CORPORATE STRUCTURE

1 The Corporate structure

A typical corporation's structure consists of three main groups: shareholders, directors and management. The management handles the day-to-day operations of the business, the directors oversee the affairs of the organization and protect the interests of the shareholders, while the shareholders are the owners of the corporation and are looking for a return on their investment. The Shareholders are the owners of the companies and is also called "members of the company". A shareholder can be an individual person, a group of persons, another company, or any other kind of organisation. There are several types of corporate structures one of which is illustrated in figure 1

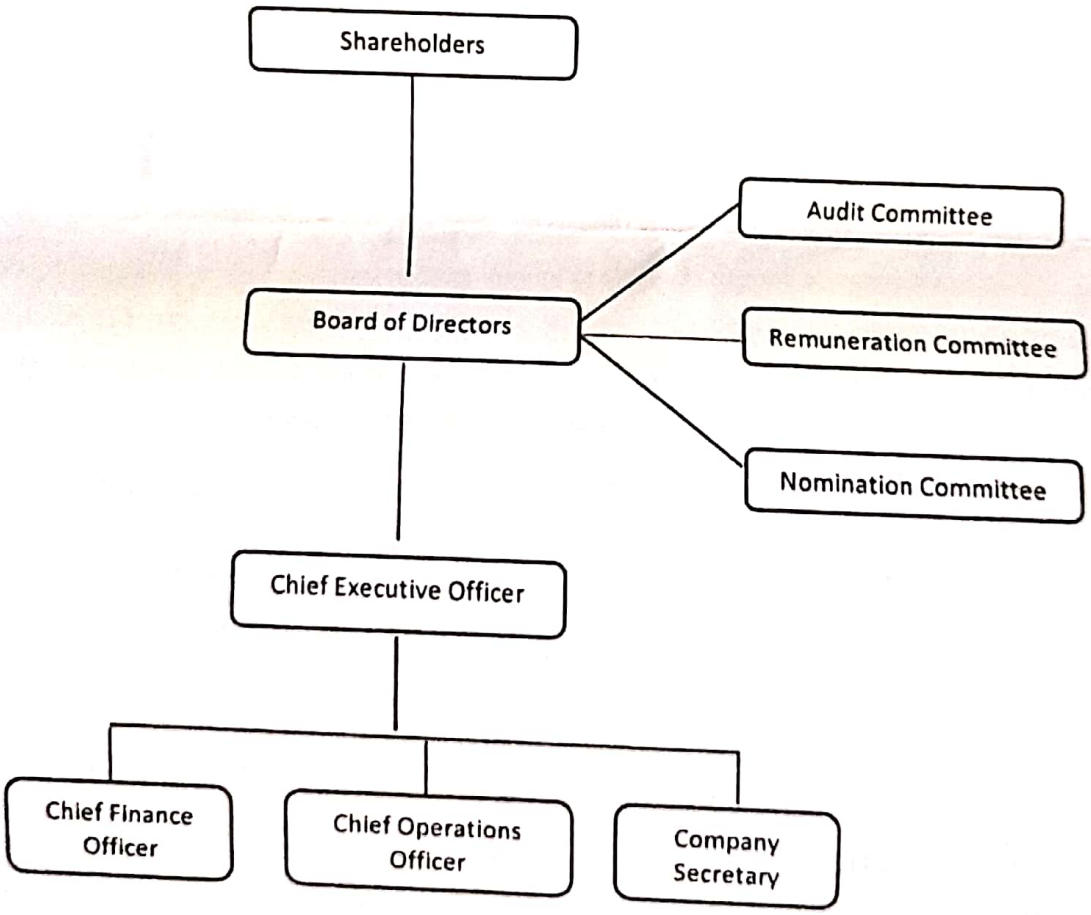

Fig 1. Corporate Structure

A public company is a corporation whose ownership is open to the public. Anyone can buy shares in the company's stocks. From this perspective, a person may argue that there cannot be a company formed by a single individual. But, due to challenges in business societies, it is no longer necessary, in several countries, for a company to be an association of two or more persons. Nowadays in the United Kingdom, the United States of America, China and India, a company maybe formed by one person. In 2012, the Tanzania's Companies Act was amended and allowed companies to be formed by only one shareholder.

A Single Shareholder Company is a type of company which has limited liability and limits the number of its shareholder to one person. A company may therefore, exist in the form of sole proprietorships, general partnerships, limited liability companies and corporations. Thus not all companies suit the requirements of a corporation. All corporations are companies, but not all companies are necessarily corporations. The number of shares an individual owns in a company determines his or her percentage of ownership. For instance, if a corporation has 2,000 shares and an individual owns 400 shares, he or she would own 50% of that company

A Corporation

Usually, a corporation is an association of persons formed for a purpose of business for profit.

—It has a common capital, divisible in to transferable shares,
—It has a legal entity and a common seal.
—It is an artificial person; invisible and intangible.
—It is something distinct from the persons who have formed it.
—It is not affected by the acts of its members.
—It has the right to sue, and can be sued in its own name.
—It can own property plus money, and operate an account in its own name,
—It can be a creditor or a debtor.
—It can do business like any natural person.
—It has a perpetual succession. This means that its life is not affected by the life of its members. New members can replace old members when they die or dispose of their shares.

Since a company has no physical personality, it must function through natural persons, such as, directors. Usually, shareholders, as such, do not carry on business of a company. From the point of view of the liability of shareholders, companies are classified into three types: Companies limited by shares; Companies limited by guarantee and unlimited companies.

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From another perspective, companies may be classified into two types: Public companies and Private companies

The Corporate structure

A typical corporation's structure consists of three main groups: (i) shareholders, (ii) board of directors (BOD) and (iii) management. The management handle the day-to-day operations of a corporate business; the BOD oversees the affairs of the corporation and protect the interests of the shareholders, while the shareholders are looking for a return on their investment.

