-GAAP net income of over $2.841 billion. Valeant’s non-GAAP numbers for 2015 and 2014 are now presented.

### Table 1 Non-GAAP Metrics

<table>
<thead>
<tr>
<th>Addbacks:</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$179</td>
<td>$191</td>
</tr>
<tr>
<td>Stock-Based Compensation</td>
<td>12</td>
<td>0</td>
</tr>
<tr>
<td>Taxes</td>
<td>$74</td>
<td>$74</td>
</tr>
<tr>
<td>Tax Effect of non-GAAP Adjustments</td>
<td>(710)</td>
<td>(99)</td>
</tr>
<tr>
<td>Restructuring and Amortization</td>
<td>0</td>
<td>1,689</td>
</tr>
<tr>
<td>Restructuring Charges</td>
<td>2,842</td>
<td>405</td>
</tr>
<tr>
<td>Other Non-Cash Charges</td>
<td>818</td>
<td>510</td>
</tr>
<tr>
<td>Consolidated Adjusted EBITDA-2014</td>
<td>4,372</td>
<td>4,372</td>
</tr>
<tr>
<td>Plus Synergies from Prior Mergers and Acquisitions</td>
<td></td>
<td>15</td>
</tr>
<tr>
<td>Plus Anticipated Synergies (within 12 months of company acquisitions)</td>
<td></td>
<td>267</td>
</tr>
<tr>
<td>Pro-Forma Consolidated Adjusted EBITDA-2014 (including subsequent transactions)</td>
<td></td>
<td>$4,639</td>
</tr>
</tbody>
</table>

One financial press reporter said: “Valeant ran itself using measures of profit invented by its managers and further commented that much of the additional non-GAAP information was distracting propaganda. This reporter recommended that investors should focus on cash flow since in 2015, 232 of the S&P 500 firms had cash flow after capital investment below their adjusted or non-GAAP profits (The Economist, 2016). While Valeant was using its distracting non-GAAP metrics, its shares collapsed in the last year for $82 billion (93%) of market cap destruction. Such non-GAAP measures were also used by Valeant for executive compensation with no clawbacks for this 93% market value decline.

### 7. PRINCIPLE V. BOARD LEADERSHIP (INCLUDING THE LEAD INDEPENDENT DIRECTOR’S ROLE)

#### 7.1. CEO Duality

The principles stated that the board’s independent directors should decide, based upon current circumstances, whether it is appropriate for the company to have separate or combined COB and CEO roles. The board should explain clearly in the proxy statement why it has separated or combined the roles. Corporate governance principles may be enhanced by using guidance from empirical corporate governance research results, such as CEO duality factor, staggered board elections, and lack of board independence (Allemand et al. 2013; Grove et al. 2011). Such key variables were found to have a significant, negative impact on risk taking and financial performance as well as possible fraudulent financial reporting. Both the CEOs of Lehman Brothers and Bear Stearns had also been the COBs for 17 and 7 years, respectively, and both had been the CEOs for 17 years and 26 years, respectively. The CEO, often the company founder, was also the COB at Parmalat, Global Crossing, Tyco, Lehman Brothers, and WorldCom. A different twist was that the brother of Satyam’s CEO was the COB while both had co-founded the company. Before its bankruptcy in 2001, Enron had this CEO duality problem with its last two COEs, Jeff Skilling and Ken Lay. Valeant also has this CEO duality problem where the recently fired CEO, Michael Pearson, was also the COB and the newly hired CEO will also have both jobs. Neither Skilling nor Pearl had any experience running a business before both joined their companies from McKinsey & Company, a consulting firm. The JP Morgan Chase CEO, Jamie Dimon, and his board recently overcame a challenge by investors to separate these two roles but he has spent his entire career in the banking industry.
7.2. Strong Lead Independent Director
The principles stated that if a board decides to combine the COB and CEO roles, it is critical that the board has in place a strong designated lead independent director and a strong governance structure.

7.3. Lead Independent Director’s Responsibilities
The principles stated that such responsibilities may include serving as a liaison between the chair and the independent directors, ensuring the board has proper input into meeting agendas, having the authority to call meetings and executive sessions of just the independent directors, guiding the annual board self-assessment, guiding the board’s consideration of CEO compensation, and guiding the CEO succession planning process.

8. PRINCIPLE VI. MANAGEMENT SUCCESSION PLANNING

8.1. Senior Management Bench Strength
The principles stated that senior management bench strength can be evaluated by the board and shareholders through an assessment of key company employees.

8.2. Planning Process
The principles stated that companies should inform shareholders of the process the board has for succession planning, and there should also be a contingency plan if an unexpected emergency succession is necessary.

