

# [Corporate governance case on apple](https://assignbuster.com/corporate-governance-case-on-apple/)

[](https://assignbuster.com/)[Business](https://assignbuster.com/essay-subjects/business/), [Corporate Governance](https://assignbuster.com/essay-subjects/business/corporate-governance/)

The case company analysed in this report is Apple Inc. I will start by identifying the company profile, which is beneficiary for the remainder of the report. The overall framework of the report will follow an agency approach. I find this approach very feasible in a corporate governance context. Per definition corporate governance is “ the control and direction of companies by ownership, boards, incentives, company law, and other mechanisms” (Thomsen, 2008). So, if proper control and direction is not applied in the company it leads to agency problems.

I will identify and discuss the different agency issues (type 1, 2 or 3) by evaluating and analyzing Apple’s capital structure, board structure, executive compensation scheme, and ownership concentration. My conclusive remarks will include a very brief summary of the governance issues and recommendation suggestion for Apple to better align management and shareholder interests. Apple Inc. – Company profile and financial performance Apple Inc. (Apple) is a US company that designs and manufactures consumer electronics and computer software. With its highly innovative and fancy designed products and an EPS of 10.

27 it takes the role as market leader in its industry. Apple has a strong financial profile. From 2005 to 2009 EBITDA has evolved from USD 1, 829, 000 (000’s) to USD 8, 361, 000 (000’s), an increase of 357 percent over the period. Worth noticing is the positive financial development from 2008 to 2009 – during the financial crisis. An increase of 23. 9 percent in EBITDA, indicates strong consumer preferences for Apple products even during economic downturns. Relative to main competitors Apple’s share price has outperformed significantly over the past 5 years, with nearly 600 percent return over the period.

Research In Motion (RIMM) is performing second best with a 5-year return of almost 250 percent (See exhibit 1). An overall assessment of Apple’s financialhealthand performance indicates that the company has very low risk following its almost invisible debt/equity ration and high market capitalization. It has very high growth rates, partly because the company is a market leader, and because zero dividends are paid out, making it possible to reinvest most of retained earnings. Finally, Apple benefits from very high profitability.

Its EBIT margin is double the industry average, its ROE is triple the industry average (See exhibit 2). These are very attractive conditions for Apple shareholders. Since the firm is mainly equity financed the associated risk is very low. In a high growth company this condition is very rare. Usually growth is associated with high reinvestment and high leverage, thus also high risk. So, I assume shareholders are satisfied with the current executive team. Apple follows the typical US market-based governance structure. The board works as a one-tier system, where the CEO is a director in the board. Read about Corporate Governance at Wipro

The legal system applied in the US is common law, which recognizes a high degree of shareholder rights (Thomsen, 2008). By law, this forces public-listed US firms to act solely in the interest of shareholders (owners). Capital structure and payout policy Given Apple’s superior financial performance, follows large annual cash flows. In 2009, Apple had a free cash flow (FCF) of around 9 billion dollars (Morningstar. com). This excessive amount of cash can create agency problems between managers and shareholders (type 1), since managers might act in their own interest and take on projects that trigger performance-based managerial compensation.

In economic terms, managers might invest in projects that generate large short-term returns but with a negative long-term NPV. Jensen’s Free Cash Flow Hypothesis (Jensen, 1986) suggests better utilization of excessive amounts of cash by engaging in debt and paying out dividend. From its debt the firm is forced to pay out cash in form of interest payments. Ideally this should make managers more efficient and take on high NPV investments, since the plowback ratio has decreased due to dividends and interest. This way aligning managers’ interest with shareholders’ interest of maximizing stock value.

However, the theory does not hold for Apple since they have no long-term debt and their short-term debt only constitute 10. 4 percent (Yahoo! Finance) of total liabilities, which limits the amount of debt interest. More interestingly is their extremely high ROCE. In 2009, Apple had a ROCE of 177. 57 percent compared to Microsoft that had a ROCE of 69. 84 percent (See exhibit 5). ROCE is a performance measure used to assess whether the firm is generating enough return to cover cost of capital. So, Apple’s managers are currently doing a good job from a shareholders perspective. I have already touched upon the subject of payout policy earlier.

It is essential to evaluate Apple’s payout policy, since they do not pay out dividends to shareholders or have not repurchased shares since 2001 (BusinessWeek, 2008). As in Jensen’s FCF theory, shareholders’ alternative to monitoring managers’ investment decisions is receiving dividends, so they get a capital compensation now rather than uncertain future returns. In other words, FCF to managers is reduced and they are forced to utilize the remaining cash flow to maximize shareholder value (Sponholtz, 2005). Another aspect of dividends is that shareholders enjoy lower taxation on dividend as opposed to that of capital gains.

