Corporate Governance - Fundamentals -

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2. Why is it important?
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What is Corporate Governance?
- Oxford English Dictionary defines "Governance" as the act, manner, fact or function of governing.
- The word has Latin origins that suggest the notion of 'steering'.
- A corporation is an association of people with legal personality.

Corporate Governance - Definitions

Very Narrow (agency problem)
- The means by which the corporation’s agency problem is resolved

Narrow (shareholders)
- The means by which an corporation is directed and controlled by its owners.

Broad (stakeholder performance)
- The long-term management and oversight of an organisation,
  - Includes all levels of management
  - Includes other parties as well as owners
  - Includes performance as well as control

Very Broad (social performance)
- Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals

Three views of the firm
1. Shareholder primacy view
   - Firm is the property of shareholders
   - Purpose: profit
2. Stakeholder view
   - Firm is an alliance
   - Purpose: mutual satisfaction
3. Society view
   - Firm is an agent of society
   - Purpose: social benefit
**Typical ownership transition**

1. **Firm established** (ownership & control are united)
   - Single owner/manager or
   - Entrepreneur with investors

2. **Transition**
   - Founder’s control becomes less absolute as more professional managers are hired
   - Founder’s share is diluted as owner withdraws capital from business or business requires additional investment

3. **Floatation**
   - Ownership and control separate
   - Ownership becomes highly dispersed
   - Control generally either exercised by professional managers elected by shareholders (or by original owner/family e.g. Forte, Airtours)

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**CG is about control:**
the control of the firm by its shareholders

- **Shareholders**

For shareholders to control the firm:
1. The shareholders must control the BOD
2. The BOD must control the firm

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**ACTIVITY**

What are the main ways of controlling corporate behaviour?

- Corporate Governance impacts on four key factors
  - Strategy
  - People
  - Performance
  - Risk

- What happened at Enron?
- Video <<

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**Why is corporate governance so important?**

**Why do we need corporate governance?**

1. Limited liability results in risks for creditors and investors
2. Dispersal of ownership increases the power of managers
3. The investment process is very important for economic stability and growth. It needs to be protected with rules
4. Experience has shown that well established companies can quickly fail due to incompetent managers:
   - Barings (1762 – 1995)
   - Lehman Brothers (1850 – 2008)
The principle of incorporation

- The four defining characteristics of the modern corporation (Clark, 1986) are:
  1. **Limited liability**, meaning that capital suppliers are not subject to losses greater than the amount of their investment
  2. **Transferability of shares**, whereby rights in the enterprise may be transferred readily from one investor to another without reconstituting the organization under law
  3. **Juridical personality**, meaning that the corporation itself as a fictive "person" has legal standing and may thus sue and be sued, may make contracts, and may hold property in a common name (this produces **indefinite duration**, whereby the life of the corporation may extend beyond the participation of any of its incorporators)
  4. **Delegated Management**. Shareholders exercise delegated not personal control, via a board of directors that they elect.

Two problems

- Two public-interest problems emerged after 1870 with the growth of the corporation:
  1. **Problems of governance** within the firm
  2. **Problems of firm behaviour towards competitors and customers**, especially monopoly power of industrial giants such as Standard Oil Company and United States Steel.
- The US government was quick to restrict the growth of monopolies, much less quick to deal with issues of corporate governance.

The modern joint-stock company

1. England was the first nation to have joint-stock companies. The earliest recognized company was the English (later British) East India Company. It was granted an English **Royal Charter** by Elizabeth I on December 31, 1600
2. 1720 – a speculative panic resulted in legislation the same year to restrict the formation of joint-stock companies
3. Incorporation was only possible by Royal Charter until the **Joint Stock Companies Act 1644**, which allowed registration and incorporation of companies without specific legislation
4. These firms did not yet have limited liability until the **Joint Stock Companies Act 1856** provided for limited liability for all joint-stock companies provided, amongst other things, that they include the word "limited" in their company name.

Limited Liability - 1856

- Acceptance of this principle by business enterprises and governments was a vital factor in the development of large-scale industry, because it enabled business concerns to mobilize large amounts of capital from a wide variety of investors who were understandably unwilling to risk their entire personal fortunes in their investments.

What happens when a company fails?

