Learning Module 3: Corporate Governance: Conflicts, Mechanisms, Risks, and Benefits

LOS 3a: describe the principal-agent relationship and conflicts that may arise between stakeholder groups;

The term ‘principal-agent relationship’ or simply ‘agency relationship’ describes an arrangement where one entity, the principal, legally appoints another entity, the agent, to act on its behalf by providing a service or performing a particular task.

The agent is expected to act in the best interest of the principal. It is, however, not unusual for principal-agent relationships to lead to conflicts. The most common example of this occurs when managers, acting as agents, do not act in the best interest of the shareholders of a company (the principals).

Shareholder and Manager/Director Relationships

Directors and managers (agents) are expected to act in the best interests of the shareholders (principal) by maximizing a company's equity value. These two groups, however, tend to have conflicting interests on issues related to the risks that a company should undertake. Managers and directors tend to act more risk-averse to protect their employment status. On their part, shareholders want directors and managers to accept more risk to maximize equity value.

In addition, managers usually have greater access to information and are more knowledgeable about a company's affairs than the shareholders. This information asymmetry makes it easier for managers to make strategic decisions that are not necessarily in the best interests of shareholders.

Managers' and stockholders' interests are rarely perfectly aligned. Examples of conflicts include:

- **Lack of Adequate Effort:** Managers may be incapable or reluctant to make investments, effectively manage costs, or make tough choices such as closing unprofitable business segments. Inadequate monitoring of employees or lack of control may lead to unintentional risks and potential legal issues.

- **Misaligned Risk Appetite:** Compensation packages heavily reliant on stock grants and options may drive excessive risk-taking by management, as these benefit from rising share prices. Conversely, minimal usage of such incentives can result in overly cautious decision-making and difficulty attracting skilled personnel. This misalignment may conflict with the company's goal of value creation or shareholders' preference for high-risk, high-reward ventures.
- **Pursuit of Excessive Growth:** Management compensation and status often correlate with the size of the business which can motivate managers to chase “growth for growth's sake,” such as acquisitions that do not boost shareholder value.
- **Entrenchment:** Directors and managers aim to keep their positions. Strategies to achieve this may include emulating competitors, risk avoidance, and undertaking complex transactions and restructurings they are uniquely qualified to handle.
- **Self-interest:** Managers might use company resources to maximize personal gains, such as excessive benefits, or deceive investors by misusing assets. The lesser the manager's stake in the company, the less they bear these costs personally, reducing their motivation to maximize company value.

Agency Costs

When an agent acts on behalf of a principal, conflicts of interest may increase expenses related to reducing these conflicts. These costs are known as agency costs. Agency costs can be direct costs, such as employing monitoring agents like auditors, or indirect costs, such as forgone benefits of missed opportunities.

Controlling and Minority Shareholder Relationships

Corporate ownership can be classified as either dispersed on concentrated. Dispersed ownership implies that a company has many shareholders, with none controlling the corporation.

On the other hand, concentrated ownership implies that among the shareholders of the company, there are controlling shareholders who have authority over the corporation—for instance, a family company.

Another factor that determines whether a company is concentrated or dispersed is the shareholder voting structures and share classes with varying degrees of voting rights.

In a simple voting structure, one shareholder carries one vote. In contrast, a dual-class structure involves one share class, say class A, that bears one vote per share and is publicly held and traded, and another class, say class B, that bears multiple votes per share and is entirely owned by company founders or insiders.

Clearly, the dual-class structure gives some of the corporation's shareholders the power to control the company even if they do have significant shares outstanding.

Minority shareholders usually have limited or no control over the management. Similarly, they have limited or no voice in director appointments or significant transactions that could directly impact shareholder value.

As a result, conflicts between minority and controlling shareholders can occur. Such conflicts arise when the influence of the controlling shareholders eclipses the opinions or desires of the minority shareholders.

Manager and Board Relationships

Whereas managers are involved in the day-to-day operations of a company, the board of directors, especially the non-executive board members, are not. This leads to information asymmetry and makes it difficult for the board to perform its functions effectively.

