CHAPTER 10: CORPORATE GOVERNANCE

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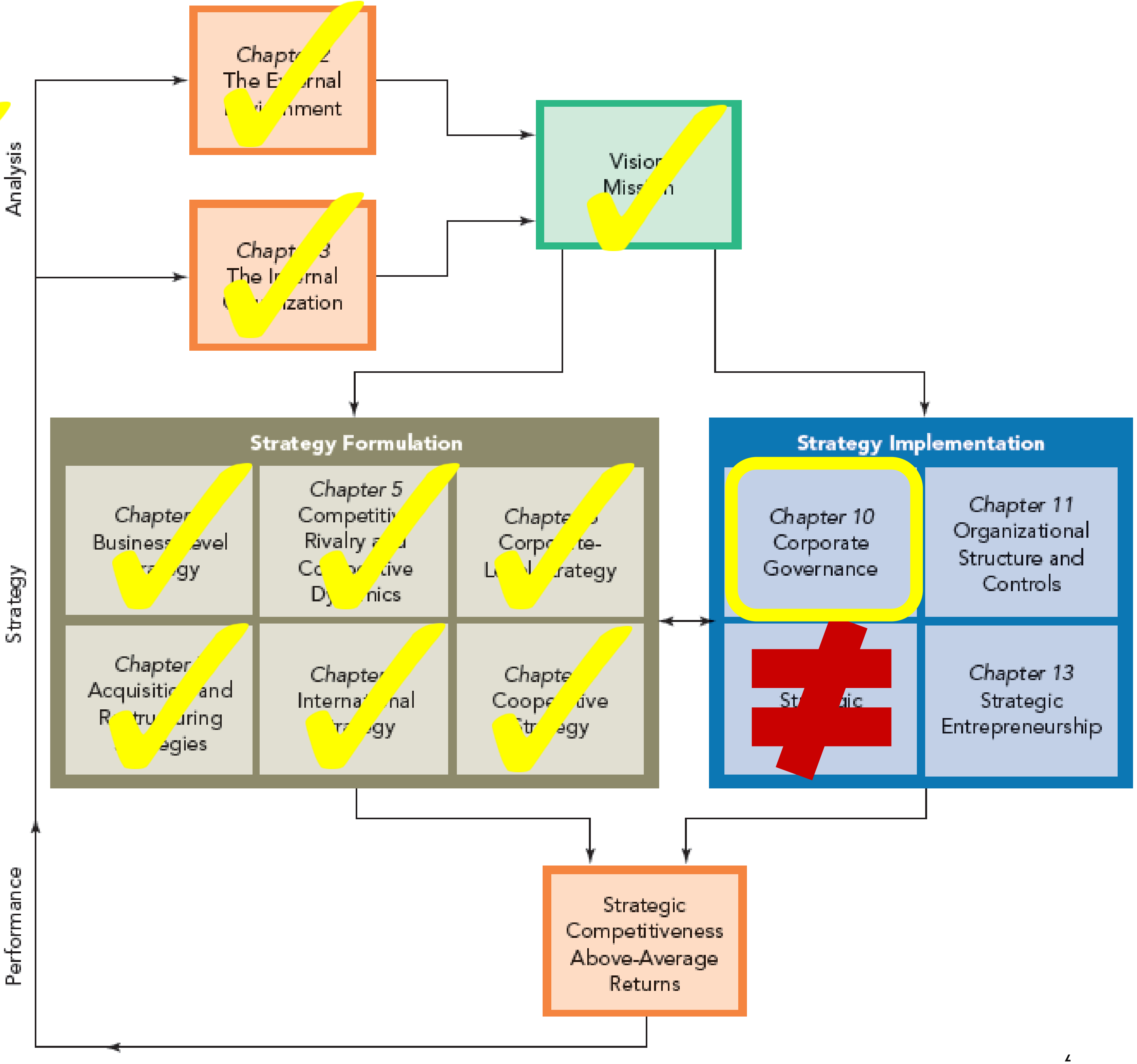
MGT4001 Business Policy and Strategy

ANALYSIS (INTERNAL AND EXTERNAL)

