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MGST 451

Corporate Governance and Ethical Decision-Making

Lecture 2 – Winter 2019 L01-L03

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Lecture 2 Agenda

1. What is a business enterprise?
2. A business enterprise for whom?
3. What is an agency problem? What is an agency cost?
4. Why corporate governance?
5. What is corporate governance?
6. Is corporate governance important?
7. The interactions within a corporate governance system
8. How did corporate governance standards evolved of late?
9. What are the key components of a corporate governance system?

The business enterprise

- A business enterprise (i.e. a firm, a company, a corporation, etc.) is a combination of people and resources (physical and financial) that come together for the purpose of earning a return on the capital invested (i.e. ‘turn a profit’).
- The participants in such business enterprise are often **afforded by the state a special ‘limited liability’ privilege** (i.e. they cannot lose more than they contributed into the firm).
- However, when conducting a business, the state requires the **business to comply with all applicable laws and regulations**, many of which specify how the business shall be organized (notably in relation with its legal form) and records kept.
  - A business enterprise not behaving as expected by the state is at risk of facing some (serious) consequences.

A business enterprise for whom?

Shareholder view

- The purpose of a business enterprise is to benefit shareholders (i.e. to maximize ‘shareholder value’).
- To support such shareholder-centric perspective, it is argued that the interests of other stakeholders (i.e. employees, suppliers, etc.) will also be ‘best-served’ as a by-product.

Stakeholder view

- The business enterprise has a societal obligation beyond increasing shareholder value. For example:
  - Providing an acceptable standard of living to employees;
  - Mitigating risks for debt holders;
  - Providing good quality and value to consumers;
  - Safeguarding the environment.

What is an agency problem?

- Many situations require you (the ‘principal’) to retain somebody (the ‘agent’) to perform some work on your behalf.
- The agent will act in its own self-interest first, and when this is contrary to the interest of the principal it creates a problem.

Principal	**Agent**	**Example**
Legal client	Lawyer	More hours are invoiced than worked
Patient	Doctor	Costly but useless procedure are performed
Investor	Broker	Investment are recommended to generate fees
Voter	Politician	How many can you list?

- Such problems can become acute as soon as the interests of the principal and the agent diverge while the agent knows more than principal (i.e. an information asymmetry is in favor of the agent).
- See https://en.wikipedia.org/wiki/Principal%E2%80%93agent_problem

The key agency problem for firms

- Firms that are 'publicly-owned' (i.e. shareholder-owned via a stock market) allow mass participation in capitalism, providing capitalism with a democratic underpinning.
- However, shareholders have to delegate decision making to 'management' (creating principal-agent problems), in addition to increasing asymmetric information (insiders vs outsiders).
- If not properly monitored and controlled, management (i.e. CEO, CFO, etc.) will often act in a self-interested manner to benefit themselves to the detriment of the interests of other stakeholders (i.e. a 'conflict of interests' with 'agency costs').
- Shareholders delegate the on-going monitoring and control of management to a 'Board of Directors', while having a General Assembly once a year – but this has proven not to work well!

Agency costs

Over the years, executives have proven extremely creative…

- Outright fraud (i.e. stealing in all kinds of fancy ways)
- Onerous perquisites (e.g. corporate jets, even birthday party!)
- Manipulation of accounting and financial data
- Securities fraud (trading on confidential information)
- Backdating of stock options
- Excessive compensation, entrenchment, etc…

Agency problems are often at the core of scandals like corporate disasters (loss of reputation and trust, or even bankruptcy).

- US: Enron, WorldCom, Madoff, Cedant, HealthSouth, Tyco
- Japan: Olympus, Takata, Toshiba, Toyo, Toa
- Canada: Bre-X, Livent, Hollinger, Nortel, Valeant, SNC-Lavalin

Why Corporate Governance?

