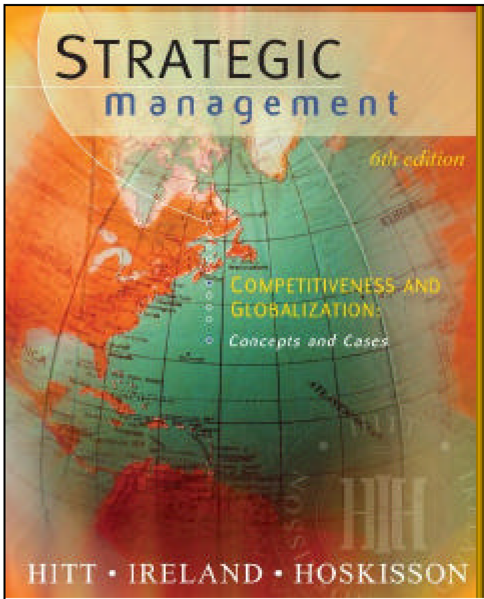
Slide 1



Chapter 10
Corporate Governance

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Slide 2

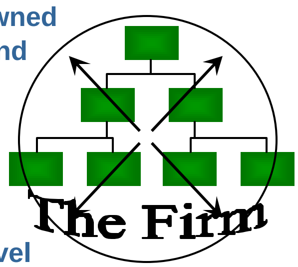
Corporate Governance

- **Corporate governance is:**
  - **A relationship among stakeholders used to determine and control the strategic direction and performance of organizations**
  - **Concerned with making strategic decisions more effectively**
  - **Used to establish order between a firm's owners and its top-level managers whose interests may be in conflict**

Slide 3

Internal Governance Mechanisms

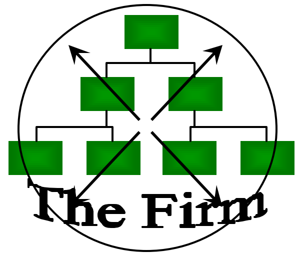
- **Ownership Concentration**
  - **Relative amounts of stock owned by individual shareholders and institutional investors**
- **Board of Directors**
  - **Individuals responsible for representing the firm's owners by monitoring top-level managers' strategic decisions**



Slide 4

Internal Governance Mechanisms

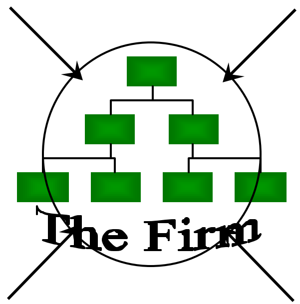
- **Executive Compensation**
  - **Use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests**



Slide 5

External Governance Mechanisms

- **Market for Corporate Control**
  - **Purchase of a firm that is underperforming relative to industry rivals in order to improve its strategic competitiveness**



Slide 6

Separation of Ownership and Managerial Control

- **Basis of the Modern Corporation**
  - **Shareholders purchase stock, becoming residual claimants**
  - **Shareholders reduce risk by holding diversified portfolios**
  - **Professional managers are contracted to provide decision making**

Slide 7

Separating Ownership and Managerial Control

- **Modern public corporation form leads to efficient specialization of tasks:**
  - **Risk bearing by shareholders**
  - **Strategy development and decision making by managers**

Slide 8

An Agency Relationship

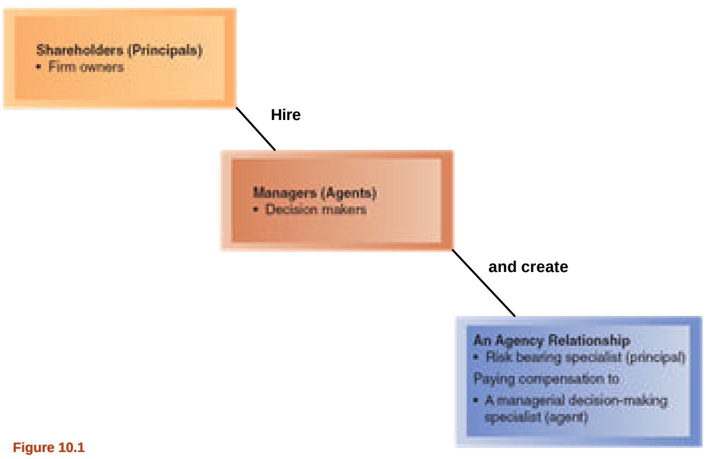


Figure 10.1

Slide 9

Agency Relationship Problems

- **Principal and agent have divergent interests and goals**
- **Shareholders lack direct control of large, publicly traded corporations**
- **Agent makes decisions that result in the pursuit of goals that conflict with those of the principal**
- **It is difficult or expensive for the principal to verify that the agent has behaved appropriately**
- **Agent falls prey to managerial opportunism**

Slide 10

Managerial Opportunism

- The seeking of self-interest with guile (cunning or deceit)
- Managerial opportunism is:
  - An attitude (inclination)
  - A set of behaviors (specific acts of self-interest)
- Managerial opportunism prevents the maximization of shareholder wealth (the primary goal of owner/principals)

Slide 11

Response to Managerial Opportunism

- Principals do not know beforehand which agents will or will not act opportunistically
- Thus, principals establish governance and control mechanisms to prevent managerial opportunism