- Corporate governance is closely related to the process of winding up a company.
- **Who is entitled to the money that is left when the company is liquidated?**
  1. Tax authorities
  2. Employees (including directors)
  3. Secured Creditors (usually banks)
  4. Unsecured Creditors (usually suppliers)
  5. Investors
- **Example** – When Lehman Brothers collapsed they owed x tax, x to creditors, x to employees and investors lost x
UK context
- Shareholders have strong legal powers but tradition of passivity
- High degree of institutional ownership
- High degree of foreign ownership
- Very low level of "retail" ownership
- Highly developed "market for corporate control"
  - Intrusive media
  - Analysts
  - Aggressive hedge funds
  - Well informed institutional shareholders
  - Watchdogs (ABI, PIRC)
- Substantial family interests remain
- Growth in "ethical investment"
- Many industries are tightly regulated, others much less so (historic rather than rational)

Why is share ownership so dispersed?
FOR
- Modern finance theory endorses a diversified portfolio
- Risk aversion
- Many firms use a passive philosophy investing across a whole index
- Owning 3% or more requires public disclosure of purchase and sale (when the 3, 4, 5 & 6% boundaries are crossed)
- Even small stakes give influence
AGAINST
- Warren Buffet believes in taking large stakes
- Large stakes give more influence
- Owning many stakes makes analysis more demanding.

Why is CG so important?
1. Protecting the process of investment
   - Investors have the legal right of control
   - Investors are very vulnerable
2. Protecting other stakeholders from abuse, underperformance and failure
   - Suppliers
   - Creditors
   - Employees
   - Customers
   - Tax authorities
3. Preserving public faith in organisations

What’s so special about investors?
- All stakeholders will lose from corrupt or inept management but investors are unique.
- Investment is an act of faith
- Investors have the legal right to control the company
- Investors generally receive nothing if the company is liquidated. (residual claimants)
- So the paradox of absolute legal control and yet no effective control means a complex body of regulation has built up in developed economies.
- It is not just individual investors who need protecting but faith in the investment process, as investment markets are highly prone to contagion.
- Who do investors need protecting from? Two main groups:
  - Senior managers
  - Other shareholders

Shareholder rights in the UK
- The UK offers shareholders amongst the most rights of any jurisdiction in the world:
  - Shareholders have exclusive control (employees and creditors have no control)
  - Right to choose and remove directors
  - Right to change constitution (75%)
  - Right to call meetings (5%)
  - Right to circulate resolutions (5%)
  - Right to equal treatment
  - Right to sell shares

Agency Theory
Have you done any of these?
- Take home company stationery for your personal use.
- Print or make photocopies of your personal documents at the office.
- Make personal calls during office hours.
- Surf the Internet for private matters during office hours.

If so, you have been guilty of exploiting an "agency relationship".

### Agency Theory

An agency relationship exists when:

- Shareholders (Principals)
- Firm Owners
- Managers (Agents)
- Decision Makers

### The Principal Agent Problem

- Shareholders
- Shareholders
- Shareholders

Managers

Heterogeneity

- in large joint-stock companies their managers use their position to protect their own interests and do not take care of the interests of the firms' owners. In other words, interests of shareholders and managers are divergent.
- Shareholders tend to maximize their wealth (for example through increase of share prices) while managers look for prestige, high salaries, safety of their jobs, etc.
- Assumption of homogeneity for both groups

### Agency Theory

- Key assumptions:
  - Share price accurately reflects management performance
  - Shareholder interests are homogeneous
  - All other stakeholders are protected by contracts
  - Agency problem is not an ‘issue’ due to direct intervention of the owner; ownership and control are not separated in this firm. Market forces prevail?

### But – Shareholders are not homogenous

How might shareholder goals differ?
- Time horizon
- Dividends vs Investment (Growth)
- Attitude to risk
- Views on corporate strategy
**Classic problems of CG**
- Shareholders vs management (agency problem)
- Shareholders vs shareholders
- Shareholders vs bondholders
- Exec vs Non-Exec
- CEO vs Chairman

NB All manager-subordinate relationships involve the agency problem, but these issues are dealt with as management problems, not under Corporate Governance.