- The **basic purpose** of 'good corporate governance' is to minimize agency costs
  - i.e. mitigate the conflict of interest between management and shareholders by using mechanisms to align the interest of management to the interest of shareholders;
  - e.g. "tying managerial incentives to performance aligns managers' incentives with investor's interests".
- The **larger purpose** of 'good corporate governance' is to minimize agency costs, and to ensure the firm complies with its legal obligations (e.g. avoid fraud and loss of reputation).
- The **holistic view** of 'good corporate governance' is to ensure the firm takes good economic decisions to the benefit of its shareholders and acts ethically to benefit all stakeholders.

Corporate governance definition

- “The collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders.” Larcker/Tayan
- How extensive the control mechanisms are chosen to be?
  - Size of the potential agency costs;
  - Ability of the control mechanisms to mitigate agency costs;
  - Costs to implement and operate the control mechanisms;
  - Legal & regulatory requirements for control mechanisms;
  - Economic efficiency (i.e. benefits > costs);
  - Some residual agency cost has to be ‘tolerated’ since reducing it to zero would be cost-prohibitive.

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The importance of Corporate Governance

The empirical evidence indicates that good corporate governance delivers shareholder value (i.e. positive NPV)

- The best governed companies were found to deliver higher ROI and ROE than poorly governed companies (ISS ranking).
- Efforts by institutional investors to improve corporate governance of poorly governed companies pays (CalPERS).
- Portfolios of companies with strong shareholder rights outperform portfolios of companies with weak shareholder protection (US: +8.5% per annum; Europe: +3% per annum).
- Shareholder activism as practiced by specialized hedge funds is quite profitable.

For other stakeholders, the effects of good CG are more difficult to quantify and value, but also appear to benefit them.

Concept check

A firm is experiencing situations potentially or evidently dysfunctional whereby decisions taken by management are often detrimental to the interest of some or all shareholders and the society, sometimes not entirely ethical or even seemingly in breach of the law. This constitutes evidence of:

- Agency costs
- Weak corporate governance
- Dumb shareholders and dumb enforcement of the law

Interactions within a CG system

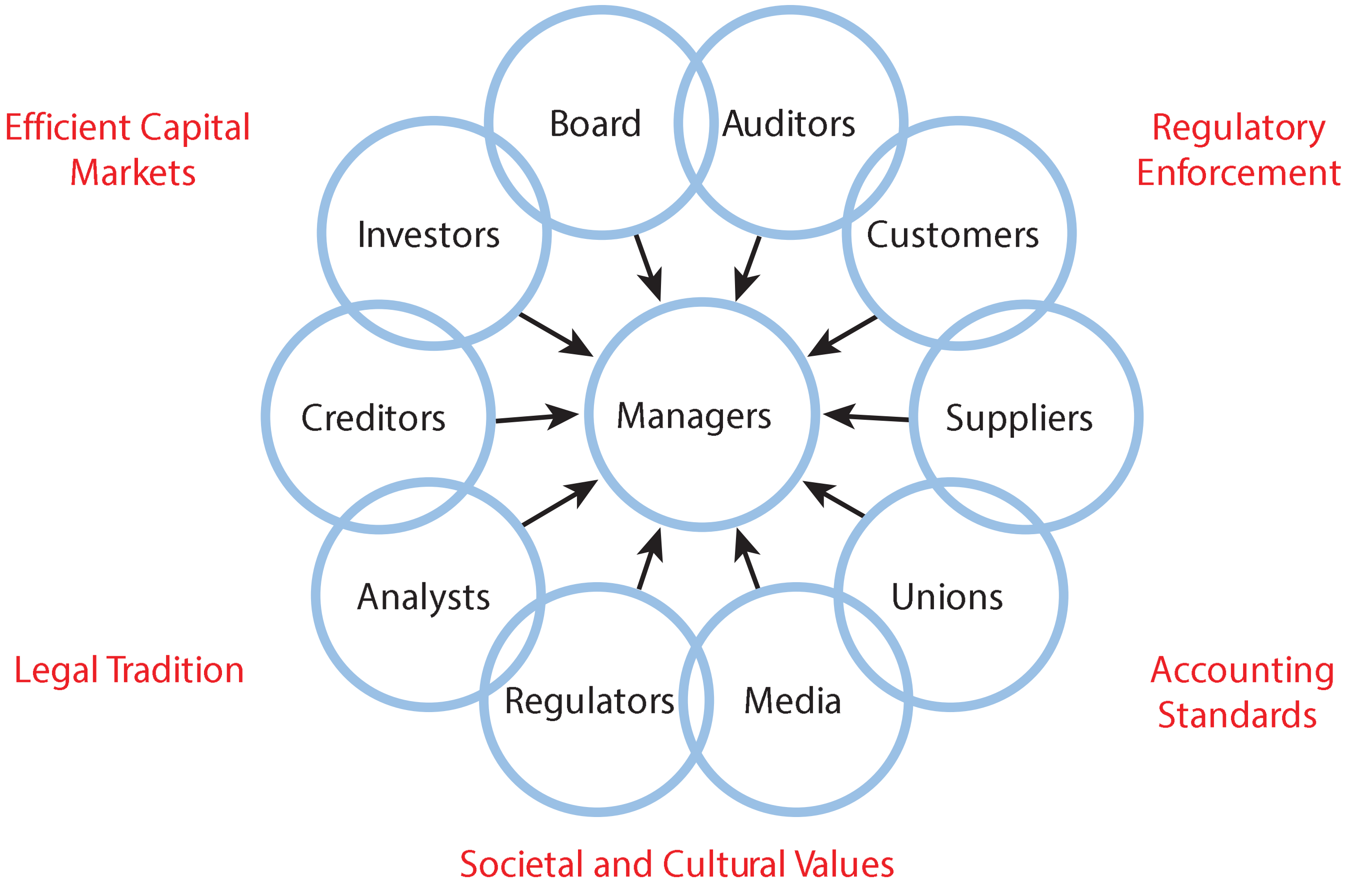
In addition to the Board, many stakeholders are monitoring and/or trying to influence management decision-making.

