
VALUE WIZARD INSIGHTER - February 2000

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1. Quality of Governance

Holman W. Jenkins, Jr. writes in his Business World column in *The Wall Street Journal*, 18 March 1998, page A23, "The emperor's new clothes remains our most instructive parable of organized life. It teaches that management can become bizarre, clinging to its mistakes, sabotaging its opportunities. It knows itself to be hopeless, but quitting and handing over to someone else would be unthinkable, thanks to a misplaced sense of pride. Instead management retreats into fantasies, and creates incentives for others to comply with its fantasies."
A separate article in *The Wall Street Journal*, 2 April 1998, page A6: "In a report to the Organization for Economic Cooperation and Development issued today, the six-member advisory group urges that the OECD recommend minimum standards for corporate governance 'to promote fairness, transparency, accountability and responsibility.' The OECD, which is based in Paris and is made up of representative of 29 leading industrial countries, commissioned the study in 1996 and is expected to pursue the recommendations.

"The advisory group agreed on three main principles ... The principles are: that the chief corporate objective should be to maximize shareholder value; that boards of directors ought to exercise independent oversight of managements, and that the role of governments is to provide regulations ensuring free markets, not to interfere with them.

"Traditionally, shareholder value has been far down the list of corporate priorities in many parts of the world, including Europe and Japan. In addition, corporate boards have often been used as rubber stamps for management, even in the U.S. Moreover, governments have for years played a strong role in the management of their nation's economy.

"Nobody was watching management; they were growing for the sake of growth with no concern for shareholder value.

"Designating shareholder value the chief corporate objective is controversial ... A tradeoff for consensus on that point was the report's acknowledgment that there are other legitimate corporate objectives. The report's final chapter discusses corporate citizenship and the role in society of corporations. 'Capital is global. ... We acknowledge that if you can raise capital without emphasizing shareholder value, go ahead and try it.'

"{The} report acknowledges that there is no single model for corporate governance and that experimentation and variety should be encouraged."

A separate article in *The Wall Street Journal*: "In a sign that Asian companies might not be providing more financial information about their operations, as investors had hoped they would, a survey found that company openness -- or transparency -- actually worsened in the past year. Investors continue to be frustrated by a lack of solid information. Ten of 11 Asian countries in the survey received a lower rating this year than last for transparency, a broad measure of the quality and availability of financial information.

"Taiwan, Japan and China showed the biggest declines. Only Indonesia showed improvement although respondents still rate it among the most opaque. "When investors look for basic information in the region, the numbers just aren't there," said Robert Broadfoot, managing director of Political and Economic Risk Consultancy in Hong Kong, which conducts the annual survey.

"The International Monetary Fund and other international lenders pushed for stricter reporting. Instead, executives feel Asian companies and banks still withhold vital financial information, such as bad loans and liabilities, while governments still underestimate the extent of their economic woes. Investors are also more demanding. Now, they're looking at information much more carefully.

"Large institutional investors are pressing companies to treat minority shareholders fairly, increase transparency, fully report executive pay, disclose important information, and adhere to good accounting standards. Money managers' biggest complaints are in the areas of planned expenditures, research and development activities, capital expenditures, environmental issues, detailed statistics about operating units, and stated objectives measured against results. Individual investors with smaller ownership interests benefit from these activist efforts."

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2. Laws and Valuation

Martin J. Whitman (*Value Investing*, 1999, Wiley & Sons): "The management, the common stock, and the holder of common stock are each separate, distinct constituencies. Each has its own interests that usually combine elements of conflict of interest and communities of interest with each and every other constituency. The distinction among these four constituencies is rarely recognized on Wall Street or in academia.

"Corporate law in the United States, especially state law, court decisions in leading corporate states, and federal bankruptcy law, is designed to entrench control groups and managements in office at the expense of outside non-control minority-interest owners' rights. In addition, securities law in the United States, as embodied in the amended Securities Act of 1933 and the amended Securities and Exchange Act of 1934, has the effect of providing management entrenchment at the expense of outside non-control minority-interest shareholders. Three such regulatory areas entrenching management are securities regulations governing cash-tender offers, exchange offers, and proxy solicitations.