By paying out dividend, the firm also sends a signalling effect (Sponholtz, 2005) that they are in a good financial state – this is especially important when ownership concentration is low and dispersed, which it is in Apple. In terms of governance and agency costs, payout policy exists to eliminate conflicts of interest and information asymmetry. Signalling effects from dividend announcements has been empirically proven to affect stock returns (Gugler and Yurtoglu, 2002), so theoretically, if managed carefully and correctly, Apple could benefit from this.

Introducing low levels of dividends and then slowly increase different long term, would continuously generate abnormal positive returns (Gugler and Yurtoglu, 2002). However, with Apple’s continuous outstanding return on capital employed, they should stick with their current strategy until growth opportunities start to stagnate. Though there has been a lot of polemics concerning Apple’s enormous “ pile” of cash in its holding. In numbers, this pile amounts to no less than 29 billion dollars (Financial Post, 2009). Analysts are sceptical to whether Apple’s management decide to repurchase stocks or introduce a one-time dividend.

Today, the payout policy remains the same. It is not acting in the best interest of shareholders, when its management is sitting on a 29 billion dollar mountain that belongs to them. But given the financial performance of Apple, they seem to get away with it. Apple’s huge cash holding brings me to the Pecking Order theory (Myers, 2001), which the management seem to be very fond of. The primary source of financing for new investments come from retained earnings, supporting the pecking order theory; that firms prioritize their sources of financing from internal financing to equity.

Remembering Apple’s short-term debt of 10. 4 percent, they make sure to take advantage of the tax shield benefits generated from the interest payments. The Trade-Off Theory (Myers, 2001) recommends firms to take on debt to the point where the present value of the interest tax shield equals the present value of the cost of financial distress. Obviously, Apple is not anywhere near this optimization point. But perhaps it is not necessary, since they do not invest all their retained earnings. So leveraging their capital seems inefficient.

The Pecking Order Theory and the Trade-Off Theory are its two opposites, and Apple appears to follow the first. Board structure The board of Apple only consist of 6 directors, including CEO, Steven Jobs. Three committees constitute the governing powers of auditing, compensation and nominating in Apple Inc. Since Steven Jobs is the only executive director, he is not a member of any of the three committees, this would violate the separation of ownership and control. The committee composition does not just follow a random walk between the remaining 5 directors. E. g. Bill Campbell; expert in taxes, accounting software and personal finance is co-chairman in the audit committee. So each director’s competencies are fully utilized in the board. The unusual small board size makes it more decisive, however it also lacks competencies. Given that co-founder and CEO, Steven Jobs is a director, indicates a low level of board independence (MacRumors, 2010). It is the boards’ job to control and monitor executives and separate control and ownership. But when Steven Jobs constitutes 17 percent of the board together with his current powerful reputation, he has too much influence on board decisions.

The board is supposed to represent the interest of the shareholders, so there is a breach in the governance mechanism here. This is a clear example of a type 1 agency problem between shareholders and managers. So shareholders are urged to nominate a new non-executive director, who can challenge the CEO, which would create more board independence. By the underlying assumption of agency cost that managers act in their own interest, Steven Jobs could exploit his powerful position, thus becoming entrenched (Thomsen, 2008). This dilemma is also connected with the agency problem of the missing payout policy in the prior section.

The board is to ensure that Apple’s obligations to its shareholders are clearly understood and nonetheless met (Combined Code, 2003). The lack of dividends and stock repurchases, given their huge capital reserve, clearly indicates that shareholder obligations are not met in terms of shareholder value. According to Hermalin and Weisbach (1997) the longer duration the CEO is a board director, the more power he accumulates. The opposite development occurs for the chairmen; they become less powerful, and the remaining members slowly decrease their level of power over time.

Since half of the board, including Steven Jobs, have been a board member for more than 10 years (See exhibit 6), this relationship applies in Apple’s board, further supporting the fact that he is very powerful. Executive compensation Given all the arguments above supporting the excessive power position of Mr. Jobs, perhaps his compensation plan can justify the situation. Since 2007, his annual pay totals one dollar. Apple believes that this aligns his interests with those of the shareholders (Annual shareholder meeting 2010, p. 22). He owns 5. 5 million Apple shares corresponding to about 1. 5 billion dollars. Together with the fact that he is the co-founder of Apple Inc. indicate strong incentives for him to act in the best interest of the company, eliminating conflicts of interest. The compensation scheme for the remaining executive team is based on three pillars: A base salary, an annual performance-based cash bonus, and long-term equity awards in the form of RSU’s. Apple shows good corporate socialresponsibility(CSR) by not overpaying its executives. The base salary is at the median of peer companies.

