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# Chapter 10 Corporate Governance

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The basics of corporate governance

<https://www.youtube.com/watch?v=7CMUfDZ0Kzk>

# CORPORATE GOVERNANCE: WHAT IS ALL THE FUSS ABOUT?

- Corporate governance can destroy or create value for a firm.
- It is concerned with:
  1. Strengthening the effectiveness of a company's board of directors
  2. Verifying the transparency of a firm's operations
  3. Enhancing accountability to shareholders
  4. Incentivising executives
  5. Maximising value-creation for stakeholders and shareholders.

# CORPORATE GOVERNANCE: WHAT IS ALL THE FUSS ABOUT?

- Corporate governance fundamentals
- Corporate directors should:
  - Focus on creating long-term value for shareholders
  - Use performance-related pay to attract and retain senior management
  - Exercise sound business judgement to evaluate opportunities and manage risk
  - Communicate with key shareholders.

## CORPORATE GOVERNANCE:

- **Corporate governance** is the set of mechanisms used to manage the relationships (and conflicting interests) among stakeholders and to determine and control the strategic direction and performance of organisations.
  - Identifying ways to ensure that decisions are effective, and facilitate the achievement of strategic competitiveness
  - Ensuring that interests of top-level managers are aligned with those of shareholders and other stakeholders.

## CORPORATE GOVERNANCE:

- Current emphasis on corporate governance is due to:
- The apparent failure of corporate governance mechanisms to adequately monitor and control top-level managers' decisions during recent times.
- The understanding that a well-functioning corporate governance and control system can create a competitive advantage for an individual firm.

# CORPORATE GOVERNANCE:

- Effective corporate governance is of interest to nations as it:
  - Reflects societal standards
  - Firms' shareholders are treated as key stakeholders, because they are the company's legal owners.
  - How nations choose to govern their corporations affects firms' investment decisions; (firms seek to invest in nations with national governance standards that are acceptable.

# SEPARATION OF OWNERSHIP AND MANAGERIAL CONTROL

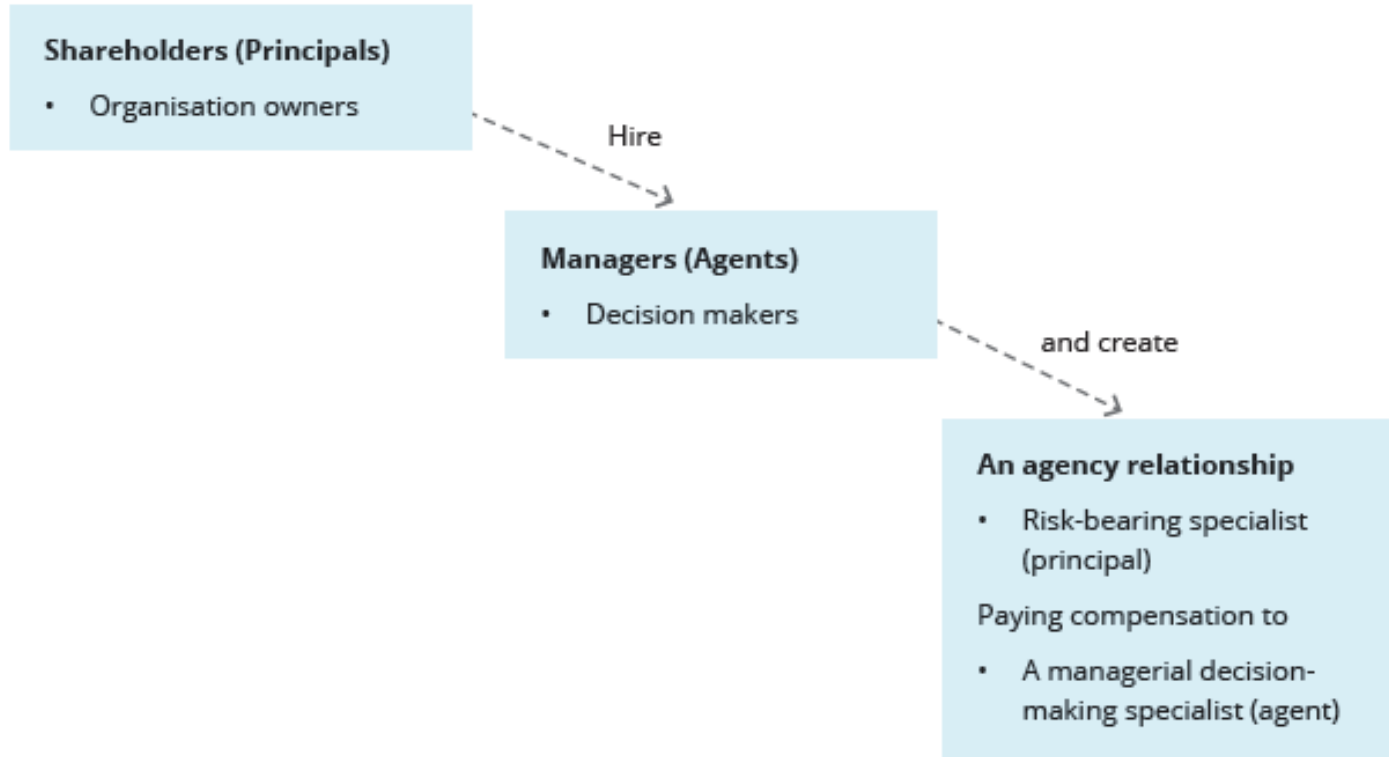
## Shareholders

- Shareholders purchase stock and are entitled to income (residual returns).
- Shareholders bear risk because a firm's expenses may exceed its revenues.
- Investment risk is managed through a diversified investment portfolio.