- Shareholders and Debtholders
- Regulators
- External auditors
- Security analysts
- Unions and employees

The environment also influence management decision-making.

- Capital markets price securities to management decisions
- The enforcement of regulations (i.e. weak or strong)
- The accounting standards (i.e. weak or strong)
- The legal tradition (i.e. consequences of getting sued)
- The societal and cultural values (i.e. consequences of breach)

Interactions within a CG system



Source: Chart prepared by David F. Larcker and Brian Tayan (2011).

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Interactions within a CG system

- Corporate governance is a complex and dynamic system that involves the interaction of a diverse set of constituents, all of whom play roles in monitoring and controlling/influencing executive behavior.
- This complexity means we need to look at corporate governance with an emphasis on **exploring the relationships** between control mechanisms and their impact on mitigating agency costs and improving shareholder and stakeholder outcomes.

Evolution of CG standards

Code of Best Practices of the Cadbury Committee (1992)
- Set of recommendations on corporate governance
- Basis of listing requirements for LSE and NYSE

Sarbanes-Oxley Act (2002)
- Series of legal requirements to improve corporate control
- CEO and CFO have to 'sign' the financial statements (as being free of material misrepresentations) and can be jailed if guilty

Dodd-Frank Act (2010)
- Provide shareholders with greater say on board of directors elections and executive compensation + clawback provisions

Investment selection and proxy votes by institutional investors
- Increasingly using CG ratings and proxy advisory firms

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Key components of a CG system

- Board of Directors
  - Responsibilities, independence, terms and election
  - Committees (audit, compensation, and nomination)
  - Code of conduct (firm acts in a lawful and ethical manner)
- Executive compensation and incentives
- Shareholders' rights and actions
- Internal controls, reporting, and external audit
  - Controls + procedures in place for day-to-day operations
  - Governance, operating and financing activities are reported in a fair, accurate, timely, relevant, complete, and verifiable manner.
- Market for corporate control (e.g. possible hostile takeover)