**Mechanisms of corporate control**
- Market Mechanisms
  - Secondary share market (via share price)
  - Market for control (take over)
  - Executive labour market
  - Market for resources (suppliers)
- Law
  - Company Law (e.g. audit)
  - Listing rules
  - CG code
- Internal Mechanisms (voluntary)
  - Board powers
  - Shareholder consultation and disclosure

**Responses to the agency problem**
- Write contracts to clarify expectations (and facilitate legal action)
- monitoring mechanisms
  - E.g. board of directors
  - Annual financial statements
- Retain key powers
- Larger ownership stakes
- Financial statements, protected by:
  - Auditors
  - GAAP
  - Audit committee
- Experienced directors to direct
- Experienced INEDS to supervise
- Management incentives aligned with owner goals
- Threat of prosecution

**Company Valuation**

**Intangible assets**
  - Coca Cola (38x)
  - Amazon (64x)
  - Market average = 3
- Reputation
- Brand
- Quality of management and board
- Governance
- Knowledge
- Protected position

**Corporate Governance How does it benefit the organisation?**
- Improves access to capital
  - Investors are willing to pay a premium for a well-governed company, particularly in emerging markets
  - Governance is now an established investment criterion
- Improves valuation and stock price
- Leads to a better system of internal control, thus leading to greater accountability and better profit margins
- Protects the firm from wrongdoing, and legal and reputational risk
- Enhances performance & growth
Is greed good?
- Video – Wall Street
- Should we encourage our staff to be ambitious?
- What boundaries should we place on ambition? <<

Corporate Governance
How does it benefit society?
- Impacts on the society as a whole
- Reduces the risk of financial crisis
- Enhances access to capital. Good corporate governance is an essential pre-requisite for the integrity and credibility of capital markets. Investment is an act of faith.
- Distributes wealth by opening the stock markets to the private investor.

Conflicts of interests
The following are the most common forms:
- Self-dealing, in which an official who controls an organization causes it to enter into a transaction with the official, or with another organization that benefits the official. The official is on both sides of the “deal.”
- Outside employment, in which the interests of one job conflict with another.
- Executives who own stock and also have influence on the company.
- Family interests (nepotism), in which a relative is employed (or applies for employment) or where goods or services are purchased from such a relative or a firm controlled by a relative. (Also applies to friends)
- Executive directors as representatives of shareholders vs self interest vs company interest vs stakeholder interest.
- Do delegates have examples of these?

Stakeholder Theory

How many markets is a firm in?

Who is the most important stakeholder?
- Which groups are essential to the operation of your organisation?
- Which group(s) is the organisation created to serve?
- Which groups want to influence the strategy of your organisation?
Exercise: Using an organisation you are familiar with, rank stakeholders by order of importance.
Typical Stakeholders

Primary - Groups that the business exists for
Secondary - Groups that can exert major influence over performance
Tertiary – groups that may be significant at times

More Attention on Directors

Increased pressure on the board of directors to provide better corporate governance was probably caused by the following:

- The tidal wave of mergers and acquisitions in the mid 1980s and late 1990s
- The continuing stream of corporate scandals that destroyed shareholder value
- The rise of “active” shareholders who began pushing for more accountability from directors
- Increased legal responsibility

Board Role & Responsibility

1. Set the organisation’s direction
   - Strategy, priorities, capital spend, budgeting, M&A, projects
2. Control the Management of the Company
   - Monitoring performance, control systems, codes of conduct, oversee audit process
3. Be Accountable at all times to All Shareholders
   - Communication, reporting, meetings

The board of directors

- The Chairman
  - Runs the board
- The CEO
  - Runs the company
- Executive directors
  - Are salaried employees
  - Tend to defer to the CEO
- Non-executive directors
  - Act purely as directors, not full time employees
  - Often directors of other companies
  - If they are free of significant links from the company, then they can be classified as independent
The role of the Chairman

- The chairman's role is to lead the board
- Chairman must ensure that board meetings are conducted in a professional manner
- Chairman is an important link between the board and shareholders (as is the SID – esp when Chairman is exec)
- The Combined Code states that the chairman should not also be the CEO because it is too much power in one person's hands
  - At the same time, separation of the two roles can bring conflict if the two do not get along
  - A CEO should not go on to become the Chairman because the ex-CEO may have too much power and will not be willing to undo earlier mistakes

Board Domination

- "That's six 'noes' and one 'aye' - the ayes have it."

How does it happen?

- "All these in favour say 'Aye'."