9. PRINCIPLE VII. COMPENSATION OF MANAGEMENT

9.1. Continuity and Long-Term Performance Alignment
The principles stated that compensation plans should be appropriately tailored to the nature of the company’s business and its industry. While such plans may evolve over time, they should have continuity over multiple years and ensure alignment with long-term performance. Another key empirical finding concerning weak corporate governance related to the focus of executive compensation on short-term results (Allemand et al., 2013; Groe et al., 2011). For example in 2014, the top Valeant executives cashed in heavily on stock options and awards, based primarily on short-term incentive pay targets, before the October 2015 short seller report slammed the stock. These Valeant executives had 2014 compensation from stock options exercised and stock awards in millions as follows: CEO ($19.8), CFO ($23.7), two executive Vice Presidents ($21.4 and $43.1) and the European Manager ($6.3), as compared to average Western Europe CEO total compensation of $3 million to $5 million. Both the CEO and CFO then retired a year later (McNish and Benoit, 2016). Such huge cash outs represent a large red flag by itself, reminiscent of the comment by the short seller, Jim Chanos, concerning the Enron CEO, Jeff Skilling, cashing out $78 million stock options before retiring only six months after becoming the CEO as “a rat leaving a sinking ship” (Grove et al., 2004).

9.2. Both Current and Long-Term Components
The principles stated that compensation should have both a current and a long-term component. Concerning long-term components, many executive compensation plans do so by vesting stock options or awards over a longer term. Four or five year vesting periods are common, but General Electric recently extended vesting periods to ten years. In the U.K., some of the biggest companies are communicating with shareholders about pay raises for their top directors whose pay packages tend to be a combination of salaries, annual bonuses, and long-term incentive plans often paid in company shares. In May 2015, the Fidelity mutual fund company released a compensation study showing that a growing number of FTSE 100, U.K. listed companies were adopting longer retention periods. 42 companies had a five-year minimum holding period versus only four in 2013, consistent with shareholders’ demands that bonuses be paid out over longer periods. Starting in 2014, companies were required to hold votes on their remuneration reports, covering annual pay and remuneration policies for the next three years. One pay consultant commented: “There should be no reason why any company engaging with its shareholders should get a high level of dissent...A vote of 10% or more is a failure of communication somewhere along the line” - both for management and Board of Directors’ compensation committees (Torean, 2015).

9.3. Disclosure of Benchmarks and Performance Measurements
The principles stated that benchmarks and performance measurements for management compensation ordinarily should be disclosed but compensation should not be entirely formula based. Companies should retain discretion (appropriately disclosed) to consider qualitative factors, such as integrity, work ethic, effectiveness, openness, etc. Warren Buffett commented on a glaring example when this compensation principle was not followed. He observed that the only time Donald Trump sold stock directly to the public was in 1995 when he formed Trump Hotels & Casino Resorts and took it public on the NYSE. Buffett said that this company lost money every year for the next decade and filed for bankruptcy in 2004 with a market cap destruction of over $1 billion. Trump’s IPO investors lost 90% of their investments while the stock market went up an average of 150% during that decade. Buffett noted the lack of any compensation performance criteria as Trump was paid $44 million in compensation during that period (Newsmax.com, 2016). Furthermore, performance measurements should focus on operating or net income growth, not earnings per share growth, which can be increased with just common stock buybacks, which are a one-time event, not a sustainable growth contribution. Also, non-GAAP metrics should not be used for performance measurements relating to executive compensation.
9.4. 50% or More Senior Management Compensation as Stock, Performance Stock Units, or Equity-Like Instruments with Long-Term Holding Periods

The principles stated that companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units, or similar equity-like instruments. The vesting or holding period should be appropriate to further senior management’s economic alignment with the long-term performance of the company. All equity grants should be made at fair market value, or higher, at the time of the grant, with particular attention given to any dilutive effect of such grants on existing shareholders. Fortunately, the repricing of stock options, which were out-of-the-money, to lower grant prices to become in-the-money again was effectively ended by the Sarbanes-Oxley Act of 2002.

9.5. Articulation of Compensation Plans with Long-Term Alignment of Management and Shareholders’ Interests

The principles stated that companies should clearly articulate how their approach links compensation to performance and aligns the interests of management and shareholders over the long-term. One of the major responsibilities of a company’s board of directors is to determine the compensation of the company’s CEO, usually the responsibility of the board’s compensation committee. The compensation package for a CEO can consist of a base salary, incentive pay frequently in the form of shares of stock and stock options, and a severance package that may include a golden parachute. There have been many examples of CEO compensation levels that have called into question as to why the board compensation committee chose to give such large amounts. During the financial crisis of 2008-2009, many U.S. financial companies lost billions of dollars, and some had to be bailed out by the U.S. government. However, there were many examples of these companies’ CEOs still receiving high levels of compensation, including bonuses. Also, several companies, like Valeant, have recently been linking short-term executive bonuses to non-GAAP numbers even while market cap destruction was occurring. These examples and many others have resulted in stockholders, regulators, and legislators questioning whether boards are acting in the best interest of shareholders when they are making the CEO compensation decision.