2. Corporate Structure: Shareholders

The corporation's shareholders have an ownership interest in the corporation by having money invested in the corporation. A "share" is an apportioned ownership interest in the corporation, and the value of a one share can range from TZS 50 to TZS 50,000 or even more. When a corporation is first formed, its original owners are usually its first shareholders, and in smaller corporations the initial investors may remain the sole shareholders throughout the corporation's existence. A smaller corporation's few shareholders may consist of those involved in day-to-day business operations (owners and managers).

In large corporations private investors or members of the general public if it is a public corporation may decide to invest money in the corporation at any time, and will become shareholders. Usually, each shareholder receives a share certificate from the corporation, *identifying the number of shares held by him or her.* Corporations are required by law to hold *Annual General Meetings* (AGM). Special meetings may also be held when significant *corporate actions require* shareholder approval. A corporation's articles of incorporation *usually set forth* shareholder voting rights and procedures.

3. Corporate Structure: Board of Directors

One of the first steps a new corporation will take is to name the members of its board of directors. Usually, directors are identified in the "articles of incorporation" or are selected by the person who takes the initial step of incorporating the business. Once the corporation is running, directors are elected by shareholders at AGMs. As suggested by its name, the board of directors "directs" the corporation's affairs and business path.

The board of directors has ultimate legal responsibility for the actions of the corporation management, employees, and agents.

The number of directors serving on a corporation's board usually depends in part on the size of the business and its holdings; however this number is usually stated in the corporation's

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articles of incorporation and/or bylaws. A small corporation might have two director (who may also serve as the sole officer and shareholder), while a large corporation may have 10 or more people serving on its board of directors..

4. Corporate Structure: Corporate Management

The corporation's management is responsible for the business's daily operations, and in their different roles they are given legal authority to act on the corporation's behalf in almost all lawful business-related activities. Management is usually appointed by the corporation's board of directors, and while specific positions may vary from one corporation to another, typical corporate management include: The CEO, The COO, The CFO and the corporation Secretary

- Chief Executive Officer (CEO) is the top boss of a corporation and reports to the corporation's BOD. The CEO has ultimate responsibility for the corporation's activities, and signs off on all legally-binding action on behalf of the corporation.
- The Chief Operating Officer (COO) who reports directly to the CEO. The COO is charged with managing the corporation's day-to-day affairs.
- Chief Financial Officer (CFO) who reports to the CEO. The CFO is responsible (directly or indirectly) for almost all of the corporation's financial matters.
- Secretary. The corporation's Secretary is in charge of maintaining and keeping corporation's records, documents, and "minutes" from shareholder meetings.

It should be noted that in smaller corporations, one person may serve as the business's sole director, officer, and shareholder.

5. Share Ownership Structure

There are two main types of share ownership: Dispersed ownership and controlling ownership. Dispersed ownership structure means that there is no individual or group with either the voting power or the incentive to exercise control and enforce profit maximization. The fraction of shares of one shareholder is low. As a consequence dispersed ownership is typified with low ownership concentration. Characteristics of dispersed ownership are the separation of risk over more shareholders and the specialization by the management. In contrast a company with 'large shareholders', there is a group who hold a sizable fraction of all voting shares. this implies significant voting power over the company. As a consequence a group of large shareholders is typified with high ownership concentration. The power to control the management is a characteristic of large shareholders.

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(i) Dispersed ownership – none or low managerial ownership of shares

In firms with dispersed ownership the main agency conflict to be addressed is the conflict between hired managers and dispersed shareholders due to the separation of ownership and control. The dispersed ownership structures of large companies could generate free rider problems insofar as they hinder direct managerial supervision by shareholders. Shareholders in firms with dispersed ownership prefer strategies of exit rather than voice to monitor management. While small shareholders do not have incentive to monitor individually, collectively all shareholders benefit from the monitoring efforts by the board of directors (BOD). Therefore, the function of the BOD is likely to focus on monitoring management to reduce the agency problems between management and dispersed shareholders.

(ii) Dispersed ownership – some managerial ownership

Managerial share ownership contributes to reducing agency costs. When a company's managers hold a substantial number of the shares of that company, there is an alignment of interests between the managers and the rest of the shareholders. Managers benefit directly from their own professional efforts and suffer the negative consequences of their opportunistic actions through the respective positive and negative variations of the market value of their shares. The BODs remains the main instrument of monitoring of shareholders but the agency problem may be less severe when managers hold relative important shareholder positions.

6. Controlled ownership – none or low managerial ownership of shares

It is argued that large shareholders have a strong incentive to monitor managers because of their significant economic stakes. Furthermore, large shareholder typically has some ability to influence proxy voting and may also receive special attention from management. Moreover, monitoring by large shareholders might give them access to value-relevant information.. For firms with controlling shareholders, however, separation of ownership and control generates a two-level agency problem: between controlling shareholders and management and between minority shareholders and controlling shareholders. The problem between controlling shareholders and minority shareholders will be less severe if management is independent from the controlling shareholders.

The BOD reflects to a high degree the shareholder structure of the company. Large shareholders are typically directly or indirectly represented on the BOD. Prioritizing the monitoring activity, over the provision of resources, of the board of directors benefits mostly

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minority shareholders, while large shareholders already dedicate individual efforts to monitoring and have access to superior information, management interaction and alternative governance mechanisms to discipline management. Furthermore, minority shareholders have less influence on the board composition compared to large shareholders. Therefore, the priorities of the board may be directed towards the provision of resources rather than adding an additional layer of monitoring.

Controlled ownership – some managerial ownership of shares

When the controlling shareholders are also actively involved in the management of the company, the agency problem related to the dispersion of ownership and control is dissolved. However, another agency problem, that between minority shareholders and controlling shareholders, may arise. A recent example of this problem was presented by the Parmalat scandal, where the controlling shareholder and CEO, Calisto Tanzi diverted about $800,000,000 shareholder's wealth towards family controlled businesses. Family firms are typically characterized by large controlling owners who are actively involved in management. The BOD typically reflects at least partially the ownership structure. Therefore, a board where the controlling family has an overwhelming influence on the BOD and control the information provided to its members is less likely to provide good monitoring.