Origins of the CEO-centric firm

- CEO as founder
- CEO as superstar
  - Personal Fame
  - Corporate Success
- CEO as owner
- CEO personality

A brief history of dominant CEOs

- Dominant CEOs may lead companies to extreme (visionary) strategies. Firms with dominant CEOs tend to have a strategy deviant from the industry central tendency and thus extreme performance – either big wins or big losses (Tang et al, 2011)
- Steve Jobs @ Apple
- Bill Gates @ Microsoft
- Fred Goodwin @ RBS
- Ken Lay @ Enron
- Robert Maxwell @ Mirror Group Newspapers
- Rocco Forte @ Forte
- Murdochs @ BSkyB
- cf Margaret Thatcher?
- Dominant CEOs may enrich themselves
  - Dennis Kozlowski @ Tyco
  - Conrad Black @ Hollinger

Solutions to CEO domination

- CEO-centric companies can be very successful:
  - Virgin
  - Berkshire Hathaway
  - Apple
- How can CEO domination be mitigated?
  - Separate CEO & Chairman
  - Majority of Independent directors
  - Succession planning
  - Clear delegation
  - Strong board committees
  - Strong executive and non-exec directors (stars)

The role of non-executive directors

- Non-executives are expected to contribute to each of the board functions described above
- Because of their commercial experience they can help with strategic advice
- They are particularly important for the monitoring and control function since executive directors are not expected to monitor themselves
- Both the audit committee, the remuneration committee, and the nominations committee should consist of non-executive directors
- In the past being a non-executive director was not a particularly onerous task, but this has changed in recent years due to the increased regulation
- A spokesperson for independent and minority interests
- A bulwark against entrenched vested interests
- A sounding board for checking effectiveness of strategy before implementing it
- Oversight for Management Performance
- Expert oversight for Financial Performance

ACTIVITY

- Read the article: Boardroom Behaviour and Governance (2007)
  - What are the signs of dysfunctional behaviour?
  - What are the causes of dysfunctional behaviour?
  - What does good behaviour look like?
  - How can we encourage good behaviour?

International Comparison of Corporate Governance Practices

<table>
<thead>
<tr>
<th>Country</th>
<th>Britain</th>
<th>Canada</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Japan</th>
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<tbody>
<tr>
<td>Authorised to be independent from management consultancy</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>Rotation of authors</td>
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<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>CEO's role in executive pay</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Shareholders may elect one class of independent directors</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Independent directors in a majority on board</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Separate chairman and CEO?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Notes:
- Yes indicates that independence is not required.
- No indicates that independence is required.
- Voluntary indicates that it is optional.

The Nigerian Context

- The role of non-executive directors
  - What problem is being referred to?
  - What's the consequence of this?
  - How can this be avoided?
At the moment Nigeria is still ranked the 32nd most corrupt country in the world by Transparency International (TI) in the Corruption Perception Index. An improvement from previous positions as the 2nd most corrupt country out of the surveyed countries in 2001, 2002 and 2003 respectively. Nigeria was also ranked as the 8th and 22nd in 2005 and 2006.

Nigeria is currently ranked at number 108 out of 178 in the World Bank 2008 Ease of Doing Business Index (Doing Business 2008 report, which covered the periods April 2006 to June 2007).

A high ranking on the Ease of Doing Business Index means the regulatory environment is conducive to the operation of business.

This index averages the country’s percentile rankings on 10 topics, made up of a variety of indicators, giving equal weight to each topic for e.g. Protecting Investors, Paying Taxes, Enforcing Contracts, Starting a Business etc. Good corporate governance can help Nigeria come up in the rankings here.

Global Best Practices: The Nigerian Situation

- The Securities and Exchange Commission (SEC) and the Corporate Affairs Commission (CAC) in October 2003 issued a Code of Corporate Governance in Nigeria known as Code of Best Practices on Corporate Governance in Nigeria.
- Amongst other things, the code gives clear guidelines on:
  - Responsibilities and composition of the Board of Directors
  - Compensation of Board Members
  - Chairman & Chief Executive Officer Positions
  - Proceedings & Frequency of Meetings
  - Executive & Non-Executive Directors
  - Reporting & Control
  - Shareholders’ Rights & Privileges
  - Composition, Qualification and Experience, Terms Of Reference for Audit Committee

The Impact of Board Structure on Corporate Financial Performance in Nigeria

Olayinka Marte Uadiale, International Journal of Business and Management, Vol. 5, No. 10; October 2010

- Dependent variable of the study is corporate financial performance which is represented by ROE (measured as the proportion of Profit after tax to issued share capital) and ROCE (measured as the proportion of profit after tax to issued share capital plus reserves).
- The independent variables are board size, board composition, board ownership and CEO duality.
- Results from the study indicate that there is strong positive association between board size and corporate financial performance. This is consistent with the findings of Dehaene et al. (2001). The study also reveals a positive association between outside directors sitting on the board and corporate financial performance. The result is consistent with previous studies e.g. (Dehaene et al. 2001, Connelly and Limpaphayom 2004, Rosenstein and Wyatt, 1990)

Four basic organisational types

1. Commercial
2. Governmental
3. Charitable
4. Membership

For each type:
- Where does income come from?
- What is the purpose of the organisation?
- Who has ultimate legal power?
- How is success measured?

