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INTRODUCTION

Modern corporations have become larger and more complex. This makes the separation of ownership and management a practical necessity. Major corporations may have hundreds of thousands of shareholders. There is no way for all of them to be actively involved in management. It would be like running Karatina University through a series of small meetings for all its students, lecturers and administrators. Or running a County government by calling numerous meetings of the county residents. Clearly, authority has to be delegated to managers.

The separation of ownership and management has clear advantages. It allows share ownership to change without interfering with the operation of the business. It allows the firm to hire professional managers. But it also brings problems if the managers' and owners' objectives differ. These incompatible objectives give rise to the Agency Conflicts whereby rather than attending to the wishes of shareholders, managers may seek a more leisurely or luxurious working lifestyle; they may shun unpopular decisions, or they may attempt to build an empire with their shareholders' money.

We will next look the theoretical foundations of corporate governance- the agency theory, transactions costs economics, resource dependence theory and the stakeholder theory. Next we shall discuss contemporary issues in corporate governance.

THEORETICAL FOUNDATIONS OF CORPORATE GOVERNANCE

THE AGENCY THEORY

Agency theory deals with the problematic relationship between principals and agents which has arisen with the separation of ownership and control (Fama & Jensen, 1983). To take a broad definition, one could describe the relationship as follows:

"*Whenever one individual depends on the action of another, an agency relationship arises. The individual taking the action is called the agent. The affected party is the principal*." (Pratt & Zeckhauser, 1985).

However the definition of agency relationship that is more commonly used is the one offered by Jensen & Meckling (1976). According to this definition, one can reconstruct the agency relationship as a

"*Contract under which one or more persons (the principal[s]) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent*" (p. 308).

While it is true that owners (i.e., shareholders in our case) do have decision rights, in the sense that they vote in general meetings on issues such as mergers and acquisitions or dividends, the majority of the decision-making is delegated to management. The shareholder (principal) employs the manager (agent) to act in his or her interests, namely so that the capital invested by the principal might bear as much interest as possible. Thus, according to capital market theory, neoclassical economics, and the shareholder value concept, management is faced with the task of directing the entire corporate strategy toward the benefit of shareholders and their interests. The shareholder bears the residual financial risk since it is broadly assumed that the manager will act rationally and attempt to increase his or her own advantage by taking benefit of the lead in information. Normally, this advantage is incompatible with the interests of shareholders. Ghoshal (2005) writes:

"*In courses on corporate governance grounded in agency theory, we have taught our students that managers cannot be trusted to do their jobs – which, of course, is to maximize shareholder value – and that to overcome 'agency problems', managers' interests and incentives must be aligned with those of the shareholders by, for example, making stock options a significant part of their pay*." (p. 75)

As such, agency theory distinguishes between two resulting agency problems. The first and well-known problem is called moral hazard, i.e., the agent's opportunistic behavior after signing a contract. Here, either the agent receives new information which was not perceived by the principal (hidden information) or the agent's activities cannot be observed or controlled without high costs (hidden action). One special type of moral hazard is shirking: the agent invests too little time and work into the delegated task, takes too many risks (or too few), wastes resources, and generally enjoys his or her advantages. This is evident in so-called consumption on the job, where the employer's resources are used by employees for private purposes (e.g., private use of the internet). A further form of moral hazard is hold-up: this occurs due to the factor specificity of transactions. Review your microeconomics for more details.

The agency problems noted above can be reduced especially by reducing information asymmetries in two ways: in *screening (monitoring)*, the principal investigates the corporation, e.g., by running controls; in *signalling (bonding)*, the agent gives signals to the principal, either in accordance with the law (e.g., through reporting), voluntarily (e.g., through codes of ethics) or in a mixed form (e.g., through a code of corporate governance). Other control and monitoring systems include *control of shareholders' voting rights, control through capital and product markets, control through employment and manager markets, or control through liability*. Normally, the principal must invest money into such monitoring which then reduces his or her return – and according to the theory, it is only the principal who is entitled to residuals. Thus, corporate governance is a form of leadership and control of a corporation in the interests of its shareholders. Next to monitoring, a second option might be the unification of principal and agent interests in advanced wage and incentive systems, which were typical in the 1990s when wages were often paid in shares or stock options. Finally, management can build up reputation capital.