Shareholder vs. Creditor (Debtholder) Interests

Creditors' interest is to have a company undertake activities that promote stable financial performance. This guarantees the maintenance of default risk at an acceptable level. Further, it essentially guarantees a safe return of their principal and payment of interest by the company. On the other hand, shareholders prefer to have a company venture into riskier activities with high return potential and are, as such, more likely to enhance equity value. There is, therefore, a divergence of interest in risk tolerance between these two groups.

Question

Which of the following instances of conflict of interest between managers and shareholders is *most likely* a result of managers' compensation being tied to the company's size?

A. Entrenchment.
B. Empire building.
C. Excessive risk-taking.

The correct answer is B.

Empire building refers to the behavior of managers who expand the size or scope of their company beyond what is necessary or beneficial for shareholders.

When managers' compensation is directly linked to the company's size, they may have incentives to pursue empire building to increase their own compensation, even if it is not in the best interests of shareholders. This can lead to inefficiencies, increased operating costs, and lower returns for shareholders.

A is incorrect. Entrenchment typically occurs when managers prioritize their own job security or personal interests over maximizing shareholder value. It often involves actions such as resisting changes to management or corporate governance structures that could potentially threaten their positions or compensation. While entrenchment can be a form of conflict of interest between managers and shareholders, it is not directly related to managers' compensation being tied to the company's size.

C is incorrect. Excessive risk-taking refers to the situation where managers pursue overly risky strategies in an attempt to maximize short-term gains or meet performance targets, often at the expense of long-term shareholder value. This is more related to managers' incentives to take on excessive risks to achieve certain performance metrics or bonuses rather than their compensation being tied to company size.

LOS 3b: describe corporate governance and mechanisms to manage stakeholder relationships and mitigate associated risks

Stakeholder management emphasizes the need for a company to consider the needs of all its stakeholder groups. It lays the structure for stakeholder groups to exercise influence, control, and protect their interest in a company.

Corporate governance lays the foundation for the legal, contractual, and organizational infrastructure that defines the rights and responsibilities of each group.

Corporate Reporting and Transparency

The principles of governance are fundamentally based on corporate reporting and transparency. The external shareholders can gain financial and non-financial information through annual reports and other company disclosures.

Investors can obtain a wide range of financial and non-financial data of a publicly traded company through various sources such as annual reports, proxy statements, corporate disclosures, investor relations resources, and others. This information encompasses details about the company's operations, strategic goals, audited financial reports, governance framework, ownership configuration, compensation strategies, transactions with related parties, and associated risks.

Specifically, investors utilize corporate reports and information for the following purposes:

- To evaluate the performance of a company as well as its directors and managers.
- To make decisions regarding valuation and investments.
- To cast votes on crucial corporate issues or changes.
- To verify adherence to legal obligations stipulated in debt agreements.

Shareholder Mechanisms

Shareholders are motivated to protect their legal and contractual rights through various procedures that vary depending on businesses and jurisdictions. Some of these procedures are discussed below:

Shareholder Meetings

General meetings allow shareholders to participate in company-related discussions and vote on significant corporate matters.
Companies usually hold an annual general meeting (AGM) within a certain period after the end of their financial year. The primary purpose of an AGM is to present shareholders with a company's annual audited financial statements, provide an overview of a company's performance over the year, and address any shareholder concerns.

It is also possible for a company or its shareholders to convene extraordinary general meetings (EGMs) within the year. This should happen whenever significant resolutions requiring shareholder approval are proposed.

Ordinary resolutions require a simple majority of votes to be passed. These usually relate to the approval of financial statements and the election of directors and auditors. Special resolutions require a supermajority vote, such as 75% of the votes to be passed. Special resolutions are more material in nature. Examples include effecting bylaws amendments and voting on a proposed merger or takeover transaction.

Proxy voting allows shareholders who cannot attend a general meeting to authorize someone else to vote on their behalf. It is the most common form of investor participation in meetings. Minority shareholders tend to use proxy voting in an attempt to increase their influence in companies.

Shareholder Activism

To force a firm to act the desired way, shareholders may employ **shareholder activism** techniques. Increasing shareholder value is an activist shareholder's primary goal.

Shareholder activism can be done by direct corporate **engagement** and **stewardship** to encourage corporate action, forcing management using **proxy fights**, **proposing shareholder resolutions**, and **publicly disclosing the issues of contention**.