Slide 12

Examples of the Agency Problem

- Possible Problems
  - Product diversification
  - Increased size, and relationship of size to managerial compensation
  - Reduction of managerial employment risk
- Use of Free Cash Flows
  - Managers prefer to invest these funds in additional product diversification (see above)
  - Shareholders prefer the funds as dividends so they control how the funds are invested

Slide 13

Manager and Shareholder Risk and Diversification

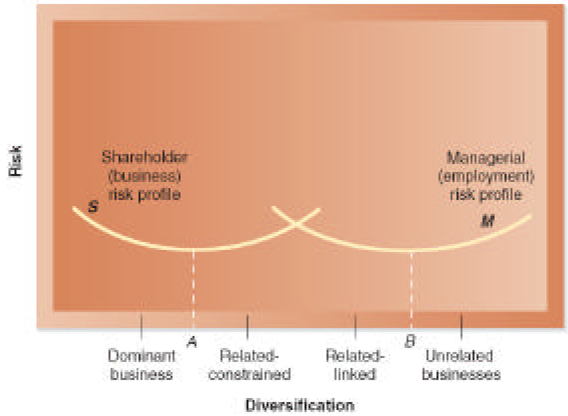


Figure 10.2

Slide 14

Agency Costs and Governance Mechanisms

- Principals may engage in monitoring behavior to assess the activities and decisions of managers
  - However, dispersed shareholding makes it difficult and inefficient to monitor management's behavior
- 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

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Governance Mechanisms

Ownership Concentration (a)

- Large block shareholders have a strong incentive to monitor management closely:
  - Their large stakes make it worth their while to spend time, effort and expense to monitor closely
  - They may also obtain Board seats which enhances their ability to monitor effectively
- Financial institutions are legally forbidden from directly holding board seats

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Governance Mechanisms (cont'd)

Ownership Concentration (b)

- **The increasing influence of institutional owners (stock mutual funds and pension funds)**
  - Have the size (proxy voting power) and incentive (demand for returns to funds) to discipline ineffective top-level managers
  - Can affect the firm's choice of strategies

Slide 17

Governance Mechanisms (cont'd)

Ownership Concentration (c)

- **Shareholder activism:**
  - Shareholders can convene to discuss corporation's direction
  - If a consensus exists, shareholders can vote as a block to elect their candidates to the board
  - Proxy fights
  - There are limits on shareholder activism available to institutional owners in responding to activists' tactics

Slide 18

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (a)

- **Board of directors**
  - Group of elected individuals that acts in the owners' interests to formally monitor and control the firm's top-level executives
- **Board has the power to:**
  - Direct the affairs of the organization
  - Punish and reward managers
  - Protect owners from managerial opportunism

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Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (b)

- **Composition of Boards:**
  - **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

Slide 20

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (c)

- **Criticisms of Boards of Directors include:**
  - 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 behavior
  - Lack of agreement about the number of and most appropriate role of outside directors

Slide 21

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (d)

- **Enhancing the effectiveness of boards and directors:**
  - More diversity in the backgrounds of board members
  - Stronger internal management and accounting control systems
  - More formal processes to evaluate the board's performance
  - Adopting a "lead director" role
  - Changes in compensation of directors

Slide 22

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- Executive Compensation (a)

- Forms of compensation:
  - Salary, bonuses, long-term performance incentives, stock awards, stock options
- Factors complicating executive compensation:
  - Strategic decisions by top-level managers are complex, non-routine and affect the firm over an extended period
  - Other variables affecting the firm's performance over time

Slide 23

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- Executive Compensation (b)

- Limits on the effectiveness of executive compensation:
  - Unintended consequences of stock options
  - Firm performance not as important than firm size
  - Balance sheet not showing executive wealth
  - Options not expensed at the time they are awarded

Slide 24

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- Executive Compensation
- Market for Corporate Control (a)

- Individuals and firms buy or take over undervalued corporations
  - Ineffective managers are usually replaced in such takeovers
- Threat of takeover may lead firm to operate more efficiently
- Changes in regulations have made hostile takeovers difficult

Slide 25

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- Executive Compensation
- Market for Corporate Control (b)

- **Managerial defense tactics increase the costs of mounting a takeover**
- **Defense tactics may require:**
  - **Asset restructuring**
  - **Changes in the financial structure the firm**
  - **Shareholder approval**
- **Market for corporate control lacks the precision of internal governance mechanisms**

Slide 26

Governance Mechanisms and Ethical Behavior

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

Capital Market Stakeholders

- Shareholders in this group are viewed as the most important stakeholder group
- The focus of governance mechanisms is to control managerial decisions to assure shareholder interests
- Interests of shareholders is served by the Board of Directors

Slide 27

Governance Mechanisms and Ethical Behavior (cont'd)

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

- Capital Market Stakeholders
- Product Market Stakeholders

- Product market stakeholders (customers, suppliers and host communities) and organizational stakeholders may withdraw their support of the firm if their needs are not met, at least minimally

Slide 28

Governance Mechanisms and Ethical Behavior (cont'd)

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

- Capital Market Stakeholders
- Product Market Stakeholders
- Organizational Stakeholders

- Some observers believe that ethically responsible companies design and use governance mechanisms that serve all stakeholders' interests
- Importance of maintaining ethical behavior is seen in the examples of Enron, WorldCom, HealthSouth and Ahold NV