This agency relationship gives rise to a real (or perceived) conflicts. Such conflicts between shareholders' and managers' objectives create principal– agent problems. The shareholders are the principals; the managers are their agents. Shareholders want management to increase the value of the firm, but managers may have their own axes to grind or nests to feather. In a bid to resolve these conflicts, shareholders take actions to protect themselves (discussed in above paragraph). The actions by shareholders give rise to agency costs. Agency costs are incurred when

(1) Managers do not attempt to maximize firm value and

(2) Shareholders incur costs to monitor the managers and influence their actions.

Of course, there are no costs when the shareholders are also the managers. That is one of the advantages of a sole proprietorship. Owner–managers have no conflicts of interest.

COSTS OF THE AGENCY RELATIONSHIP

There are costs involved with any effort to minimize the potential for conflict between the principal's interest and the agent's interest. Such costs are called agency costs, and they are of three types: monitoring costs, bonding costs, and residual loss.

Monitoring costs are costs incurred by the principal to monitor or limit the actions of the agent. In a corporation, shareholders may require managers to periodically report on their activities via audited accounting statements, which are sent to shareholders. The accountants' fees and the management time lost in preparing such statements are monitoring costs. Another example is the implicit cost incurred when shareholders limit the decision-making power of managers. By doing so, the owners may miss profitable investment opportunities; the foregone profit is a monitoring cost. The board of directors of corporation has a fiduciary duty to shareholders; that is the legal responsibility to make decisions (or to see that decisions are made) that are in the best interests of shareholders. Part of that responsibility is to ensure that managerial decisions are also in the best interests of the shareholders. Therefore, at least part of the cost of having directors is a monitoring cost.

Bonding costs are incurred by agents to assure principals that they will act in the principal's best interest. The name comes from the agent's promise or bond to take certain actions. A manager may enter into a contract that requires him or her to stay on with the firm even though another company acquires it; an implicit cost is then incurred by the manager, who foregoes other employment opportunities.

Even when monitoring and bonding devices are used, there may be some divergence between the interests of principals and those of agents. The resulting cost, called the residual loss, is the implicit cost that results because the principal's and the agent's interests cannot be perfectly aligned even when monitoring and bonding costs are incurred.

REVIEW QUESTIONS/ ASSIGNMENT 1

1. In most large corporations, ownership and management are separated. What are the main implications of this separation? (8 mks)

2. What are agency costs and what causes them? How can agency conflicts be minimized? (Need further reading here) (4 mks)

3. Discuss the stakeholder theory, transaction cost economics and resource dependence theories and show how they relate to the governance of corporations. (15 mks)

4. Discuss the applicability of the agency theory to public corporations? In the public sector, what options do citizens have in resolving agency conflicts? (15 mks)

REFERENCES

Refer to the course outline- ensure you download and read Jensen and Meckling, 1976 paper.

CORPORATE GOVERNANCE

DEFINITIONS

What is corporate governance? The dominant view in economics, articulated, for example, in Shleifer & Vishny's (1997) and Becht et al.'s (2002) surveys on the topic, is that corporate governance relates to the "ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment." Relatedly, it is preoccupied with the ways in which a corporation's insiders can credibly commit to return funds to outside investors and can thereby attract external financing. The more common definition, however, is the way corporations are controlled and directed.

This definition is, of course, narrow. Many politicians, managers, consultants, and academics object to the economists' narrow view of corporate governance as being preoccupied solely with investor returns; they argue that other "stakeholders," such as employees, communities, suppliers, or customers, also have a vested interest in how the firm is run, and that these stakeholders' concerns should somehow be internalized as well. This is why we looked at the stakeholder theory in the previous topic.