## Managers

- Professional managers are contracted to make decisions.
- Managers develop strategy.

**Figure 10.1** An agency relationship



# MANAGER AND SHAREHOLDER RISK AND DIVERSIFICATION

## ▪ Risk

- In general, shareholders prefer riskier strategies than managers.

## ▪ Diversification

- Shareholders prefer:
  - More focused diversification
- Managers prefer:
  - Greater diversification
  - At a level that maximises firm size and their compensation while also reducing their employment risk.

# Board of directors

Ownership  
concentration

Board of directors

The **board of directors** is a group of shareholder-elected individuals (usually called 'directors') whose primary responsibility is to act in the owners' interests by formally monitoring and controlling the corporation's top-level executives.

# Board of directors

Ownership  
concentration

Board of directors

As stewards of an organisation's resources, an effective and well-structured board of directors can influence the performance of a firm by:

- overseeing managers to ensure the company is operated in ways that maximise shareholder wealth
- directing the organisation's affairs
- punishing and rewarding managers
- protecting shareholders' rights and interests
- protecting owners from managerial opportunism.

# Board of directors

Ownership  
concentration

Board of directors

## Three director classifications

- **Insiders** – the firm’s CEO and other top-level managers
- **Related outsiders** – individuals uninvolved with day-to-day operations, but who have a relationship with the firm
- **Outsiders** – individuals who are independent of the firm’s day-to-day operations and other relationships

# Board of directors

Ownership  
concentration

Board of directors

Criticisms of boards of directors include that they:

- too readily approve managers' self-serving initiatives
- are exploited by managers with personal ties to board members
- are not vigilant enough in hiring and monitoring CEO behaviour
- lack agreement about the number of and most appropriate role of outside directors.

# Board of directors

Ownership  
concentration

Board of directors

Outside directors are sometimes viewed as problematic because they have limited contact with the firm's day-to-day operations and incomplete information about managers.

This results in:

- ineffective assessments of managerial decisions and initiatives
- an emphasis on financial, rather than strategic controls to evaluate performance of managers and business units

# Board of directors

Ownership  
concentration

Board of directors

To enhance the effectiveness of the board of directors:

- elect board members with diverse backgrounds (e.g. public service, academic, scientific; ethnic minorities and women; other nationality)
- strengthen internal management and accounting control systems
- establish and consistently use formal processes to evaluate the board's performance.

# Board of directors

Ownership  
concentration

Board of directors

To enhance the effectiveness of the board of directors:

- modify the compensation of directors, in particular reduce or eliminate stock options as part of their package
- create a 'lead director' role that has strong powers with regard to the board's agenda and oversight of non-management board member activities
- require directors to own a significant equity stake in the firm to keep focus on shareholder interests.

# Executive compensation

Ownership  
concentration

Board of directors

Executive  
compensation

Executive compensation is:

- a governance mechanism that seeks to align the interests of top managers and owners through salaries, bonuses and long-term incentive compensation, such as stock awards and stock options
- thought to be excessive and out of line with performance.

# Executive compensation

Ownership  
concentration

Board of directors

Executive  
compensation

## Factors complicating executive compensation:

- Strategic decisions by top-level managers are complex, non-routine and affect the firm over an extended period, making it difficult to assess the effectiveness of current decisions.
- Other intervening variables affect the firm's performance over time.
  - The alignment of pay and performance is complicated.
  - The effectiveness of pay plans as a governance mechanism is suspect.

# Executive compensation

Ownership  
concentration

Board of directors

Executive  
compensation

## The effectiveness of executive compensation:

- Performance-based compensation is used to motivate decisions that best serve shareholder interests, but can be imperfect in their ability to monitor and control managers.
- Incentive-based compensation plans aim to increase firm value in line with shareholder expectations but is subject to managerial manipulation to maximise managerial interests.

# Executive compensation

Ownership  
concentration

Board of directors

Executive  
compensation

The effectiveness of executive compensation:

- Many plans are seemingly designed to maximise manager wealth rather than to guarantee a high stock price that aligns the interests of managers and shareholders.
- Stock options are popular.
  - **Repricing:** The strike price value of options is commonly lowered from its original position.
  - **Backdating:** Options grants are commonly dated earlier than when they are actually drawn up to ensure an attractive exercise price.

# Executive compensation

Ownership  
concentration

Board of directors

Executive  
compensation

Limits on the effectiveness of executive compensation:

- Unintended consequences of stock options
- Firm performance not as important as firm size
- Balance sheet not showing executive wealth
- Options not expensed at the time they are awarded.

# MARKET FOR CORPORATE CONTROL

Ownership  
concentration

Board of directors

Executive  
compensation

Market for corporate  
control

**External governance** is a mechanism consisting of a set of potential owners seeking to acquire undervalued firms and earn above-average returns on their investments.

- It becomes active only when internal controls have failed.
- Ineffective managers are usually replaced in such takeovers.

# GOVERNANCE MECHANISMS AND ETHICAL BEHAVIOUR

It is important to serve the interests of a firm's multiple stakeholder groups.

Capital market  
stakeholders

Capital market  
stakeholders

- Shareholders in Australia and the USA (in the capital market group) are the most important stakeholder group served by the board of directors.
- Governance mechanisms focus on control of managerial decisions to protect shareholder interests.

# GOVERNANCE MECHANISMS AND ETHICAL BEHAVIOUR

It is important to serve the interests of a firm's multiple stakeholder groups.

Capital market  
stakeholders

Capital market  
stakeholders

Organisational  
stakeholders

- Some observers believe that ethically responsible companies design and use governance mechanisms that serve all stakeholders' interests.
- The importance of maintaining ethical behaviour can be seen in the examples of Enron, Arthur Andersen, WorldCom, HealthSouth and Satyam.