

POLD 707 CORPORATE GOVERNANCE

NAME: DOREEN KIRUNGI MAINA

STUDENT NO.: POLD/11305/0/18

DATE: 28TH FEBRUARY 2021

ASSIGNMENT: MINOR PAPER 1

EVALUATION OF THE CAUSES OF CONFLICT BETWEEN SHAREHOLDERS AND MANAGERS

**Introduction**

Corporate governance has traditionally been related to the “principal-agent” or “agency” problem. A “principal-agent” relationship arises when the one who owns a firm isn't identical because the one that manages or controls it. for instance, investors or financiers (principals) hire managers (agents) to run the firm on their behalf. Investors need managers’ specialized human capital to come up with returns on their investments, and managers may have the investors’ funds since they'll not have enough capital of their own to speculate. during this case, there's a separation between the financing and therefore the management of the firm, i.e. there's a separation between ownership and control (Boshkoska, 2014).

It has long been known that in large companies the interest of the managers could also be different from the shareholders' profit maximization goal. In these companies, managers are appointed by the shareholders to create decisions and act within their interests. Lasher (2008) says that this type of relationship creates a conflict of interest called place of work problem.

According to the shareholder model, the target of the firm is to maximise shareholder wealth through allocative, productive and dynamic efficiency i.e. the target of the firm is to maximise profits. the factors by which performance is judged during this model can simply be taken because the value (i.e. shareholder value) of the firm. Therefore, managers and directors have an implicit obligation to make sure that firms are run within the interests of shareholders.

The underlying problem of corporate governance during this model stems from the principal-agent relationship arising from the separation of beneficial ownership and executive decision-making. it's this separation that causes the firm’s behaviour to diverge from the profit-maximizing ideal. This happens because the interests and objectives of the principal (the investors) and also the agent (the managers) differ when there's a separation of ownership and control. Since the managers don't seem to be the owners of the firm they are doing not bear the complete costs or reap the total benefits, of their actions. Therefore, although investors have an interest in maximizing shareholder value, managers may produce other objectives like maximizing their salaries, growth in market share, or an attachment to particular investment projects, etc.

**Evaluation of Conflicts between Corporate Managers and Shareholders**

Principal-agent theory’s central premise is that shareholders and corporate managers have different interests and objectives as well as different access to specific information of a company. Agency costs mainly occur when ownership is separated, or when managers have objectives other than shareholder value maximization.

The “agency view” of corporations argues that the decisions rights (or control) of a corporation should be entrusted to a manager so that the manager can act in the interest of shareholders. Partly as a result of this, mechanisms of corporate governance include a system of controls that are intended to align the incentives of managers with those of shareholders.

The term “agency costs” refers to instances when an agent‘s behaviour has deviated from a principal‘s interest. In this case, the principal would be the shareholder. These types of costs mainly arise because of contracting costs, or because individual managers might only possess partial control of corporate behaviour. They also arise when managers have personal objectives that are different from the goal of maximizing shareholder profit.

Typically, the CEO and other top executives are responsible for making decisions about high-level policy and strategy. Shareholders, on the other hand, are individuals or institutions that legally own shares of stock in a corporation. Typically, these people have the right to sell those shares, to vote on directors nominated by various boards, and many other privileges. This being said, shareholders usually concede most of their control rights to managers.

While attempting to benefit shareholders, managers often encounter conflicts of interest. Below are the analyzed areas where conflicts of interest between corporate managers and shareholders arise:

* *Management Risk Assessment*

The managers may be more willing to take on higher levels of risk, – operating, financial or investing – while shareholders desire maximized returns in the form of capital gains and dividends. Shareholders are generally risk-averse, which is viewed as prudent and conservative. If the management team receives a large portion of its compensation in annual salaries and stock options, managers have less to lose because salaries are constant, and stock option values rise in response to increased volatility, a form of risk.

* *Returns for Shareholders*

Shareholders desire minimized taxes, as opposed to maximization of shareholder wealth. Management teams sometimes exploit this by setting salaries in excess of industry norms, presumably because compensation expenses are tax-deductible and lower taxable income.