In this section, we will look deeper into agency relationship, and how shareholders ensure that firms are run in their best interests.

HOW AGENCY CONFLICTS MANIFEST THEMSELVES

There are various ways in which management may not act in the firm's (understand: its owners) best interest. For convenience, we divide these into four categories, but keep in mind that all are fundamentally part of the same problem, generically labelled by economists as "moral hazard."

(a) Insufficient effort

By "insufficient effort," we refer not so much to the number of hours spent in the office (indeed, most top executives work very long hours), but rather to the allocation of work time to various tasks. Managers may find it unpleasant or inconvenient to cut costs by switching to a less costly supplier, by reallocating the workforce, or by taking a tougher stance in wage negotiations. They may devote insufficient effort to the oversight of their subordinates; scandals in the 1990s involving large losses inflicted by traders or derivative specialists subject to insufficient internal control are good cases in point. Lastly, managers may allocate too little time to the task they have been hired for because they overcommit themselves with competing activities (boards of directors, political involvement, investments in other ventures, and more generally activities not or little related to managing the firm).

(b) Extravagant investments.

There is ample evidence, both direct and indirect, that some managers engage in pet projects and build empires to the detriment of shareholders. A standard illustration, provided by Jensen (1988), is the heavy exploration spending of oil industry managers in the late 1970s during a period of high real rates of interest, increased exploration costs, and reduction in expected future oil price increases, and in which buying oil on Wall Street was much cheaper than obtaining it by drilling holes in the ground. Oil industry managers also invested some of their large amount of cash into noncore industries. Relatedly, economists have long conducted event studies to analyse the reaction of stock prices to the announcement.

(c) Entrenchment strategies.

Top executives often take actions that hurt shareholders in order to keep or secure their position. There are many entrenchment strategies. First, managers sometimes invest in lines of activities that make them indispensable (Shleifer and Vishny 1989); for example, they invest in a declining industry or old-fashioned technology that they are good at running. Second, they manipulate performance measures so as to "look good" when their position might be threatened. For example, they may use "creative" accounting techniques to mask their company's deteriorating condition. Relatedly, they may engage in excessive or insufficient risk taking. They may be excessively conservative when their performance is satisfactory, as they do not want to run the risk of their performance falling below the level that would trigger a board reaction, a takeover, or a proxy fight. Conversely, it is a common attitude of managers "in trouble," that is, managers whose current performance is unsatisfactory and are desperate to offer good news to the firm's owners, to take excessive risk and thus "gamble for resurrection." Third, managers routinely resist hostile takeovers, as these threaten their long-term positions. In some cases, they succeed in defeating tender offers that would have been very attractive to shareholders, or they go out of their way to find a "white knight" or conclude a sweet nonaggression pact with the raider. Managers also lobby for a legal environment that limits shareholder activism and, in Europe as well as in some Asian countries such as Japan, design complex cross-ownership and holding structures with double voting rights for a few privileged shares that make it hard for outsiders to gain control.

(d) *Self-dealing.*

Lastly, managers may increase their private benefits from running the firm by engaging in a wide variety of self-dealing behaviours, ranging from benign to outright illegal activities. Managers may consume perks (costly private jet, plush offices, private boxes at sports events, country club memberships, celebrities on payroll, hunting and fishing lodges, extravagant entertainment expenses, expensive art); pick their successor among their friends or at least like-minded individuals who will not criticize or cast a shadow on their past management; select a costly supplier on friendship or kinship grounds; or finance political parties of their liking. Self-dealing can also reach illegality as in the case of thievery (Robert Maxwell stealing from the employees' pension fund, managers engaging in transactions such as below-market-price asset sales with affiliated firms owned by themselves, their families, or their friends, CMC scandal), or of insider trading or information leakages to Wall Street analysts or other investors. Needless to say, recent corporate scandals have focused more on self-dealing, which is somewhat easier to discover and especially demonstrate than insufficient effort, extravagant investments, or entrenchment strategies.

