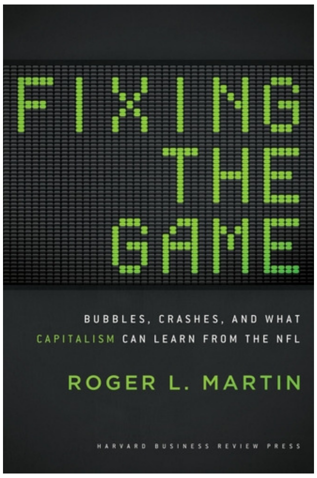
Book Review

Fixing the Game



Martin, Roger, L., (2011). ‘Fixing the Game: Bubbles, Crashes and what Capitalism can learn from the NFL’ . Harvard Business Review Press, Boston, Massachusetts.

I was attracted to this book even before I started to read it because I have long been concerned about the passion that many organisations have for ‘maximising shareholder value’. Having worked in organisations that were in constant turmoil through ever more frequent restructures leading to reduction in expenditure (read employees), I was shocked at executive’s disregard for the organisation’s employees and the focus on the short-term in order to maximise shareholder value.

The idea that shareholders are the most important stakeholders affects the organisation’s ability to truly understand who their stakeholders are. To treat shareholders as the most important category of stakeholders and to ignore (or reduce the importance of) customers and employees is, in my opinion, counterproductive. It is an issue that I need to constantly address when assisting organisations and their projects and programs to identify their stakeholder community effectively.

Martin uses examples of organisations that are the most recent victims of this type of short-term thinking – for example, Enron went from named as “America’s most innovative company 6 years running” up to 2001 when it filed for bankruptcy reorganisation. Billions of dollars of shareholder wealth vanished at this time. The Congressional hearings that followed identified serious issues with organisational governance: Board members didn’t understand their job or were too partial to management; auditors weren’t sufficiently independent -they made more money from consulting to the company than from their auditing assignments. Finally the issue of executive compensation: organisations increasingly offered their executives incentives in the form of stock options – that gave the executives rewards for improved company performance but no penalties for negative performance: supporting risky actions leading to disasters such as Enron.

According to Martin the idea of maximisation of shareholder value and executive incentive programs is based on *agency theory* where executives are *agents* of the owners (now the shareholders). The idea of shareholder value as being an organisation’s guiding principal is to ensure that the agents optimise their decisions and activities to ensure that the owners receive maximum value for their investments and that the agents are incentivized to ensure that this occurs through rewarding the agents in additional stock options so that shareholder compensations would also mean executive compensation. (p12)

The theory is flawed because it now ties together two markets: the *real market* and the *expectation market*. The real market is the world of factories, production, real products and services and real dollars of profit on the bottom line. The expectation market is the world of shares traded between investors – the stock market.

After the mid 70s compensation became increasingly stock-based: by 2009 Larry Ellison of ORACLE was the highest paid CEO in the US with 97% of his recompense coming from gains on stock options: to ensure that to ensure best outcomes for shareholders executives and board members should receive a large portion of their pay in the form of stock options.

The problem with expectations: *no matter how good you are you cannot beat expectations forever. When you reach the original expectations you will find that there are new expectations*. As performance improves this is now considered the norm and new expectations are set higher than the former set. If the executive is constantly being forced to increased performance against an ever-increasing set of expectations a point will be reached when it is no longer possible to satisfy the market or the shareholders – struggling to even meet expectations!

The result according to Martin is that executives focus on what they can control – managing share prices over the short term destroying long-term shareholder value through this short-term focus, generating the accounting scams of 2001-2002 as practiced be Enron, WorldCom, Tyco International, Global Crossing and Adelphia; the options backdating scandal; and then the subprime mortgage crisis.

Martin offers remedies in positive steps to 'fix the game':

1. Focus back to customer and away from shareholder
2. Restore authenticity to the lives of executives through this focus on customer
3. Address Board governance
4. Regulate and manage expectations market players more effectively, most notable hedge funds – better regulate the relationships between hedge funds and pension funds
5. Business executives need to take on a more expansive and positive view of the role of for-profit companies on society.
6. Devise a new theory of the firm.