Studies suggest that family owners may have superior monitoring abilities relative to diffused shareholders, especially when family ownership is combined with family control over management and the board. Because current generation owners have the tendency and obligation to preserve wealth for the next generation, family firms often have longer time horizons compared to nonfamily firms. Moreover, the controlling family is likely to commit more human capital to the firm and to care more about its long-run value. Family members therefore represent a special class of large shareholders that may have a unique incentive structure, a strong voice in the firm and powerful motivation to make longer term strategic decisions. The monitoring happens however largely beyond the board of directors.

However, families, like managers in a widely held company, can abuse their power and use corporate resources to their own advantage. When this happens in a family-controlled firm, things are even worse than in a widely held company, because controlling families cannot be ousted through a hostile takeover or replaced by the BOD or by the shareholders' meeting.

Ownership of corporations in Tanzania is mostly concentrated to private shareholders including foreign investors. Foreign ownership is significant in several corporations due to

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the privatization strategy of attracting strategic investors. From 2003 foreigners were allowed to buy and sell shares at the Dar es Salaam Stock Exchange (DSE) subject to certain restrictions; for instance, foreigners are not allowed to hold shares in a corporation that exceeds 60% of the equity in any local corporation. The decision to allow foreigners to transact and to be listed at the DSE is an attempt to boost the liquidity and strength of the stock market.

7. The roles of the board of Directors and its Composition

The guidelines of corporate governance in Tanzania requires every listed company to be be headed by an effective board that offers strategic guidance, lead, control the company and be accountable to its shareholders (See CGC – 2002 framed under CMSA – 1994)

Effective corporate governance requires a clear understanding of the respective roles of the board, management and shareholders; their relationships with each other; and their relationships with other corporate stakeholders. The following are the key responsibilities and duties of the board of directors and corporate management. The duties and responsibilities of the shareholders will be covered in a separate hand-out

Key Responsibilities of the Board of Directors and Management

An effective system of corporate governance provides the framework within which the board and management address their key responsibilities.

✓ ***Responsibilities of the Board of Directors***

A corporation's business is managed under the board's oversight. The board also has direct responsibility for certain key matters, including the relationship with the outside auditor and executive compensation. The board's oversight function encompasses a number of responsibilities, including:

— **Selecting the Chief Executive Officer (CEO).** The board selects and oversees the performance of the company's CEO and oversees the CEO succession planning process.

— **Setting the "tone at the top."** The board should set a "tone at the top" that demonstrates the company's commitment to integrity, competence and legal compliance. This tone lays the groundwork for a corporate culture that is communicated to personnel at all levels of the organization

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— **Approving corporate strategy and monitoring the implementation of strategic plans.** The board approve the company's strategic plans and should regularly evaluate implementation of the plans that are designed to create long-term value. The board should understand the risks inherent in the company's strategic plans and how those risks are being managed.

— **Setting the company's risk appetite, reviewing and understanding the major risks, and overseeing the risk management processes.** It oversees the process for identifying and managing the significant risks facing the company..

— **Focusing on the integrity and clarity of the company's financial reporting.** The board should be satisfied that the company's financial statements accurately present its financial condition and results of operations, that the company's internal controls and procedures are in place.

— **Reviewing, understanding and overseeing annual operating plans and budgets.** The board oversees the annual operating plans and reviews annual budgets presented by management. The board monitors implementation of the annual plans and assesses whether they are responsive to changing conditions.

— **Reviewing the company's plans for business resiliency.** As part of its risk oversight function, the board periodically reviews management's plans to address business resiliency, its continuity, physical security, cyber security and crisis management.

— **Nominating directors and committee members, and overseeing effective corporate governance.** The board, under the leadership of its nominating/corporate governance committee, nominates directors and committee members and oversees the structure, composition (including independence and diversity), succession planning, practices and evaluation of the board and its committees

✓8 Responsibilities of the CEO and Management

The CEO and management are responsible for the development of the company's long-term strategic plans and the effective execution of the company's business in accordance with those strategic plans. As part of this responsibility, management is charged with the following duties.

— **Business operations.** The CEO and management run the company's business under the board's oversight, with a view toward building long-term value.

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— **Strategic planning.** The CEO and senior management generally take the lead in articulating a vision for the company's future and in developing strategic plans designed to create long-term value for the company, with meaningful input from the board. Management implements the plans following board approval, regularly reviews progress against strategic plans with the board, and recommends and carries out changes to the plans as necessary.

— **Identifying, evaluating and managing risks.** Management identifies, evaluates and manages the risks that the company undertakes in implementing its strategic plans and conducting its business. Management also evaluates whether these risks, and related risk management efforts, are consistent with the company's risk appetite. Senior management keeps the board and relevant committees informed about the company's significant risks and its risk management processes.

Accurate and transparent financial reporting and disclosures. Management is responsible for the integrity of the company's financial reporting system and the accurate and timely preparation of the company's financial statements and related disclosures. It is management's responsibility to establish, maintain and periodically evaluate the company's internal controls over financial reporting.

— **Annual operating plans and budgets.** Senior management develops annual operating plans and budgets for the company and presents them to the board. The management team implements and monitors the operating plans and budgets, making adjustments in light of changing conditions, assumptions and expectations, and keeps the board apprised of significant developments and changes.

— **Selecting qualified management, establishing an effective organizational structure and ensuring effective succession planning.** Senior management selects qualified management, implements an organizational structure, and develops and executes thoughtful career development and succession planning strategies that are appropriate for the company.

9. Board Structure

Public companies employ diverse approaches to board structure and operations within the parameters of legal requirements and stock market rules. Although no one structure is right for every company, regulators of corporate governance believe that the practices set forth in the following sections provide an effective approach for companies to follow.