It can be difficult to balance the return requirements of shareholders with different long-term goals and tax situations. The business could also form a plan that comes at the expense of shareholder returns. Common examples fueling these decisions include concern about leaving a legacy, engaging in “empire building," which involves acquiring companies at a fast pace, even if it involves taking on too much debt or sacrificing profitability.

* *Control of Debt and Equity*

Management teams sometimes alter capital structures – the mix of debt and equity financing employed – in ways that preserve a level of control rather than a mix that maximizes wealth for your shareholders. Another example is poison-pill amendments adopted by boards of directors in support of a management team that purposely causes the company’s shares to lose substantial value in the event of a hostile takeover, offering high returns to shareholders at the expense of the company's leaders.

* *Capital and Debt*

There may be a constant tug-of-war between management and shareholders over the company’s capital. Shareholders often view excess cash on a company’s balance sheet and agitate for its return to shareholders in the form of cash dividends or the repurchase of shares, which boosts stock values (Fabozi & Peterson, 2003). However, managers may be very hesitant to do so, sometimes rightly so. One should not repurchase shares simply to appease shareholders, but only when the company’s shares are undervalued.

Also, corporate management may want to raise capital to invest in new projects while shareholders view this as a threat. Issuing new shares can dilute existing shareholders’ stakes, and issuing debt can increase leverage risk and, therefore, the risk associated with the company’s stock. Shareholders should always read management reports on financing closely and examine the statement of cash flows to understand the methods of financing the business is using.

Other conflicts of interest analyzed were that Managers might also engage in self-dealing, entering into transactions that benefit themselves over shareholders. Managers might also purchase other companies to expand individual power, or spend money on wasteful pet projects, instead of working to maximize the value of corporation stock. Venturing onto fraud, they may even manipulate financial figures to optimize bonuses and stock-price-related benefits.

**How good corporate governance practices can be used to ameliorate the situation of conflict between shareholders and managers**

The chief goal of good corporate governance is to eliminate instances when shareholders have conflicts of interest with one another. Another important goal is to evaluate whether a corporate governance system hampers or improves the efficiency of an organization. After the high-profile collapse of a number of large corporations in the past two decades, several of which involved accounting fraud, there has been a renewed public interest in how modern corporations practice governance, particularly regarding accounting (Tikvarovska, 2007).

Advocates of governance typically encourage corporations to respect shareholder rights, and to help shareholders learn how and where to exercise those rights. Disclosure and transparency are intertwined with these goals.

To prevent the managers to abuse their position and power and protect their interests, the stockholders may use several different mechanisms. In the text that follows, the measures are divided into two groups first and then analyzed as such:

a) **Internal measures:**

* Internal audit;
* Change in the salaries and payments of the managers;
* Concentrate ownership;
* Good corporate governance/management.

b) **External measures:**

* External audit;
* Market of capital;
* Law/legal frame.

***Internal Measures for Controlling of the Company***

To secure the continuity and the development of the company, the *internal audit* is of great importance to be made. It helps to evaluate the efficiency of the company, to detect and stop the eventually inefficient operations as well as to protect the assets and the capital (Jovanova, 2014). Existing legal frame for the corporate sector in the Republic of Uganda provides internal audit within the business Law.

One of the measures that can be taken to overcome this agency problem is the *way of financial rewarding of the managers.* The best way is to calculate their bonuses as a percentage of the realized profit of the company. Why is this rewarding method beneficial? The answer to this question can be illustrated by a simple example of a situation when we ask an agent to help us sell our computer. In the beginning, we can arrange with the agent a certain amount that he/she would get for his/her engagement for selling the computer. In this case, the agent will not be interested to ask and get a better price for the computer from the potential buyer and he/she will only be interested in just selling the computer as quickly as possible to get his/her money arranged previously.