There are two great examples to support his case: BP's disaster in the Gulf of Mexico and Johnson & Johnson's recall of Tylenol when they discovered that some containers had been tampered with.

BP's response when the *Deepwater Horizon* oil well exploded in 2010 went into damage-control mode, blaming the rig owners, Transocean, for safety lapses, in an attempt to minimise the scope of the damage. Through the months it took to stop the oil flow and the aftermath BP showed how not to handle a public relations crisis.

Johnson & Johnson on the other hand are a good example of how to handle a public relations crisis in 1982 a 12 year old girl in Chicago died after taking a capsule of J&J's Extra Strength Tylenol. Six other deaths followed shortly thereafter. Although it appeared that the tampering was limited to Chicago J&J's chairman immediately recalled all Tylenol products and ceased its production. J&J went on to develop tamper-proof packaging for its products.

Were there organisation cultural issues that drove the different responses to crises of these organisations? Martin argues that there were. He suggests that Hayward's actions suggest that BP's profits were at the heart of its crisis response plan. The company's values statements focus shareholder value-oriented priorities. Protecting the company's share price and financial viability was paramount. All of Hayward's actions – limiting liability, distributing blame elsewhere – were an attempt to protect his shareholders. BP lost more than half its market capitalisation between April and July of 2011.

J&J's company vision has built a culture with a focus on customers come first, employees second, communities third, and shareholders absolutely last. So J&J's CEO acted within the leads of its culture - to protect customers he went ahead with the product recall as soon as possible. Tylenol sales took a huge hit in the months immediately after the recall, but J&J's share price was largely unaffected by the crisis. J&J is one of the fifteen most valuable companies in the world having created as much shareholder value as any company in the world. Proctor and Gamble and Apple follow the same principles and are similarly successful.

Martin claims that there is no clear data supporting the notion that making shareholder value maximisation the objective of the firm actually does maximise shareholder value over the long term. By comparing the period before and after the shareholder value era, Martin is able to build a case against shareholder maximisation theory (60). By the middle of the 20th century owner-CEOs were being replaced by professional managers who may have been enhancing their own financial well-being at the expense of the shareholders in a way that an owner-manager may not have done. Martin's data says not! "Shareholders did worse, not better, in the shareholder value era, and several prominent companies demonstrate that an effective route to genuinely increasing shareholder value lies in rejecting rather that embracing the prevailing theory." (p66)

Martin also included chapters as guidance to organisation's who wanted to move away from the ideology of shareholder maximisation theory. Some of his most important points were:

- CEO rewards included stock options. Martin provides evidence that backdated created conflict of interest.
- Earnings management – tailoring returns to meet market expectations rather than to reflect performance – through accounting manipulations and expectations management: fudging financial statements artificially typically inflating them to meet expectations or in the second case 'talk down' analysts forecasts.
- Prevent CEOs from selling their shares until a significant time after the shares have been awarded – even a long time after they had left the company.
- Reward executives for long-term value creation through royalty schemes, such as authors, musicians and patent holders, rather than short-term incentives based on share price.
- Ensure that independent directors serving on Boards have the necessary capability to serve the interests of outside shareholders but also have incentives to do so (the same incentives issues that affect executives will also apply to Board Directors).

For anyone wishing to explore the sources and causes of the irresponsible and fraudulent actions of organisations executive over the last three decades will find this book invaluable. Those seeking answers for the short-termism and focus on shareholders to the detriment of customer, community and employees with all the issues connected to this will find this book provides many interesting views about the cause of the theory and practice of shareholder value maximisation theory. The examples he provides may be of relevance in the US or even North America but have no significance for me. But the data presented to support his case and the arguments are useful to me in raising the profile of the impacts of shareholder value maximisation theory in the general world of business and the importance of other stakeholders beyond shareholders.

Fixing the Game reviewed by: Dr. Lynda Bourne FAIM: 6th April 2012

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