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Board Composition

Size. In determining the appropriate board size, companies should consider the nature, size and complexity of the company as well as its stage of development. Larger boards often bring the benefit of a broader mix of skills, backgrounds and experience, while smaller boards may be more cohesive and may be able to address issues and challenges more quickly.

Composition. The composition of a board should reflect a diversity of thought, backgrounds, skills, experiences and expertise and a range of tenures that are appropriate given the company's current and anticipated circumstances and that collectively, enable the board to perform its oversight function effectively.

— **Board Balance.** The board should compose of a balance of executive directors and non-executive directors (including at least one third independent non-executive directors) of diverse skills or expertise in order to ensure that no individual or small group of individuals can dominate boards decision-making processes.

— **Diversity.** In corporate governance diversity is the range of human differences, including social diversity and professional diversity. Social diversity includes gender identity, age, physical attributes, social classes, political ideology etc. Professional diversity includes relevant knowledge, relevant experience and relevant skills such as accounting, law, marketing, human resources, banking, insurance etc.

— **Tenure.** Tenure refers to the period of time a person works at a particular job or in an office. Directors with a range of tenures can contribute to the effectiveness of a board. Recent additions to the board may provide new perspectives, while directors who have served for a number of years bring experience, continuity, institutional knowledge, and insight into the company's business and industry.

— **Characteristics.** Every director should have integrity, strong character, sound judgment, an objective mind and the ability to represent the interests of all shareholders rather than the interests of particular constituencies.

— **Experience.** Directors with relevant business and leadership experience can provide the board a useful perspective on business strategy and significant risks and an understanding of the challenges facing the business.

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— **Independence.** Director independence is critical to effective corporate governance, and providing objective independent judgment that represents the interests of all shareholders is at the core of the board's oversight function. Accordingly, a substantial majority of the board's directors should be independent, according to applicable rules and regulations and as determined by the board.

— **Definition of "independence."** An independent director should not have any relationships with the company that may impair, or appear to impair, the director's ability to exercise independent judgment. Many boards have developed their own standards for assessing independence under stock market definitions, in addition to considering the views of institutional investors and other relevant groups.

— **Assessing independence**. When evaluating a director's independence, the board should consider all relevant facts and circumstances, focusing on whether the director has any relationships, either direct or indirect, with the company, senior management or other directors that could affect actual or perceived independence. While long-standing board service may be perceived to affect director independence, long tenure, by itself, should not disqualify a director from being considered independent.

Election: Directors should be elected by a majority vote for terms that are consistent with long term value creation. Boards should adopt a resignation policy under which a director who does not receive a majority vote tenders his or her resignation to the board for its consideration. Although the ultimate decision whether to accept or reject the resignation will rest with the board. The board should think critically about the reasons why the director did not receive a majority vote and whether or not the director should continue to serve.

Time Commitments: Serving as a director of a public company requires significant time and attention. Certain roles, such as committee chair, board chair and lead director, carry an additional time commitment beyond that of board and committee service. Directors must spend the time needed and meet as frequently as necessary to discharge their responsibilities.

10. Roles of the Chairman and the Chief Executive Officer

There should be a clear separation of the role and responsibilities of the chairman and chief executive officer (CEO) which will ensure a balance of power of authority and provide for checks and balances such that no one individual has unaffected powers of decision- making. Where such roles are combined a rationale for the same should be disclosed and approved by

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the shareholders. In addition No person shall hold more than two chairmanships in any public listed company at any one time.

11. Board Committee Structure

Paragraph 4.5.1 of the Guidelines on Corporate Governance Practices (GCGP) 2002 on Public Listed Companies in Tanzania requires every board to establish an audit committee of at least three independent and non-executive directors who shall report to the board, with written terms of reference, which deal clearly with its authority and duties. The chairman of the audit committee should be an independent or non-executive director

Attributes of Audit Committee Members

Important attributes of committee members includes:

(i) Broad business knowledge relevant to the company's business;

(ii) keen awareness of the interests of the investing public;

(iii) Familiarity with basic accounting principles; and

(iv) Objectivity in carrying out their mandate and no conflict of interest

Duties of the audit committee (AC)

—**Selecting and retaining the external auditor.** The AC selects the external auditor; reviews their qualifications, reputation; and reviews quality of their performance.

—**Overseeing the independence of the external auditor.** The AC should maintain an on-going, open dialogue with the external auditor about independence issues.

— **overseeing the financial reporting process.** The AC Should review the quarterly, half-yearly and year-end financial statements of the company, focusing particularly on: (i) any changes in accounting policies and (ii) significant adjustments arising from the audit..

—**Internal controls.** The committee should oversee the company's system of internal controls over financial reporting.

— **Risk assessment and management.** Has some responsibility for risk assessment and risk management.. It should report regularly to the board on the risks they oversee

— **Compliance.** The AC should oversee the company's compliance program, including the company's code of conduct. The AC should establish procedures for handling compliance concerns related to potential violations of law or the company's code of conduct, including concerns relating to accounting, internal controls, auditing and securities law issues.

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— **Internal audit.** The committee oversees the company's internal audit function and ensures that the internal audit staff has adequate resources and support to carry out its role.

- The committee reviews the scope of the internal audit plan,
- Reviews significant findings by the internal audit staff and management's response,
- Reviews the appointment and replacement of the senior internal auditing executive and assesses the performance and effectiveness of the internal audit function annually.

Internal auditors

Activities of internal audit include: Evaluating controls and advising managers at all levels; evaluating risks; analysing operations and confirm information

Internal auditors deal with issues that are fundamentally important to the survival and prosperity of any organisation. They look beyond financial risks and statements to consider wider issues such as the organisation's reputation, growth, its impact on the environment and the way it treats its employees. Internal auditors help organisations to succeed. They do this through a combination of assurance and consulting. The assurance part of their work involves telling managers and governors how well the systems and processes designed to keep the organisation on track are working. Then, they offer consulting help to improve those systems and processes where necessary

Assessing the management of risk: The profession of internal audit is fundamentally *concerned with evaluating* an organisation's management of risk.. For example, risks to the *organisation's reputation if it* treats customers incorrectly The key to an organisation's *success is to manage those risks effectively* than competitors

To evaluate how well risks are being managed the internal auditor will assess the quality of risk management processes, systems of internal control and corporate governance processes, across all parts of an organisation and report this directly and independently to the most senior level of executive management and to the board's audit committee.