9.6. Careful Evaluation and Explanation of Large Special Compensation Awards

The principles stated that large special compensation awards (not normally recurring annual or biannual awards) should be carefully evaluated and clearly explained in the proxy statement. During the stock market decline of the early 2000s, the CEOs of Merrill Lynch and Citigroup were fired because their companies were generating losses in the billions of dollars. However, both were given golden parachutes of over $100 million each.

In July 2016, there was another non-explanation example when a $40 million severance package was given by Fox News to its chairman, Roger Ailes, who had to resign after sexual harassment charges were brought against him.

The Volkswagen CEO resigned the same month the cheating was disclosed and, subsequently, eight top Volkswagen managers were either suspended or resigned by late 2015 with no mention of any golden parachute buyouts (Ewing, Bowley, and Eddy, 2015). Jim Chanos, the short seller, commented that one of his firm’s “historical signposts of a company in trouble is when numbers of senior people leave over a short period of time” (Wang, 2016).

9.7. Use of Clawback Policies for Both Cash and Equity Compensation

The principles stated that companies should maintain clawback policies for both cash and equity compensation. The former Valeant CEO, Michael Pearson, was fired in March 2016, after being in charge during the entire $82 billion market cap destruction in the last year. Instead of any clawbacks for such investment destructions, Pearson could still walk away with a severance package of $9 million in cash and stock currently valued at $100 million in May 2016. Valeant’s former CFO was replaced in 2015 but still had total compensation of $606,805 with no clawbacks. In 2015, the new CFO had total compensation of $60.4 million, including long-term stock awards of $53.1 million, obviously not based on any clawbacks as the $82 billion market cap destruction was occurring (Rapoport and Lublin, 2016).

Clawbacks should be extended to include market capital destruction, such as the recent Wells Fargo investment loss of $24.3 billion or 9.5%, going from $256.5 billion to $232.2 billion in just two months after the rampant sham customer deals were exposed in early September 2016. The Wells Fargo CEO did have $41 million or 17% of his $247 million worth of Wells Fargo shares clawed back and the head of the community banking division, who was also a Wells Fargo board member, had $19 million or 15% of her $125 million worth of Wells Fargo shares clawed back. The Wells Fargo clawback provisions were based upon misconduct that forced the company to significantly revise its financial results or pay that was received based on inaccurate financial information (Cowley 2016), similar to the Sarbanes-Oxley and Dodd-Frank clawback provisions. Since neither was the case in this fraud, the Board took advantage of a clause that allowed the company to retract performance-based stock awards if an executive causes significant reputational harm to the company.

Wells Fargo had long suggested that it was the bank for Main, not Wall, Street and its entire ethos was one of trust and ethics. However, in causing such reputation harm to the company, this fraud was breathtaking in its reach as 5,300 employees bilked customers of over $1.5 million in fees over five years, including the opening of 566,000 phantom credit card accounts and 1.5 million false transaction accounts (Sorkin 2016). It had a non-GAAP metric of number of accounts per customer and its target and slogan was “Eight is Great”, chosen because it rhymes! The Wells Fargo CEO
emphasized this metric in quarterly conference calls with financial analysts in touting how the bank had increased this metric from under 6 to over 6 for each customer in just three years (Morgenson, 2016). Both executives subsequently resigned in 2016.

Board compensation committees could follow the executive compensation policy of Berkshire Hathaway. Concerning executive pay, Berkshire Hathaway dramatically departs from convention. Both the CEO, Warren Buffett, and his vice-chairman, Charlie Munger, have annual fixed salaries of $100,000 with no bonuses. The majority of their compensation, as well as the board’s compensation, is variable from price appreciation or depreciation of their own Berkshire Hathaway common share holdings which aligns their compensation with their shareholders’ interests for market capitalization creation (Williams, 2015). Thus, they all had a real clowback impact on their 2015 compensation as the Berkshire Hathaway Class A stock decreased from $225,000 on January 1, 2015 to $198,000 on January 1, 2016. This $27,000 stock price decrease was a 12% clowback on their 2015 compensation, consistent with the $21.8 billion (12%) market cap destruction for 2015. However, from January 1, 1991 to January 1, 2016, the stock price went up by a factor of 30 from $6,575 to $198,000, a dramatic increase in market capitalization and corresponding executive and board compensation.