RESOLVING AGENCY CONFLICTS

As noted earlier, shareholders take actions to protect themselves from the potentially harmful management actions. Please refer to the topic above. We shall now look deeper into some three ways of resolving agency conflicts.

INCENTIVES

Explicit and implicit incentives partly align managerial incentives with the firm's interest. Bonuses and stock options make managers sensitive to losses in profit and in shareholder value. Implicit incentives, on the other hand, stem from the managers' concern about their future. The threat of being fired by the board of directors or removed by the market for corporate control through a takeover or a proxy fight, the possibility of being replaced by a receiver during financial distress, and the prospect of being appointed to new boards of directors or of receiving offers for executive directorships in more prestigious companies, all contribute to keeping managers on their toes.

The compensation package.

Explicit incentives

A typical top executive receives compensation in three ways: salary, bonus, and stock-based incentives (stock, stock options). The salary is a fixed amount (although revised over time partly on the basis of past performance). The risky bonus and stock-based compensations are the two incentive components of the package. They are meant to induce managers to internalize the owners' interests. Stock-based incentives, the bulk of the incentive component, have long been used to incentivize managers. There has been a dramatic increase in equity-based pay, especially stock options. Managerial compensation should not be based on factors that are outside the control of the manager. One implication of this idea is that managerial compensation should be immunized against shocks such as fluctuations in exchange rate, interest rate, or price of raw materials that the manager has no control over. This can be achieved, for example, by indexing managerial compensation to the relevant variables. Studies on the compensation practices in the Kenyan setting are yet to be comprehensively carried out.

Implicit incentives

Managers are naturally concerned about keeping their job. Poor performance may induce the board to remove the CEO and the group of top executives. The board either voluntarily fires the manager, or, often, does so under the implicit or explicit pressure of shareholders observing a low stock price or a low profit. Poor performance may also generate a takeover or a proxy fight, or else may drive a fragile firm into bankruptcy and reorganization. There is need for more studies on the relationship between corporate performance and executive turnover.

Monitoring

Monitoring of corporations is performed by a variety of external (nonexecutive) parties such as boards of directors, auditors, large shareholders, large creditors, investment banks, and rating agencies. To understand the actual design of monitoring structures, it is useful to distinguish between two forms of monitoring, active and speculative, on the basis of two types of monitoring information, prospective and retrospective.

Active monitoring consists in interfering with management in order to increase the value of the investors' claims. An active monitor collects information that some policy proposed or followed by management (e.g., the refusal to sell the firm to a high bidder or to divest some noncore assets) is value decreasing and intervenes to prevent or correct this policy. In extreme cases, the intervention may be the removal of current management and its replacement by a new management more able to handle the firm's future environment. Active monitoring is forward looking and analyses the firm's past actions only to the extent that they can still be altered to raise firm value or that they convey information (say, about the ability of current management) on which one can act to improve the firm's prospects.

The mechanism by which the change is implemented depends on the identity of the active monitor. A large shareholder may sit on the board and intervene in that capacity. An institutional investor or a bank holding a sizeable number of the firm's shares as custodian may intervene in the AGM by introducing resolutions on particular corporate policy issues; or perhaps they may be able to convince management to alter its policy under the threat of intervention at the general meeting. A raider launches a takeover and thereby attempts to gain control over the firm. Lastly, creditors in a situation of financial distress or a receiver in bankruptcy force concessions on management. While active monitoring is intimately linked to the exercise of control rights, speculative monitoring is not. Furthermore, speculative monitoring is partly backward looking in that it does not attempt to increase firm value, but rather to measure this value, which reflects not only exogenous prospects but also past managerial investments. The object of speculative monitoring is thus to "take a picture" of the firm's position at a given moment in time, that is, to take stock of the previous and current management's accomplishments to date. This information is used by the speculative monitor in order to adjust his position in the firm (invest further, stay put, or disengage), or else to recommend or discourage investment in the firm to investors. The typical speculative monitor is the stock market analyst, say, working for a passive institutional investor, who studies firms in order to maximize portfolio return without any intent to intervene in the firms' management. But, as the examples above suggest, it would be incorrect to believe that speculative monitoring occurs only in stock markets. A short-term creditor's strategy is to disengage from the firm, namely, to refuse to roll over the debt, whenever he receives bad news about the firm's capacity to reimburse its debt. Or, to take other examples, an investment bank that recommends purchasing shares in a company or a rating agency that grades a firm's public debt both look at the firm's expected value and do not attempt to interfere in the firm' s management in order to raise this value. They simply take a picture of the firms' resources and prospects in order to formulate their advice.