Assisting management in the improvement of internal controls: An internal auditor's knowledge of the management of risk also enables him or her to act as a consultant providing advice and acting as a catalyst for improvement in an organisation's practices.

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12. Theoretical Framework of Corporate Governance

There are a number of theoretical perspectives which are used to explain corporate governance structures and systems. The common theories include: agency theory; stakeholder theory; resource dependence theory; stewardship theory; transaction cost theory; managerial hegemony theory; social contract theory; corporate control; and behavioral theory.

Some of these theories complement each other while others contrast each other. For example, the agency theory and the stewardship theory contrast each other and present different models of corporate governance. According to the agency theory, all agents (employees of the owners) are opportunistic and utility maximizing actors, and if left uncontrolled they will maximize their own interests at the expense of the owners. In contrast, the stewardship theory believes that all employees are good stewards who will act in the best interest of the owners

A comparison of the agency and steward theories suggest that the agency theory has a negative assumption regarding the human nature. According to the theory, people are opportunistic and utility maximizing actors, and if left uncontrolled they will maximize their own interests at the expense of others. The theory ignores the possibility that some agents are trustworthy and will work in their principals' interests whether they are monitored or not. In contrast the stewardship theory presents a different model of management, where managers are considered to be good stewards who will act in the best interest of the owners.

This handout adopts the agency theory. The agency theory has been selected for several reasons. First, it is used to explain the relationship between the company shareholders who are regarded as principals and the corporate managers who are the agents of the shareholders. Second, it is used to explain the relationship between the company shareholders who are regarded as principals and the external auditors who are the agents of the shareholders. Third, the legal and regulatory framework in Tanzania has adopted the Anglo-Saxon Model of corporate governance in the United Kingdom. This model is characterized by a strong legal protection for shareholders and pays less attention to other stakeholders (shareholder model).

13. The Agency Theory and Corporate Governance

The agency theory is one of the prominent theories that have been used to explain corporate governance practices. In corporate governance, the agency theory is used to describe the contractual relationship between the shareholders and the managers of a modern corporation. The theory posits that in modern corporations, shareholders employ skilled managers to

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manage businesses on their behalf. This is because the shareholders are either unskilled or have no time to manage the business. The relationship between the shareholders and managers is therefore, the agency relationship in which the shareholders are the principals and the corporate managers are the agents of the company shareholders.

The agency theory is also used to explain the contractual relationship between the shareholders and the BOD, between the BOD and the top management of the corporation, and between the corporate management and their subordinates. In the above relationships, the former are referred to as the principal and the latter are referred to as the agent. Another important contractual relationship is formed when the shareholders appoint an external auditor to audit the company accounts. In this relationship the external auditors are referred to as agents of the shareholders.

Agent's Duties to the Principal

Loyalty: An agent has the duty to act solely for the benefit of his or her principal, and not in the interest of the agent or a third party. Moreover, any information or knowledge obtained in the course of the agency is confidential.

Obedience: An agent has the duty to follow all lawful and clearly stated instructions of the principal. Why else would anyone agree to have an agent/principal relationship?

Accounting: Unless otherwise agreed, an agent has the duty to keep and make available to the *principal an account of all* property and money received and paid out on the principal's behalf. in

Performance: *An agent impliedly* agrees to use reasonable diligence and skill in performing the task in *its entirety. In other words,* the agent should exercise due care.

Notification: *An agent* is required to notify the principal of all matters that come to the agent's attention *concerning* the subject matter of the agency..

14. The Agency Problem in Corporate Governance

Due to the separation of ownership between the managers and the shareholders, the problems with agency relationships may arise. First, both the shareholders and the corporate managers are assumed, in economics, to seek to *maximize their own best interests*. Specifically, the agency theory is based on the economic model of a man: that *individuals are always opportunistic and driven by incentives; and if left uncontrolled they will maximize their own interests at the expense of others.* For example, managers may maximize their best interest by

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accumulating not only monetary benefits but also a variety of non-monetary benefits, such as luxurious offices, expensive cars, unnecessary 'high tech' equipment and foreign trips.

The second problem relates to the difficulties the shareholders may face in observing the managers' actions due to inadequate information they get about their business. In contrast the managers have substantial and significant information of the corporation than the shareholders. This information asymmetry can be used by the managers to deceive the shareholders and peruse their own goals. Information asymmetry arises because the shareholders do not have any control over the day-to-day operations of the corporation. As a result, the contract between the shareholders and the managers leaves the managers with much discretion because they have the knowledge and the ability to run the company.

The Agency Costs of Corporate Governance

Agency problems lead to agency costs. The agency costs may be described as the costs incurred in resolving the conflicts of interest between the shareholders and corporate managers. They are also incurred in order to reduce the information asymmetry between the shareholders and the managers. There are three types of agency costs: Monitoring costs, bonding costs and the residual losses. They include the costs of providing managers with incentives to maximize shareholder wealth and of monitoring the corporate managers. Agency costs are the sum of: the monitoring expenditure; bonding expenditure; and the residual loss.

Monitoring costs (the costs of monitoring the agent's performance)

Monitoring costs are costs that are incurred by the shareholders to monitor and control the managers through various governance mechanisms such establishing the BODs and appointing external auditors to audit corporate accounts. For example, BOD acts on behalf of shareholders to monitor the management to ensure behaviour that maximizes shareholder value. The cost of having a BOD includes directors' fees' allowances and other remunerations. Agency costs also include costs of establishing and maintaining internal audit department, payment of external auditors as well as costs associated with issuing financial statements.