10. PRINCIPLE VIII. ASSET MANAGERS’ ROLE IN CORPORATE GOVERNANCE

The following eight principles are not elaborated as they appear to be quite straight-forward:
a) Evaluation of company proposals to shareholders in context of long-term value creation; b) Appropriate oversight of proxy voting and corporate governance activities; c) Evaluation of board of directors’ performance; d) Have access to management and, in some circumstances, the company’s board on proxy issues important to long-term value creation; e) Raise critical issues to companies as early as possible in a constructive and proactive way; f) Asset managers’ votes should be based on independent analysis while possibly using proxy advisors’ data and recommendations; g) Asset managers should make public their proxy voting process and guidelines; h) Asset managers should consider sharing their issues and concerns with the company, especially when they oppose the board’s recommendations.

11. CONCLUSIONS

Weak corporate governance facilitated over $1.5 trillion in investment or market capitalization losses in the 21st Century in just 17 primarily U.S. public companies. The magnitude of this amount is demonstrated by noting that it would be 14% of the $11 trillion investment losses from the global recession of 2008-2009. If an investor would just put money into an S&P 500 index fund, as Warren Buffett has recommended, that investment would have increased 61% from 2001 to 2016. Sir David Tweedy, the former chair of the International Accounting Standards Board, has commented: “The scandals that we have seen in recent years are often attributed to accounting although, in fact, I think the U.S. cases are corporate governance scandals involving fraud” (Tweedy, 2007). Thus, the importance of implementing good corporate governance principles, as developed by this blue ribbon committee, is stressed. This paper has developed lessons learned from these scandals which reinforce these corporate governance principles and procedures in order to avoid such malpractices in the future. Attention should be particularly paid to the violations of two critical principles which amassed the majority of these investment losses: Principle I. Board of Directors – Composition and Internal Governance, especially Composition and Independence and Director Effectiveness, and Principle IV. Public Reporting, especially Transparency and Non-Generality Accepted Accounting Principles.

Significant influence and impacts on these corporate governance principles can be taken from Warren Buffett’s CEO letters in the annual reports of Berkshire Hathaway. (Buffett and Jamie Dimon, the JPMorgan Chase CEO, had the idea to undertake this effort.) The following observations are based upon Buffett’s more than 40 years of experience with various boards of directors. He observed: “true independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare.” He looks for people whose interests are in line with shareholders in a very big way. All eleven of his directors each own more than $4 million of Berkshire stock. They are paid nominal director fees. No directors or officers liability insurance is carried, not wanting them to be insulated from any corporate disaster that might occur. Basically, Buffett wants the directors’ behavior to be driven by the effect of their decisions on their net worth, not by their compensation. He calls this approach “owner-capitalism” and says he knows of no better way to create true independence for board directors. Buffett has observed that many intelligent and decent directors failed miserably due to a “boardroom atmosphere.” He elaborated: “it’s almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It’s equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his advisors are present and support his decision.” To avoid these “social” difficulties, Buffett has endorsed the NYSE requirement that outside directors regularly meet without the CEO which is also one of the corporate governance principles in this new document.

Buffett has stated: “in judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren’t encouraging.” He noted that when CEOs meet with boards’ compensation committees, too often one side (the CEO) has cared much more than the other side about the pay package. The difference often has seemed unimportant to the compensation committee, particularly when stock option grants had no effect on earnings under prior U.S. accounting rules. He observed that such negotiations often had a “play-money” quality and said that directors should not serve on compensation committees unless they are capable of negotiating on behalf of the shareholders.
Buffett noted that "CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. It would be a travesty if the bloated pay of recent years became a baseline for future compensation." Also, Buffett has argued that a red flag should exist if a company always does meet its quarterly and annual goals, especially for 20 quarters in a row, since such performance ignores the reality of competitive environments and business cycles. These views are reinforced by the corporate governance principles' emphasis on CEO pay guidelines, the discouragement on non-GAAP numbers, especially adding back equity stock compensation for executives, and the discouragement of quarterly earnings guidance and emphasis in making such short-term numbers.

Concerning board competence, Buffett commented: "In addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company. In my 40 years of board experience, the great majority of these directors lacked at least one of these three qualities. As a result, their contribution to shareholder well-being was minimal at best and too often negative. They simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation."

Concerning an effective board culture, Buffett observed that when the CEO cares deeply and the directors don't, a necessary and powerful countering force in corporate governance is missing. He said: "getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners—big owners. Twenty, or even fewer, of the largest institutions, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior."

There was a majority of major asset managers on this committee of 13 who created these corporate governance principles.

REFERENCES


46. Turner, L. (2011, September 13). Does Wall Street really run the world? *Town Hall Discussion, School of Accountancy, Daniels College of Business, University of Denver.*