Product-Market Competition

It is widely agreed that the quality of a firm's management is not solely determined by its design of corporate governance, but also depends on the firm's competitive environment. Product-market competition matters for several reasons. First, close competitors offer a yardstick against which the firm's quality of management can be measured. It is easier for management to attribute poor performance to bad luck when the firm faces very firm specific circumstances, say, because it is a monopoly in its market, than when competitors presumably facing similar cost and demand conditions are doing well. There is no arguing that this benchmarking is used in the assessment of managerial performance.

THE BOARD OF DIRECTORS

Another important component of the corporate governance debate revolves around the board of directors. Shareholders elect a board of directors to act on their behalf. Whether or not the board carries out its oversight role properly is the subject of debate. In the literature a number of factors have been advanced to explain why boards may not always be effective. These are discussed next.

Boards of Directors: Watchdogs or Lapdogs?

The typical complaints about the laidback behaviour of boards of directors can be found in Mace's (1971) classic book. Directors rarely cause trouble in board meetings for several reasons.

Lack of independence.

A director is labelled "independent" if she is not employed by the firm, does not supply services to the firm, or more generally does not have a conflict of interest in the accomplishment of her oversight mission. In practice, though, directors often have such conflicts of interest. This is most obvious for insiders sitting on the board (executive directors), who clearly are simultaneously judge and party. But nonexecutive directors are often not independent either. They may be handpicked by management among friends outside the firm. They may be engaged in a business relationship with the firm, which they worry could be severed if they expressed opposition to management.

Insufficient attention.

Outside directors are also often carefully chosen so as to be overcommitted. Many outside directors in the largest corporations are CEOs of other firms. Besides having a full workload in their own company, they may sit on a large number of boards. In such circumstances, they may come to board meetings (other than their own corporation's) unprepared and they may rely entirely on the (selective) information disclosed by the firm's management.

Insufficient incentives.
Directors' compensation has traditionally consisted for the most part of fees and perks, although there is a trend towards increasing compensation in the form of stock options for directors. Explicit compensation is, of course, only part of the directors' monetary incentives. They may be sued by shareholders. But, four factors mitigate the effectiveness of liability suits.

Avoidance of conflict.
Except when it comes to firing management, it is hard even for independent directors to confront management; for, they are engaged in an ongoing relationship with top executives. A conflictual relationship is certainly unpleasant. And, perhaps more fundamentally, such a relationship is conducive neither to the management's listening to the board's advice nor to the disclosure to the board of key information. A major research question has been, how can boards be rendered more effective?

REFERENCE
Important reference
Shleifer, A., Vishny, R. (1997). A Survey of Corporate Governance. *Journal of Finance*, 52(2): 737–784.

Plus those cited in the main body of the text above.

REVIEW QUESTIONS
Please attempt the following questions as allocated. Please source your materials mainly from current journal articles

1. Discuss the three prevalent corporate governance systems in the world. Highlight the advantages and disadvantages of each.
2. Discuss the link between ownership structure and corporate governance, and the major issues that arise out of this link.
3. Review the paper, "*What matters in corporate governance*" by Lucian Bebchuk, Alma Cohen, and Allen Ferrell. Describe the six major factors that influence corporate governance. Include findings from other similar studies.