Bonding costs

Bonding costs are incurred by the agent. For example, corporate management may be bond to contractual obligations that limit or restrict the management's activity. For example, a

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manager may agree to stay with a corporation even if the corporation is acquired. The manager must forego other potential employment opportunities. That implicit cost would be considered an agency bonding cost. On the other hand

Residual losses

Generally it is not possible to eliminate all agent behaviour that is inconsistent with principals' interests. The cost of this remaining behaviour is known as residual loss. The residual loss is borne by the principal in the first instance

Thus: Agency costs – Monitoring Cost – Bonding Cost = Residual loss.

Reducing Agency Costs in Corporate Governance

The agency theory proposes a number of mechanisms to reduce agency costs and in bringing managers' behaviour into alignment with their shareholder interest. Two mechanisms that have received much attention are: management compensation schemes and governance structures.

Management compensation schemes: The aim of management compensation schemes is to provide rewards that may align the interests of both the shareholders and corporate managers. The agency cost can be reduced by introducing a compensation scheme, in the form of risk premium, where rewards are based on outcome, commonly share price. If managers receive compensation that is subject to effective completion of the shareholders goals such as direct ownership of shares, or bonus payments, they will be motivated to behave in a manner consistent with the shareholders' interests.

Governance structures: A second mechanism aimed at bringing managers' behaviour into alignment with their shareholder interest is governance structures such as establishing strong internal control systems and monitoring the behaviour of corporate managers. The monitoring mechanism watches the divergent behaviour of corporate managers. *This is usually carried out by several components of corporate governance system such as the external and internal auditors, as well as the BOD.*

The BOD acts on behalf of the shareholders to monitor and restrict the activities of management to ensure behaviour that maximises shareholder value. The BOD must periodically report about the financial condition of their corporations to the shareholders through the annual reports. These reports provide a measure of accountability and effectiveness of board monitoring. Through reliable financial reports, the information

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asymmetry inherent in the system is reduced and thus, the shareholders can be able to check whether the management is working in their best interests.

Strong internal control: The emphasis on strong internal control arises because it is considered to be a significant factor in achieving effective financial reporting. The responsibility for designing, implementing, and maintaining proper internal control rests with the management and those charged with governance such as a BOD. Strong internal control in a corporation attempts to prevent, detect and correct manager's behaviour. For example, an effective control environment is usually, characterized by having a strong BOD that recruits management with *high integrity* as well as having employees who are honest and objective

Definitions of directors and shareholders (GCGP, 2002) Tanzania

Executive Director - means a director who is involved in the administrative or managerial operations of the company 1/2 ō total directors.

Non-Executive Director - means a director who is not involved in the administrative or managerial operations of the company.

Majority shareholder - means a shareholder who has more than 50% shareholding of a company

Substantial Shareholder - A substantial shareholder, for the purpose of these guidelines is a person who holds not less than fifteen per cent of the voting shares of a listed company and has the ability to exercise a majority voting for the election of the director.

Independent Director - "Independent director" means a director who: Zay ás NED ē 1/3 ō to

(a) has not been employed by the company in an executive capacity within the last five years;

(b) is not affiliated to an advisor or consultant to the company or a member of the company's senior management or a significant customer or supplier of the company or with a not-for-profit entity that receives significant contributions from the company or within the last five years, has not had any business relationship with the company (other than service as a director) for which the company has been required to make disclosure;

(c) has no personal service contract(s) with the company, or a member of the company's senior management;

(d) is not employed by a public company at which an executive officer of the company serves as a director;

(e) is not a member of the immediate family of any person described above; or

(f) has not had any of the relationships described above with any affiliate of the company.

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Question One: IFM, BAC3/BTX 3 Exams Adapted

Serena VDW Co (Serena) has been trading for over 20 years and obtained a listing on a stock exchange five years ago. It provides specialist training in accounting and finance.

The listing rules of the stock exchange require compliance with corporate governance principles, and the directors are fairly confident that they are following best practice in relation to this. However, they have recently received an email from a significant shareholder, who is concerned that Serena does not comply with corporate governance principles.

Serena's board is comprised of six directors; there are four executives who originally set up the company and two non-executive directors who joined Serena just prior to the listing. Each director has a specific area of responsibility and only the finance director reviews the financial statements and budgets.

The chief executive officer (CEO), Daniel Brown, set up the audit committee and he sits on this sub-committee along with the finance director and one non-executive director (NED). As the board is relatively small, and to save costs, Daniel Brown has recently taken on the role of chairman of the board. To save costs, no internal audit function has been set up to monitor internal controls.

Required:

(a) Describe any SIX (6) corporate governance weaknesses faced by Serena VDW Co

(b) Provide recommendations to address each weakness, to ensure compliance with corporate governance principles. **(12 marks)**

Solution One

	weakness	**recommendation**
01	*The chairman, daniel brown, is both the chairman and chief executive. there should be a clear division of responsibility at the head of the company and no one individual should have such unrestricted levels of decision-making, as this can lead to an abuse of power.*	the roles of chairman and the CEO should be split and not performed by the same individual. daniel brown should remain as CEO, but one of the NED should be appointed as chairman. CG principles recommend that the chairman should be an independent or a NED.
02	The board is comprised of four executives and two NEDs. there should be an appropriate balance of executives and NEDs, to ensure that the board makes the correct objective decisions, which are in the best interest of the stakeholders of the company, and no individual or group of individuals dominates the board.	at least half of the board should be comprised of non-executive directors. hence serena vdw co should consider recruiting and appointing an additional one to two non-executive directors.
03	The audit committee is comprised of one non-	The audit committee must be comprised

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	executive and two executive directors (the chairman and the finance director). The audit committee is supposed to be made up of at least three independent and non-executive directors	of NEDs only; the chairman and finance director should resign from the committee. The Board should appoint at least three independent and NEDs
04	The task of appointing external auditors is undertaken by the chairman and the finance director. this should be performed by the audit committee	the audit committee should have primary responsibility in appointing the auditors and in setting their remuneration.
05	in order to reduce costs, serena vdw co has not established an internal audit function. the audit committee should consider the effectiveness of internal controls and internal audit could perform this role..	Further consideration should be given to establishing an internal audit function. both costs and benefits should be considered, as it is not sufficient to solely consider cost savings.

