Corporate Governance

What we will look at…

- What is Corporate governance?
- Issues in Corporate governance
- Difference between Corporate Governance and Corporate Management
- Theories of Corporate Governance
- Models of Corporate Governance (International and Indian)

Some Definitions…

- "*Corporate Governance is the system by which business corporations are directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among different participants, such as, the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. By doing so it also provides the structure through which company objectives are set, and the means of attaining those objectives and monitoring performance." –* **OECD, April 1999**

Some Definitions…

- *"A system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers with the legal and regulatory requirements apart from meeting environmental and local community needs. It leads to the building of a legal, commercial and institutional framework. It also demarcates the boundaries within which these functions are to be performed."* – **Corporate Governance: Time for a Metamorphosis**

Corporate Governance

Relationship among stakeholders that is used to determine and control the strategic direction and performance of organizations

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Concerned with identifying ways to ensure that strategic decisions are made effectively

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Used in corporations to establish order between the firm's owners and its top-level managers

Separation of Ownership and Managerial Control

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Basis of the modern corporation

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Shareholders purchase stock, becoming...

Residual Claimants

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Modern public corporation form leads to efficient specialization of tasks

- Risk bearing by shareholders
- Strategy development and decision-making by managers

Issues in Corporate Governance

Issues in Corporate Governance…

- ***Ethical Issues***
- ***Efficiency Issues***
- ***Accountability Issues***

Image source: www.theliptongroup.com

… Issues in Corporate Governance

- Ethical Issues
  - Adopting fraudulent means to achieve goals
- Efficiency Issues
  - Concerned with performance of managers
- Accountability Issues
  - Accountability to various stakeholders
  - Need for Transparency

Changing business scenario

- Growth of private companies
- Growing complexity of corporate groups
- Growing influence of institutional investors
- Rise in hostile takeovers
- Insider trading
- Litigations against directors
- Need for restructuring of boards
- Changes in auditing practices

Theories of Corporate Governance

Theory of Douglas McGregor

- *Assumption*: Humans are by nature trustworthy and act in good faith.
- Reflected in company law
- Monitoring is required only to curtail rare misconduct

To read more about Douglas McGregor visit: http://www.economist.com/node/12366698

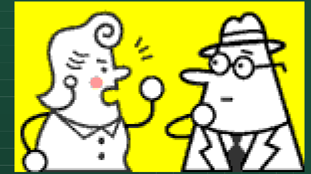
Image: Source: http://www.unreasonable-learners.com/why-wisdom-matters-to-you/

Stewardship theory

- Donaldson and Davis in 1988
- Also accepted assumptions of McGregor's Theory Y
  - Management responsible for organising resources
  - Employees by nature not averse to behaving in accordance to co. requirements
  - Built-in motivation to behave in a way that will help a corporation to achieve objectives

To read more about Stewardship theory vs. Agency Theory, read the following Research paper by Donaldson and Davis "*Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*" http://faculty.wwu.edu/dunnc3/rprnts.stewardshiporagency.pdf

Stewardship theory



- Criticism :
  - Separation of ownership from management
  - No single shareholder who holds major chunk
  - Inability of small investors to monitor
  - Control shifting from owners to management
  - Divergence of interests of owners and management

Agency Theory

An agency relationship exists when:

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Shareholders (Principals)

Firm Owners

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Hire

Managers (Agents)

Decision Makers

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Decision Makers

which creates

Agency Relationship

Risk Bearing Specialist (Principal)

Managerial Decision-Making Specialist (Agent)

Agency Theory

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- The desires or goals of the principal and agent conflict and it is difficult or expensive for the principal to verify that the agent has behaved appropriately

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Solution: Principals engage in incentive-based performance contracts, monitoring mechanisms such as the board of directors and enforcement mechanisms such as the managerial labour market to mitigate the agency problem

Agency Theory

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- However, dispersed shareholding makes it difficult and and inefficient to monitor management's behavior

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For example: Boards of Directors have a fiduciary duty to shareholders to monitor management

- However, Boards of Directors are often accused of being lax in performing this function

Governance Mechanisms

Ownership Concentration

Boards of Directors

Executive Compensation

Multidivisional Organizational Structure

Market for Corporate Control

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Governance Mechanisms

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- Large stakes make it worth their while to spend time, effort and expense to monitor closely

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Ownership Concentration

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- May also obtain Board seats which enhances their ability to monitor effectively (*although financial institutions legally forbidden from directly holding board seats*)

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- Related Outsiders
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- Review and ratify important decisions

- Set compensation of CEO and decide when to replace the CEO

- Lack contact with day to day operations

Governance Mechanisms

Recommendations for more effective **Board Governance**

Governance Mechanisms

Recommendations for more effective
Board Governance

- Increase diversity of board members backgrounds
- Strengthen internal management and accounting control systems
- Establish formal processes for evaluation of the board's performance

Executive Compensation

Governance Mechanisms

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Salary, Bonuses, Long term incentive compensation

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- Executive decisions are complex and non-routine
- Many factors intervene so difficult to establish how managerial decisions directly responsible for outcomes
- Stock ownership (long-term incentive compensation) makes managers more susceptible to market changes which are partially beyond their control