"The ideas of substantive consolidation, in which the interests of the company and its stockholders are combined, and structural subordination, in which the company/s *raison d'être* is to serve the best interests of its stockholders ... are relative rarities in the real world.

"The terms *substantive consolidation* and *structural subordination* originated in reorganizations under Chapter 11 of the U.S. Bankruptcy Code. Substantive consolidation occurs when, for purposes of a reorganization, two separate entities are combined into one; say, for example, a solvent parent company is merged with and into an insolvent subsidiary as part of a reorganization plan. Structural subordination occurs when a senior class of claimants is made junior to a lower class of claimants even though, on the strict basis of stated creditors' rights, the senior class would normally enjoy priority over other creditors; say, for example, that because of findings of previous domination and control, secured bank debt is made the lowest class of claimant in a Chapter 11 reorganization plan.

Graham & Dodd (*Security Analysis*, 1934) write on page 26, "It is a matter of great moment to the analyst that the facts be fairly presented, and this means that he must be highly critical of accounting methods. Finally, he must concern himself with all corporate policies affecting the security owner, for the value of the issue which he analyzes may be largely dependent upon the acts of the management. In this category are included questions of capitalization set-up, of dividend and expansion policies, of managerial compensation, and even of continuing or liquidating an unprofitable business." And further, on page 330, "But if stockholders' opinion were properly informed, it would insist upon curtailing the despotic powers given the directorate over the dividend policy. Experience shows that these unrestricted powers are likely to be abused, and for various reasons. Boards of directors usually consist largely of executive officers and their friends. The officers are naturally desirous of retaining as much cash as possible in the treasury, in order to simplify their financial problems; they are also inclined to expand the business persistently for the sake of personal aggrandizement and to secure higher salaries." Membership in the Fortune 500 and on the prestigious Corporate Roundtable beckons the ambitious Chief Executive Officer.

Institutional investors, unlike most individual investors, have the wherewithal to influence management when it diverges from the interests of the company stock owners. An egregious example of management misuse of power pursuant to then-existing by-laws is the establishment in some companies of anti-takeover provisions, also known as "poison pills." These legal tactics serve to frustrate the market for corporate control by destroying the value of a company if another company makes an unsolicited bid to buy a relatively small percentage of the outstanding shares, typically at a significant premium to the then-current market price. The current stock owners lose at the expense of an entrenched management that has not efficiently used the assets under its control to enhance stock owner value and thus prevent just such a takeover attempt.

Valuation applies to both strictly continuing long-term going concerns and to short-term resource conversions. The laws and legal issues are more important in so-called special situations or resource conversions such as mergers and acquisitions, takeovers, spin-offs, and reorganizations. Such investment opportunities may appeal to the value investor even though they are short-term in horizon, usually a few months between announcement of a deal and its consummation or dissolution.

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3. Regulated Industries

The U.S. securities' regulations apply to all companies with publicly-traded stocks, regardless of industry. In addition, there are generally accepted accounting principles (GAAP) that apply to all companies in all industries. Nevertheless, GAAP allow managements to choose among different accounting treatment of, for example, inventories, depreciation, and cost, if consistently applied from year to year and disclosed when changed. In addition, there are certain special industry accounting principles as follows as of 1999:

- Banking and Thrift Institutions
- Entertainment Industry
  - Broadcasters
  - Cable Television
  - Motion Picture Films
  - Records and Music
- Franchise Fee Revenue
- Insurance Industry
- Insurance Enterprises
- Title Plant
- Mortgage Banking Industry
- Not-For-Profit Organizations
- Oil and Gas Producing Companies

Real Estate Transactions
Real Estate Costs and Initial Rental Operations
Real Estate: Recognition of Sales-Regulated Industries

Some providers of standardized databases offer a chart of accounts for general industrial companies that differs from those for other companies in regulated industries such as utilities, banking and thrift, and insurance. State laws often control pricing and other economic factors in regulated industries.

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