Shareholder Litigation

Shareholders can also employ lawsuits. One common type is shareholder derivative lawsuits. **Shareholder derivative lawsuits** are legal actions brought by one or more shareholders against the board of directors, management, or controlling shareholders. The plaintiff shareholder in these actions is deemed to be acting on behalf of the company in lieu of its directors and officers who have failed to act appropriately in the interest of the firm and its shareholders.

Corporate Takeovers

Corporate takeovers are scenarios in which shareholders of a company hire and fire management to achieve better resource utilization. They can be pursued through a **proxy contest** where shareholders are persuaded to vote for a group seeking a controlling position on a company's board. Alternatively, a **tender offer** strategy can be employed. In this case, shareholders sell their interests directly to the group seeking control of a company. Lastly, a **hostile takeover** can be resorted to. This refers to an attempt one company makes to acquire another company without the consent of the company's management.

Creditor Mechanisms

Creditors use many mechanisms to protect their interests in a company. These include:

- **Bond indenture:** This legal document outlines the components of a bond, a company's responsibilities, and bondholders' rights.

- **Creditor committees:** Once a corporation declares bankruptcy, creditor committees are constituted to represent bondholders throughout the bankruptcy process. Their primary brief is to safeguard bondholder interests in any restructuring or liquidation.

Board of Directors and Management Mechanisms

Company shareholders elect a board of directors to provide oversight to a company. A board of directors appoints the top management of a company, is held accountable by shareholders, and is responsible for the overall governance of a company.

Board Committees

The boards usually assign specific tasks to committees drawn from the board members. The core committees include an audit committee, nominating or governance committee, and a compensation or remuneration committee.

The committees are in charge of considering, monitoring and acting on issues related to their competence. A committee regularly reports to the board and makes recommendations. Typical board committees are:

- **Audit committee:** The appointment of external auditors, as well as the implementation of high-quality accounting principles, are all overseen by the audit committee. In addition, this committee ensures the accuracy of the financial statements.

- **Remuneration or compensation committee:** This committee focuses on issues related to compensation. Such issues include defining director and executive remuneration policies, managing the administration, and assessing performance policies. Further, this committee establishes human resources policies regarding employee compensation.

- **Nomination committee:** It oversees director nominations and elections, identifies candidates for senior leadership positions, and maintains the makeup and independence of a board of directors. It is also concerned with the process of nominating and electing board members.

Additional Committees

Other committees include governance committees, risk committees, investment committees, and other industry-specific committees.

- **Risk committee:** It helps the board identify a firm's risk profile and appetite. Besides, it ensures an organization has a suitable enterprise risk management system and coordinates corporate operations with risk appetite.

- **Investment committee:** It examines and assesses the viability of the vital investment options suggested by the management.

Employee Mechanisms

By managing employee relationships, employers may make sure that their staff members can act in the business's best interests, meet their obligations to the organization, and have the requisite motivation to serve in their roles efficiently.

Labor Laws

The rights of employees are primarily secured through labor laws. Labor laws define the standards for employees' rights and responsibilities. The laws cover working hours, pension plans, hiring and firing practices, and vacation and leave entitlements. Unions seek to influence certain matters that affect employees' well-being in their jobs.

Employment Contracts

Employment contracts specify an employee’s rights and responsibilities. However, they do not cover every situation between employees and employers.

Effective human resource policies seek to attract and recruit high-quality employees. Such policies provide remuneration, training or development, and career growth prospects to improve employee retention. Employee Stock Ownership Plans (ESOPs) are also used to retain and motivate employees.

Companies sometimes use Codes of Ethics and business conduct to establish their values and standards of ethical and legal behavior that employees are expected to follow.

Customer and Supplier Mechanisms

Customers and suppliers of a firm enter into contracts that define the goods and services that underlie the relationship, the costs and terms of payment, the rights and obligations of each party, and any guarantees. Contracts also outline the steps to be followed and available options in the event of a contract breach.

Government Mechanisms

Laws and Regulations

Governments and regulators create regulations that businesses must abide by. In addition, governments keep track of how well the regulations are being followed. A stricter regulatory framework is applied to industries whose services and goods are more likely to put the public at risk.