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Executive Compensation

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- Many factors intervene making it difficult to establish how managerial decisions are directly responsible for outcomes
- In addition, stock ownership (long-term incentive compensation) makes managers more susceptible to market changes which are partially beyond their control

Incentive systems do not guarantee that managers make the “right” decisions, but they do increase the likelihood that managers will do the things for which they are rewarded

Multidivisional Organizational Structure

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- Increased managerial interest in wealth maximization

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- May lead to greater rather than less diversification

Broadly diversified product lines makes it difficult for top-level managers to evaluate the strategic decisions of divisional managers

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- The 1980s saw active market for corporate control, largely as a result of available pools of capital (junk bonds)
- Many firms began to operate more efficiently as a result of the "threat" of takeover, even though the actual incidence of hostile takeovers was relatively small
- Changes in regulations have made hostile takeovers difficult

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The market for corporate control acts as an important source of discipline over managerial incompetence and waste

Anglo American

- Company
- Officers
- Board of Directors

- *Shareholders*
- *Creditors*
- *Stakeholders*
- *Legal System*

Germany

Source: http://www.123rf.com/photo_6496039_business-people-shaking-hands-on-germany-map-flag-illustration.html

Source: http://www.sprachcaffe.com

International Corporate Governance

Germany

- Owner and manager are often the same in private firms
- Public firms often have a dominant shareholder too, frequently a bank

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Medium to large firms have a two-tiered board

- Vorstand monitors and controls managerial decisions

- Aufsichtsrat selects the Vorstand

- Employees, union members and shareholders appoint members to the Aufsichtsrat

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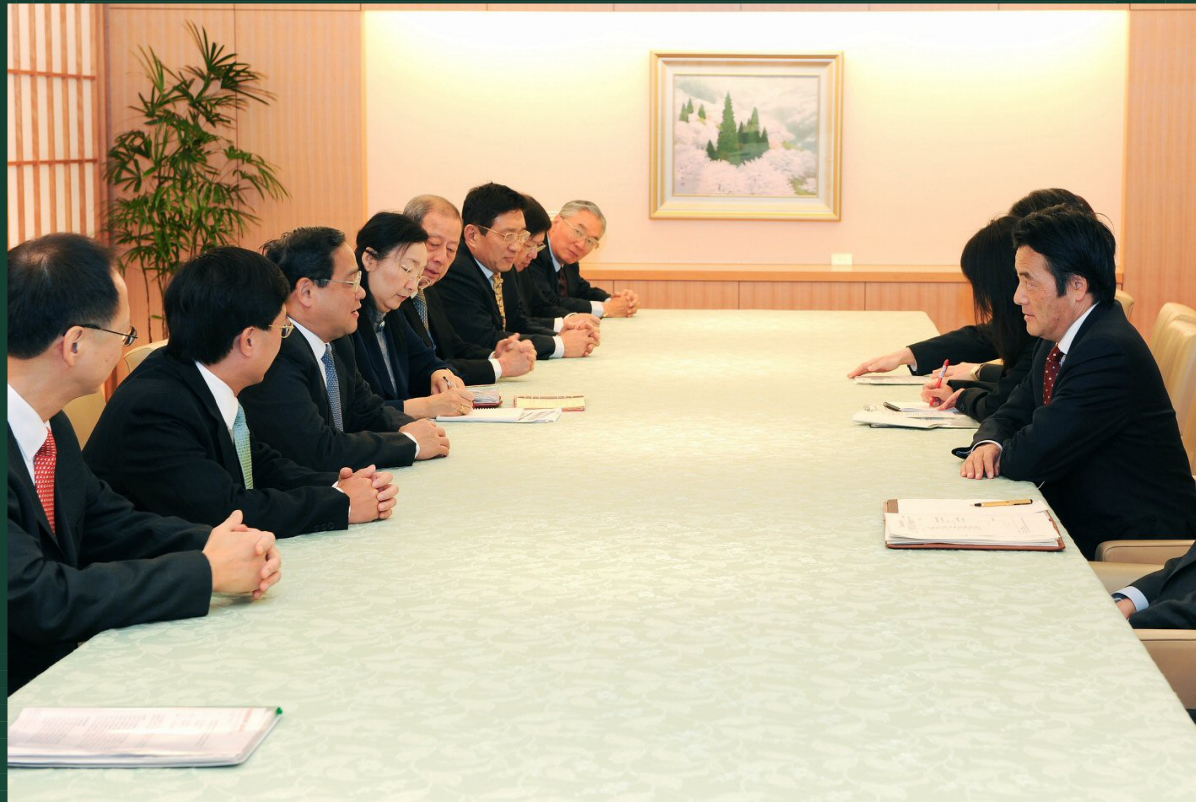
Frequently there is less emphasis on shareholder value than in U.S. firms, although this may be changing

Japan



Source: http://info.hktdc.com/hkjbcc/plenary2010.htm

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Japan

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Other characteristics:

- Powerful government intervention
- Close relationships between firms and government sectors
- Passive and stable shareholders who exert little control
- Virtual absence of external market for corporate control

Corporate Governance and Ethical Behavior

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Although controversial, some believe that ethically responsible firms should introduce governance mechanisms which serve all stakeholders' interests