Question Two: IFM, BAC3/BTX 3 Exams Adapted

Mgeni Nani Co. (Mgeni Nani) has been trading for 15 years selling insurance serices. The corporation has recently become listed in the Dar es Salaam Stock Exchange (DSE). Mgeni Nani is required to comply with corporate governance principles in order to maintain its listed status; Mgeni Nani maintains a small internal audit department. The directors feel that the internal audit team needs to increase in size and specialist skills are required, however, they are not sure whether to recruit more internal auditors, or to outsource the whole function to their external auditors, Haruna & Co. Ditopile Mzuzuri is the chairperson of the board of directors (BOD) of Mgeni Nani, until last year Mzuzuri was the Chief Executive Officer (CEO). Mzuzuri is not certain whether Mgeni Nani needs more non-executive directors as there are currently three non-executive directors out of the eight board members. Mzuzuri is considering appointing one of his close friends, who is a retired CEO of a manufacturing company, as a non-executive director. The CFO, Rose Msumari decides on the amount of remuneration each director is paid. Currently all remuneration is in the form of an annual bonus based on profits. Rose is considering setting up an audit committee, but has not undertaken this task yet as she is very busy. A new sales director was appointed nine months ago. He has yet to undertake his board training as this is normally provided by the chief executive and this role is currently vacant. There are a large number of shareholders and therefore the directors believe that it is impractical and too costly to hold an annual general meeting of shareholders. Instead, the board has suggested sending out the financial statements and any voting resolutions by email; shareholders can then vote on the resolutions via email.

Required::

(a) Identify and explain FIVE corporate governance weaknesses (10 Marks)

(a) Provide a recommendation to address each weakness (10 Marks).

Solution Two

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Corporate governance weaknesses and recommendations

	(a) Weaknesses	(b) Recommendations
1	The board is comprises of five executives and only three non-executive directors (NEDs). There should be an appropriate balance of executives and non-executive, to ensure that the board makes the correct objective decisions, which are in the best interest of the shareholders, and no individual or group of individuals dominates the board's decisions	At least half of the board should be comprised of non-executive directors. Hence the board of Mgeni Nani should consider recruiting and appointing an additional one to two non-executive directors
2	Mzuzuri is considering appointing his close friend as a NED; NEDs bring valuable experience to a company, but they must also exercise their independent judgement over the whole board. If this director is a close friend of Mzuzuri, then it is possible that he will not be independent. In addition, he does not have any relevant experience of the insurance industry and so it is questionable what value he will add to Mgeni Nani	Only independent non-executives with relevant experience and skills should be appointed to the board of Mgeni Nani. The close friend of Mzuzuri is unlikely to meet these criteria, as he has no experience in the insurance industry, and so should not be appointed
3	The remuneration for directors is set by Rose Msumari the CFO. However, no director should be involved in setting their own remuneration as this may result in excessive levels of pay being set.	There should be a fair and transparent policy in place for setting remuneration levels. The NEDs should decide on the remuneration of the executives. The CFO or chairperson should decide on the pay of the NEDs
4	All directors' remuneration is in the form of an annual bonus. However, the pay should motivate the directors to focus on the long-term growth of the business. Annual targets can encourage short-term strategies rather than maximising shareholder wealth.	The remuneration of executives should be restructured to include a significant proportion aimed at long-term company performance. Perhaps they could be granted share options, as this would help to move the focus to the longer term.
5	Moreover, NEDs' pay should not be based on meeting company targets as their pay should be independent of how the company performs	Non-executives should be paid an annual fee for their services, which is unrelated to how Mgeni Nani performs.
6	Mgeni Nani does not currently have an audit committee. Audit committees	Mgeni Nani should appoint an audit committee (AC). The AC should comprise

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	undertake an important role in that they help the directors to satisfy their responsibility of accountability with regards to maintaining an appropriate relationship with the company's auditor	of at least three independent and non-executive directors, one of whom should have relevant financial experience. The three current non-executives should be appointed to the AC, assuming that they meet the requirements of independence.
7	A new sales director was appointed nine months ago, however, he has not undergone any board training. All directors should receive induction training when they first join the board so that they are fully aware of their responsibilities.	The new sales director should immediately receive relevant training from Ditopile Mzuzuri to ensure that he has a full understanding of his role and responsibilities.
8	Mgeni Nani is not planning to hold an an AGM as it appears to be too costly and impractical. But, the AGM is an important meeting in that it gives the shareholders an opportunity to raise any concerns, receive an answer and vote on important resolutions. The proposal to send the financial statements and resolutions by email is not suitable as it won't allow the shareholders an opportunity to raise questions.	The company should continue to hold the AGM. Sending information by email in advance of the meeting may be practical and save some costs; however, this should not be seen as a replacement for the AGM.

Question Three: IFM, BAC3/BTX 3 Exams Adapted

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Kijichi Co. has been trading for over six years and obtained a listing on Dar es Salaam Stock Exchange (DSE) two years ago. It provides specialist training in accounting and information technology (IT). The listing rules of the DSE require compliance with good corporate governance practices, and the directors are fairly confident that they are following best practice in relation to this. However, they have recently received an email from a significant shareholder, who is concerned that Kijichi does not comply with good corporate governance practice.

Kijichi's board is comprised of six directors; there are four executive directors who originally set up the company and two non-executive directors who joined Kijichi just prior to the listing. The board consists of all men with ages ranging from 35 to 65 years. Each director has a specific area of responsibility and only Mr. Ahmed Ruttainulwa, the Chief Finance Officer (CFO) reviews the financial statements and budgets. To save costs, the company's Chief Executive Officer (CEO), Robin Micky has recently taken on the role of chairman of the board

The company's board of directors established a three members' audit committee two years ago. The company's CEO Robin Micky, sits on this audit committee along with the CFO. The third committee member is Mr. John Kijanga who is a non-executive director. It is the CEO who makes decisions on the appointment and remuneration of the external auditors. Moreover, to save costs, no internal audit function has been set up to monitor internal controls of the company.