Corporate Governance Codes

Numerous regulatory bodies have implemented corporate governance codes comprised of guiding principles for publicly listed firms. These codes mandate companies to either reveal their compliance with the suggested corporate governance practices or provide reasons for non-compliance, a method known as the “comply or explain” approach.

For instance, in Japan, companies without external directors must provide a rationale for why the appointment of such directors is not suitable.

Question

Which of the following is *most likely* a board of a shareholder mechanism used to promote good corporate governance?

A. Bond indenture.
B. Employment contracts.
C. Shareholder derivative lawsuit.

The correct answer is C.

A shareholder derivative lawsuit is a shareholder mechanism used to promote good corporate governance. These are legal actions brought by one or more shareholders against the board of directors, management, or controlling shareholders.

A is incorrect. Bond indentures are credit mechanisms a company's creditors use to protect their interests in a company. It is a legal document that outlines the components of a bond, a company's responsibilities, and bondholders' rights.

B is incorrect. Employment contracts are employee mechanisms used by employees to promote good corporate governance. They specify an employee's rights and responsibilities in a company.

LOS 3c: describe potential risks of poor corporate governance and stakeholder management and the benefits of effective corporate governance and stakeholder management;

Weaknesses in corporate governance practices and stakeholder management processes expose a company and its stakeholders to several risks. On the contrary, effective corporate governance and stakeholder management practices can benefit a company's stakeholders.

Adopting effective rules and implementing acceptable control is critical in corporate governance. It breeds stronger business connections, operational efficiency, improved control procedures, and improved financial performance.

Operational Risks and Benefits

Weak Control Systems, Ineffective Decision-making

Businesses with higher inherent risks require more robust controls in order to minimize residual risks. Otherwise, one stakeholder may gain from a company's inadequate control mechanisms and lack of board oversight at the expense of other stakeholders.

It is worth appreciating that a manager with access to more information than directors and shareholders may be able to make better decisions for a firm.

(Adequate) Scrutiny and Control

At all business levels, practical methods for oversight and control are established through solid governance standards. These strategies make it possible to reduce risk factors and fraudulent actions.

Adopting policies for handling conflicts of interest enables a business to maintain fairness. In addition, it prevents any unintended expenses that could result from favoring related parties.

(Improved) Operating Performance

Employees are aware of their obligations in organizations that practice effective governance. This is because, in such organizations, there is clarity regarding the delegation of authority and reporting lines. In such organizations, decision-making is easier, and managers have the autonomy they need to seize opportunities.

Legal, Regulatory, or Reputational Risks and Benefits

A company with compliance issues may be subject to legal, regulatory, or reputational concerns, including litigation for contract violations and government or regulatory investigations. These risks might cause the company to incur expensive penalties besides reputation damage.

Financial Risks and Benefits

Debt Default and Bankruptcy

Poor corporate governance can impact a corporation's financial condition, inferior handling of creditors' interests. This can make it difficult for a firm to repay its debts. In turn, failure to settle debts can lead to default and bankruptcy.

(Lower) Default Risk and Cost of Debt

Maximizing shareholder value is a result of sound corporate governance. Additionally, it is attributed to decreased financial and investment risks. Governance structures that aim to control creditor conflicts of interest limit corporate actions. This makes it difficult for a business to pay back its debt. Note that higher credit ratings result from decreased credit risk, which lowers the cost of borrowing.

(Enhanced) Valuation and Stock Performance

Investors are certain that their money is safe thanks to governance systems such as the board of directors and its committees. Disclosing important information promptly and suitably boosts investor confidence and a company's credibility.

Question

Which of the following is *likely* an operational risk of poor corporate governance?

A. Default risks.

B. Stock performance.

C. Weak control systems.

The correct answer is C.

Weak control systems may result in managers accessing more information than directors and shareholders. This may result in them taking actions that benefit them at the expense of the shareholders.

A is incorrect. Default risk is a financial risk resulting from a company's inability to pay debt. Companies may take actions that conflict with creditors' interest and ability to make timely debt payments.

B is incorrect. Stock performance may be poor if the disclosure of the information is neither done in a timely nor suitable manner. This is a type of financial risk.