**11. Corporate Governance**

It is about the mechanisms/means to ensure that the interests of top-level managers are aligned with the interests of shareholders.

At its core, corporate governance (CG) is concerned with identifying ways to ensure that strategic decisions are made effectively to maximize company value i.e. the shareholder value.

CG has been emphasized in recent years because:

1. The CG mechanism has failed to adequately monitor and control top-level manager’s strategic decisions.
2. Evidence suggests that a well-functioning CG and control system can result in a competitive advantage.
3. CG is vital importance to national interest in terms of employment, wealth and satisfaction as well as improving standard of living and social cohesion.

4. CG reflects standards of company and social standard.

5. Nations that govern their corporations effectively may gain CA over rival countries.

Interest of Shareholders

* Shareholders are the key stakeholders and legal owners of the firm.
* They expect the top-level managers and any others who are influencing the firm’s actions (such as the Board of Directors) to make decision to maximize company value.

Therefore the fundamental goal of business organisations is to maximize shareholder value.

This is possible if the company achieves competitive advantage i.e. to be better than the competitors and to attain above average profit of the industry.

**Relationship between Owners & Managers**

In a company, where there is a separation of ownership and managerial control:

Owners

* The owners do not get involved in the day-to-day management of the firm.
* They own shares in the firm and entitle to income from the operation of the firm if there is profit.
* The shareholder value is reflected by the price of the firm’s shares.

**Managers:**

* Managers are appointed to take control of the day-to-day running of the business.
* They oversee decision-making and are compensated.
* They act as agents to the owners.
* They have the primary responsibility for initiating and implementing an array of strategic decisions.

**Agency Relationship**

* The separation between owners and managers creates an agency relationship.
* This agency relationship exists when one or more persons (called the principal/principals) hire another person/persons (the agent/agents) as decision-making specialists to perform a service.
* The principal pays compensation to the agent for making professional decisions.

*Problems in Agency Relationship*

* Principals and agents have different interests.
* Principals lack direct control of large publicly traded corporations
* Managers tend to diversify into businesses that can provide benefits to themselves rather than the shareholders. E.g. they increase the size of the firm in order to get more compensation and to reduce their employment risk such as job loss, loss of compensation and loss of managerial reputation. They gain power, status & income.
* Managers use available cash to invest in products that are not associated with the current lines of business. This can lead to over diversification and tie up the free cash. This may act contrary to the interest of the shareholders who prefer to have the free cash flows to be distributed as dividends or to diversify into related businesses.

*Reasons for owners’ diversification*

* Reduce risk of the firm’s total failure while increasing company’s value through development of economies of scale and scope.
* Shareholders preferred the diversified position at point A on curve S between the dominant business and related constrained classification strategies.

Shareholder Managerial

(business) (employment)

S risk profile risk profile M

Risk

A B

Dominant Related Related Unrelated

business constrained linked business

*Reasons for top-level executives in diversification*:

* To improve their employment risk and employment opportunities.
* They prefer higher levels of product diversification than shareholders as shown by the point B on curve M.
* They go for a level of diversification that maximizes the size and their compensation and that reduces their employment risk.
* Managers (agents) capitalize on managerial opportunism to gain self-interest i.e. improve their employment risk at the expanse of shareholders.
* This leads to conflict between principals and agents.

Profitability against the Rate of Growth in Company Revenue

P\*

Profitability P1

P2

G1 G\* G2

Revenue Growth Rate

* A moderate revenue growth rate at G\* allows a company to maximize profitability, generating a return of P\*.
* Growth rate G1 is not consistent with maximizing profitability (P1<P\*)
* Diversify into areas the company knows little about to attain growth rate.
* Consequently G2 may be the growth rate favoured by CEO, where P2<P\*.
* P2 may attain managerial goals of power, status and income.

**Governance Mechanisms**

Two types:

1. Internal Governance Mechanisms (four types are mentioned) and

2. External Governance Mechanism.

***1. Internal Governance Mechanisms***

(a) Ownership concentration

Where big firms (such as banks, mutual funds and EPF) own a certain percentage of

the shares of the company such as 5% or more. These large firms have the capable

people to make sure that the managers do not make wrong strategic decisions. They

could make the

CEOs and Board of Directors accountable for all performances of the company.

(b) Board of Directors

It is made up of a group of elected individuals whose primary responsibility is to act in the owners’ interest by formally monitoring and controlling the top-level executives. The managers do not have the opportunity to do things different from he shareholder interest. They need to get the board’s approval for diversifying the interests of the firm, for example.