What about the not for profit sector?

- There is no separate body of theory on corporate governance for not for profit organisations:
  - Charities
  - Public Bodies
  - Membership organisations
- Whilst these organisations do not have shareholders, they share many of the same potential control and performance issues of companies:
Characteristics of Non-Profit Organisations

- Multiple publics
- Multiple objectives
- Service goods orientation
- Public accountability

Why is governance so important?
Corporate Governance can be a life and death matter.

Bristol Royal Infirmary
- In the period from 1991 to 1995 between 30 and 35 many more children under 1 died after open-heart surgery in the Bristol unit than might be expected had the unit been typical of other similar units in England at the time.
- Whistleblowers were repeatedly ignored

Why is governance so important?
Corporate Governance can be a life and death matter.

Iraq War
- A meeting between George W. Bush and Tony Blair took place on January 31, 2003, in the White House.
- Invasion by UK & USA begins 20th March 2003
- 120,000 Iraqi deaths
- Should the power to make war be concentrated in one person?
- Can the PM be compared to the CEO of an organisation?

What do the public expect from politicians & public officials?
- Competence
- Improved control over public spending
- Value for money
- Honesty
- Openness
- Accountability

What keeps companies good?
Three levels of control

- Society
- The Organisation
- The Market

- What level is missing for the public sector?
- What is the consequence of this?

What agency problems might exist in the public sector?
- Taxpayers Vs Officials
- Taxpayers want value, officials want to grow departments
- Central government Vs local government
- Central government wants uniformity, local government wants local responsiveness
- Any others?
**Public Vs Commercial Sector**

**Similarities**
- Both need to control costs
- Both need leadership

**Differences**
- The Public sector:
  - is not measured on profit.
  - obtains money in advance.
  - has a captive market
  - often has no competition
  - is often highly unionised
  - No owners
  - Relatively unscrutinised

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**The Principles of Corporate Governance apply to the Public Sector but there are differences**

- ‘Board of Directors’ may be difficult to define
- No owners
- No single agreed style of financial reporting
- No single framework of governance would apply to all public sector entities
- Difficulty identifying the public sector stakeholders
- Performance is much harder to measure
- Non-execs (trustees) tend to be unpaid

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**Nolan’s Seven Principles of Public Life**

1. Selflessness
2. Integrity
3. Objectivity
4. Accountability
5. Openness
6. Honesty
7. Leadership

*Source: Nolan Committee on Standards of Public Life*

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**The Mountain of Public Administration**

**Purpose**

- PUBLIC
- TRUST

**The Pinnacle**

- Integrity
- Efficiency
- Effectiveness
- Involvement
- Dependability
- Fairness
- Honesty
- Honesty

**Byproduct**

- Legality
- Effectiveness
- Involvement
- Efficiency
- Integrity
- Dependability
- Transparency
- Fairness

**Foothill Goals**

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**ACTIVITY**

How can CG work better?
Reform: Barriers & Drivers

**Barriers**
- Concentrated ownership
- Poor enforcement
- Government hesitancy
- Vested interests & lobbying
- Cultural difficulties
- Inactive shareholders
- Lack of media scrutiny
- Regulator capture

**Drivers**
- Political Momentum
- Public Disquiet
- International harmonisation
- Desire to attract investors
- Investor activism
- Investor watchdogs

What Will Expedite Changes? 1

- **Corporate action**
  - More effective disclosure
  - Compliance with CG code
  - Shareholder engagement

- **Government action**
  - More Direct Regulations on Corporate Governance
  - Regulation on Cross/Circular ownership
  - Strengthen shareholder rights
  - Improve accounting standards
  - More effective disclosure
  - Stronger enforcement

What Will Expedite Changes? 2

- **Investor action**
  - Pro-active role of institutional investors
  - Minority shareholder activism

- **Stakeholders & Society**
  - Media scrutiny
  - Other stakeholders taking a greater interest (suppliers, customers, employees)
  - Public outrage and complaints

Further Reading

Corporate Governance
Bob Tricker (2009)
Oxford University Press

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Any Questions?