Required:

(a) Describe FIVE (5) corporate governance weaknesses faced by Kijichi Co. (10 Marks)

(b) Provide recommendations to address each weakness, to ensure compliance with corporate governance principles. (5 marks)

(Total 15 Marks

Solution Three

88	weakness	recommendation
01	The chairman of Kijichi, Robin Micky, is both the chairman and CEO.. Corporate governance principles recommends that the chairman should be an independent or a non-executive director	The roles of chairman and CEO should be split and not performed by the same individual. Robin Micky should remain as CEO, but one of the non-executives should be appointed as chairman..
02	The board is comprised of four executives and two non-executive directors. There should be	At least half of the board should be non-executive directors. Hence Kijichi

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	an appropriate balance of executives and non-executives, to ensure that the board makes the correct objective decisions,	should consider recruiting and appointing an additional one to two non-executive directors.
03	The board is not gender sensitive as all board members are women	The board should include at least one woman
04	The CFO, Mr Ruttainulwa reviews the financial statements and the budgets. These financial statements have been prepared by him. He cannot be independent of his own work	These should be reviewed by the audit committee as it has at least three independent and non-executive directors who shall report to the board
05	The audit committee is comprised of one non-executive and two executive directors (chairman Micky and CFO Rutta). The audit committee is supposed to be made up of at least three independent and non-executive directors	The audit committee must be comprise the non-executives only; the chairman and CFO should resign from the committee. The Board should appoint at least three independent and non-executive directors
07	In order to reduce costs, Kijichi has not established an internal audit function. The audit committee should consider the effectiveness of internal controls and internal audit could perform this role.	Further consideration should be given to establishing an internal audit function. both costs and benefits should be considered, as it is not sufficient to solely consider cost savings.

Question Four (a) : IFM, BAC3/BTX 3 Exams Adapted

The agency theory states that "Good corporate Governance practice should the split of the roles of Chairpersons and the CEO". On the other hand the stewardship theory suggests that in good corporate governance the same person should hold both positions of the Chairperson and the CEO. The Tanzania's Companies Act and the corporate governance guidelines require companies in Tanzania to comply with the agency theory. However if a company fails to comply with such guidelines it should provide the reasons for non-compliance

Required

Give any five (5) reasons suggesting why it is best corporate governance practice that the roles of CEO and chairperson should not be held by the same individual. **(10 marks)**

Question Four (a): IFM, BAC3/BTX 3 Exams Adapted

(a) Answers are expected to cover the following points, or something similar.

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(i) The two roles should be held by different individuals so that no individual on the board has "unregulated power". The chairperson is responsible for leading the board and the CEO is responsible for leading the management. Combining the two roles creates a position of dominant power.

(ii) They are two different roles, requiring different sets of skills. The same individual may not have the set of skills required to perform both role effectively.

(iii) When an individual has a dominant position on the board, there is a risk that the board will lose the balance that is required, and NEDs might not be able to contribute as effectively as they should.

(iv) In some cases, there may be a risk of the chairperson/CEO being a domineering personality, who disregards the views and opinions of board colleagues.

(v) The need for a division of the two roles is sufficiently important that the roles of each position should be set out in writing and agreed by the board.

Question Four (b) : IFM, BAC3/BTX 3 Exams Adapted

The legal and regulatory framework of corporate governance in Tanzania provides that the board shall establish an audit committee of at least three independent and non-executive directors who shall report to the board, with written terms of reference, which deal clearly with its authority and duties. The chairman of the audit committee should be an independent or non-executive director. The board should disclose in its annual report whether it has an audit committee and the mandate of such committee.

Required

Indicate whether the following audit committees (ACs) from A to G are strong or weak

ACs	Categories of Audit Committee (AC) Members and their size				
	Independent directors	Non-Executive Directors	Executive Directors	Total number of Directors	Strong or Weak
A	1	1	1	3	~~S~~ W
B	2	0	1	3	W
C	3	0	0	3	W
D	0	2	1	3	W
E	1	2	2	5	S
F	2	1	2	5	S
G	1	1	3	5	W
	3	0	2	5	W

Question Five : IFM, BAC3/BTX 3 Exams Adapted

The agency theory is used to describe the relationship between the shareholders and the managers of a corporation. It posits that, in corporations, shareholders (owners) employ

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skilled managers to manage the corporations on their behalf. The relationship between the corporation's shareholders and corporate managers is thus, the agency relationship in which the shareholders are the principals and the corporate managers are the agents of the shareholders.

The agency theory sees the corporation as a nexus of contracts between the shareholders (principals) and corporate managers (agents). In this contract there is a separation of ownership and control of the corporation: The shareholders own the corporation while the managers control it. The separation of ownership and control of the company often results in a conflict of interest between the principal (shareholders) and the agent (manager) who directly controls the company.

Required

(a) Explain the two common agency problems that may arise due to the separation of ownership and control of a public corporation. **(7 marks)**

(b) Explain measures that are taken by shareholders to reduce the agency problems **(7 marks)**

(c) The agency theory is criticized for its negative assumption regarding the human nature that "*individual are always opportunistic and driven by incentives; and if left uncontrolled they will maximize their own interests at the expense of others*". Discuss this critic **(8 marks)**

Tips: in answering this question discuss in detail on

(a) Agency problems = The first agency problem The second agency problem

(b) Reducing Agency problems through governance structures, Such as,

(i) appointing the board of director,

(ii) appointing an external auditor and

(iii) by installing strong internal controls

OR through Management compensation schemes such as, introducing a compensation scheme where rewards are based on outcome, bonus issue of shares to management

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