Even we, as sellers, will be in a better position if we offer 10% of the reached value of the computer to the agent. This agreement makes the agent more motivated to reach and sell the computer at a higher price, which makes his/her commission bigger (Westerfield & Jaffe, 2008)

Accordingly, the same will happen with the top managers if their rewarding depends on the profit of the company. This type of calculated rewarding will motivate the managers to make decisions and take activities that lead toward a better company profit – the goal that the shareholders strive to as their main interest.

Another established practice is to offer the managers to buy shares and become owners themselves. This is the way of aligning the interests of the managers and the shareholders-long-term development, continuity and increasing the value of the shares.

Eun-Resnick (2004) indicate that concentrated ownership is an effective way to prevent the agency problem. According to them, managerial ownership share increases, their interest aligned with the shareholder's interest, so they will act in a way that will increase the shareholder value. A good system of corporate governance is of great importance for efficient control of the companies, for the enhancement of their performances, as well as for a better approach and availability of external financing.

*Corporate governance* is a term that regards to the relations and roles of every party involved as interested in the company. In the code of conduct of the banks, corporate governance means standardization of the processes, procedures and behaviour of the companies. The principles of corporate governance are as follows: responsibility, transparency and control within the decision-making process, as well as reporting about the daily work of the company.

Larcker and Tayan (2011) defined corporate governance as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stockholders. The level of alignment of the interests of the interested parties within the company shows how good their corporate governance is. In most cases, there are a large number of involved and interested parties such as shareholders, the board of directors, the board of managers, the managers, the government, the employees, the clients, the suppliers, the regulation officers, the media, the investors etc.

***External Measures to Control the Company***

It is essential to obey home and international standards and rules of work, in order for a company to grow and develop. These standards and rules can help to control the work of the managers, together with the prevention of the agency problem.

One of the measures taken to control the work of the company and prevent the agency problem is having effective external control of the work of the managers. The most effective way in this situation is to engage *external audits* who would periodically value the reality and objectivity of the company’s financial reports. Precise financial reporting is critical to ascertain that the results are stated fairly and the management has not manipulated results for personal gain (Larcker & Tayan, 2011).

The audit reports are delivered to the shareholders, the managers, the employees, and to the ones who are involved at the market in order to use them as a part of the valuation of the company.

The market price of the shares of a company, according to which the company is valuated, is a signal of the successful work of the company. If the company is governed by a manager whose decisions make the company less efficient, it can lead to a situation when the shareholders would sell their shares. As big the offer of shares is, as lower the price gets, which should be a signal enough for the members of the board of directors that some changes within the managerial department have to be made. Nevertheless, it is very important to point out that in situation like the previously mentioned one; firstly some analysis should be made, meaning whether the lower price comes as a result of bad managing or as a result of the change of some external factors.

In conclusion, Miller (2005) states that there are multiple solutions but none is perfect. Therefore, to overcome or even prevent this problem, it is necessary to control the work of the managers constantly and to make sure that the company works in accordance with the laws and the international rules in financing.

**References:**

Boshkoska, M. (2014). The Agency problem: Measure of its overcoming. *International Journal of Business and Management*. 10(1). 204-209.

Eun-Resnick. (2004). *International Financial Management* (3rd ed.). The McGraw-Hill Companies Inc.

Fabozi, F., and Peterson, P. (2003). *Financial management & analysis*. Wiley & Sons, Inc. New Jersey.

Jovanova, M. (2014). *Internal audit as a service of management for improvement of economic efficiency of the enterprises in Republic of Macedonia*. MA thesis, Faculty of Economics, Prilep, Macedonia.

Larcker, D., and Tayan, B. (2011). *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences*. Pearson Education Inc., New Jersey.

Lasher, W. (2008). *Practical Financial Management* (5th ed.). USA.

Miller, G. (2005). *Solution to Principal-Agent Problems in Firms*. http://dx.doi.org/10.1007/0-387-25092-1\_15

Tikvarovska, O. (2007). *Handbook of Corporate Management in Macedonian shareholding companies*. International Financial Corporation, USA.

Westerfield, R., and Jaffe. (2008). *Corporate Finance*. The McGraw – Hill Companies, Inc.