The members of the Board of Directors can come from:

(1) Top-level managers who are to provide information about the firm’s day-to-day

operations.

(2) People who are from related businesses but are not involved in the day-to-day

activities of the firm.

(3) Individuals who are able to provide independent advice to the firm and may hold top level managerial positions in another company.

Limitations on the Board’s Ability to Govern

1. They have constraint in their own available time and knowledge.

2. They lack a consensus about their goals.

3. They feel the superior power of management especially if the CEO is the

Chairman.

(Source: Jay Lorsch, author of Pawns or Potentates: The Reality of America’s

Corporate Boards.)

4. Directors have little individual accountability to shareholders.

(Source: Cynthia A. Montgomery & Rhorida Kaufman: “The Board’s Missing

Link”, Harvard Business Review, March-April 2003.)

(c) Executive Compensation

Where salary, bonuses and long term incentives are used to get the managers to act in

the interest of the shareholders.

(d) The Multi-Divisional Structure

It is where individual business divisions are created to closely monitor the strategic

decisions of top-level managers.

***2. External Mechanism***

There are individuals and firms that buy ownership positions in (or takeover) potentially

undervalued companies.

This mechanism is used when a firm is performing badly in relative to that of the competitors in the industry.

Managers of the firm must ensure that their company performs well if not there are other parties who would like to take over the firm.\*

**\*Managerial Defence Tactics against Takeover**

(How managers reacted to the threat of takeover.)

* Golden Parachute –pays a guaranteed salary for a specific period in the event of a takeover and the loss of one’s job - a way to prevent top executives from blocking the acquisition.
* Golden Goodbye – an automatic payment to top executives if their contracts are not

renewed, regardless of the reason for the non-renewal.\*

* Managerial ownership of the firm’s shares – gives managers power to protect their

interests.

* Asset restructuring.
* Financial restructuring i.e. repurchasing firm’s outstanding shares.
* Poison Pills – authorised issuance of preferred stock that existing shareholders could redeem at a premium after the takeover.
* Companies may not show to be what it was expected before the takeover.

**Role of the CEO**

CG is actually a delicate system of checks and balances among the three parties – management, boards of directors and shareholders. Unless they play their parts well, the integrity of the whole organisation is threatened. Therefore forging strong links across three parties is necessary to help rebalance the CG system and help pave the way for lasting change.

Whatever changes may have been made to improve the CG, CEOs continue to bear the ultimate responsibility for the performance of their companies. This requires them to fulfil a broad range of leadership functions – maintaining ethical standards, creating a challenging work environment, maintenance of corporate purpose. Even though boards and stakeholders are playing a greater role in strategic decisions, the CEO remains the only person with the knowledge, time and authority to truly understand the firm’s position and develop the appropriate corporate strategy. The CEO and his /her team of corporate executives are the ones in a position to initiate and deliver on a strategy and to achieve the CA.

**Governance Mechanisms and Ethical Behaviour**

* It is imperative that there are effective governance mechanisms to ensure that the interests of all stakeholders are served. This means that it is not only the shareholder but other stakeholders as well such as customers, suppliers and employees.
* It is also imperative that the companies discharge ethical behaviour especially in the formulation and implementation of strategies.

It is necessary that the tools like CG and business ethics are taken into consideration in the strategy making process.

References:

1. Johnson, Scholes & Whittington (2005), Exploring Corporate Strategy, 7th ed. C.4, p. 163-195)
2. Hanson, Dowling, Hitt, Ireland and Hoskission (2002), Pacific Rim Ed. Strategic Management, Competitiveness and Globalisation. C.10, p. 346.
3. Collis Montgomery (2005), Corporate Strategy, a resource based approach, 2nd ed., C.8, pp. 207-213.

Assignment

1. Assume that you overheard the following comment: “As a top executive, the only agency

relationship I am concerned about is the one between myself and the firm’s owners. I

think that it would be a waste of my time and energy to worry about any other agency

relationships.”

What are these other agency relationships?

How would you respond to this person? Do you accept or reject the view? Explain.

2. What is corporate governance? What factors account for the considerable amount of

attention corporate governance receives from several parties including shareholders,

activists, business press writer and academic scholars? Why is Governance necessary to

control managerial decision?

3. How can corporate governance mechanism create conditions that allow top executives to

develop a competitive advantage and focus on long term performance?