The annual performance-based bonus, can only be up to 100 percent of the base salary, with a target bonus of 50 percent. The median for peer companies is between 105-130 percent. The lower cash bonus is due to Apple’s belief that it is less incentive effective than the long-term equity awards. Compared to the median of 74 percent of total compensation for peer companies, Apple executives’ long-term equity awards constituted 89 percent of total compensation. The use of RSU’s instead of stock options aligns performance and compensation better since the value of RSU’s move in accordance with the stock price.

Stock options do not. So type 1 agency problems are eliminated by the better alignment of interest between executives and shareholders. Ownership concentration Fama and Jensen (1983) suggest that too high ownership concentration lead to entrenchment effects, since the largest owner moves towards complete control. In the other end, too low ownership concentration means that there is no real owner in control, giving rise to entrenched behaviour by the management. With a total of about 2000 owners Apple has a very dispersed ownership. The largest shareholder dominates only 4. 8 percent, and Steven Jobs is the largest personal investor with a holding of 0. 6 percent of total shares outstanding. From the prior section I concluded that Apple’s executive compensation plan is fair, so transaction costs are low. Tying this aspect with the strong financial performance, then Apple has a very efficient ownership structure (Hansmann, 1996). However, from Fama and Jensen’s viewpoint the ownership structure is too dispersed, indicating lower firm performance. But given Steven Job’s status, his level of control cannot be measured based on his share of ownership.

Instead his positive reputation amongst consumers and shareholders (Hansen et al. , 2010) indicates a higher level of control and managerial freedom, since they believe he is acting in the interest of firm, hence the shareholders. Conclusion and recommendation It is difficult to give a clear set of recommendations for Apple. Basically, the company is performing very well. I calculated its CAGR over a 4-year period to be over 30 percent, with peer companies not even reaching 10 percent (See exhibit 4). Looking ahead, forecasts show that Apple’s performance will grow even more (See exhibit 3).

Despite its high performance, there are some warning signals in their current governance structure. Given the low independence on the board of directors and Steven Jobs powerful position, I strongly recommend shareholders to elect a director, who can challenge Jobs on the board. Apple’s share price has increased substantially following the financial crisis. The management should announce its plan to repurchase shares or issue a one-time dividend payout. This signals managements’ interest in satisfying shareholder needs. It also shows that management believe in future growth opportunities.

These changes together with the current governance structure, I believeApple’s management is acting in the interest of shareholders and board independence will increase.

References

Books:

Thomsen, S. (2008). An Introduction to Corporate Governance. DJOF Publishing Copenhagen, 1st edition.

Brealey, Myers and Allen (2008). Principles of Corporate Finance. McGraw Hill, 9th edition

Hendrikse, G. (2003). Economics and Management of Organizations: Co-ordination, Motivationand Strategy. McGraw Hill.

Articles: Fama, F. & Jensen, M. (1983). Separation of ownership and control. Journal of Law and Economics 26, 301-325.

Gugler, K. & Yurtoglu, B. (2002). Corporate governance and dividend pay-out policy in Germany. European Economic Review 47. Pp. 731-758.

Hansen, M. , Ibarra, H. & Peyer, U. (2010). The Best-Performing CEOs in the World. HarvardBusiness Review. Feb. 2010.

Hansmann, H. (1996). The Ownership of Enterprise. Harvard University Press, Cambridge Mass. Hermalin, B. & Weisbach, M. (1997).

Endogenously chosen boards of directors and their monitoring of the CEO.

American Economic Review, forthcoming. Higgs, D. (2003). Review of the role and effectiveness of non-executive directors.

Department for Business, Enterprise and Regulatory Reform. Jensen, M. (1986).

Agency costs of free cash flow, corporate finance and takeovers. American Economic Review 76, 323-339. Myers, S. (2001).

Capital Structure. The Journal of Economic Perspectives 15 (2). Pp. 81-102.

Sponholtz, C. (2005). Separating the Stock Market’s Reaction to Simultaneous Dividend and Earnings Announcements. Working paper, University of Aarhus.