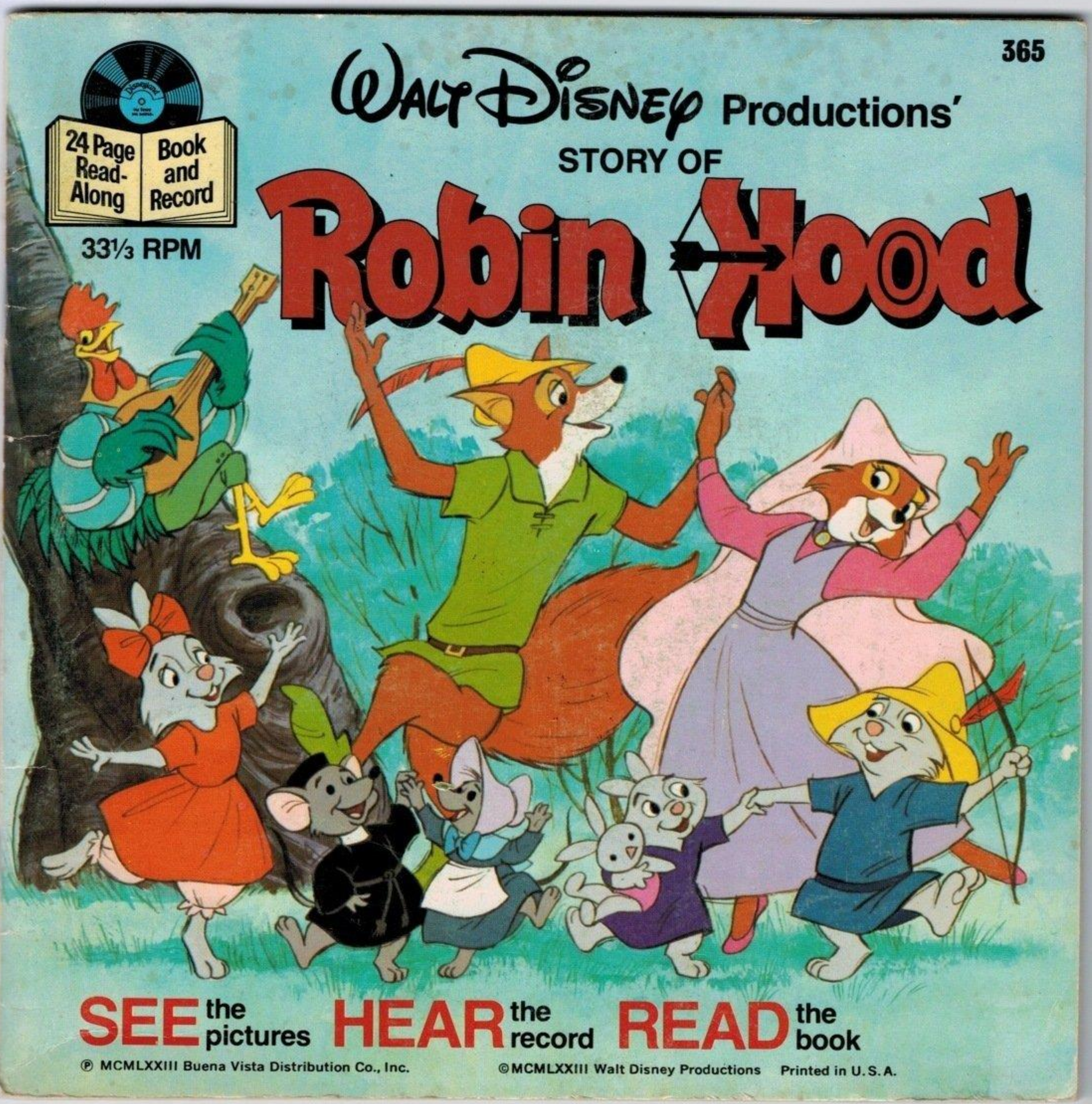
STRATEGY FORMULATION



STRATEGY IMPLEMENTATION

LEARNING OBJECTIVES

1. Define **corporate governance** and explain why it is used to monitor and control top-level managers' decisions.
2. Explain why ownership is largely separated from managerial control in organizations.
3. Define an **agency relationship** and managerial opportunism and describe their strategic implications.
4. Explain the use of **three internal governance mechanisms** to monitor and control managers' decisions.
5. Discuss the types of **compensation** top-level managers receive and their effects on managerial decisions.
6. Describe how the external corporate governance mechanism—the market for corporate control—**restrains** top-level managers' decisions.
7. Describe how corporate governance fosters **ethical decisions** by a firm's top-level managers.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CORPORATE GOVERNANCE

Corporate governance refers specifically to the set of rules, controls, policies and resolutions put in place to dictate corporate behavior.

- **Corporate governance** is the set of mechanisms used to manage the relationships (and conflicting interests) among stakeholders; and to determine and control the strategic direction and performance of organizations.
- A means to establish and maintain harmony between parties (the firm's owners and its top-level managers) whose interests may conflict.
- **Internally-focused:** concerned with identifying ways to ensure that strategic decisions are made more effectively.

CORPORATE GOVERNANCE

- **Importance of corporate governance:** Alignment of the interests of top management with those of shareholders
  - Monitoring of top-management decisions
  - Source of competitive advantage and increased market value
  - Prevention of and recovery from executive frauds

BERNARD MADOFF

TOP LEVEL / SCHEMER

The schemer convinces someone to invest by promising an unusually high rate of return.

SECOND LEVEL / INVESTORS

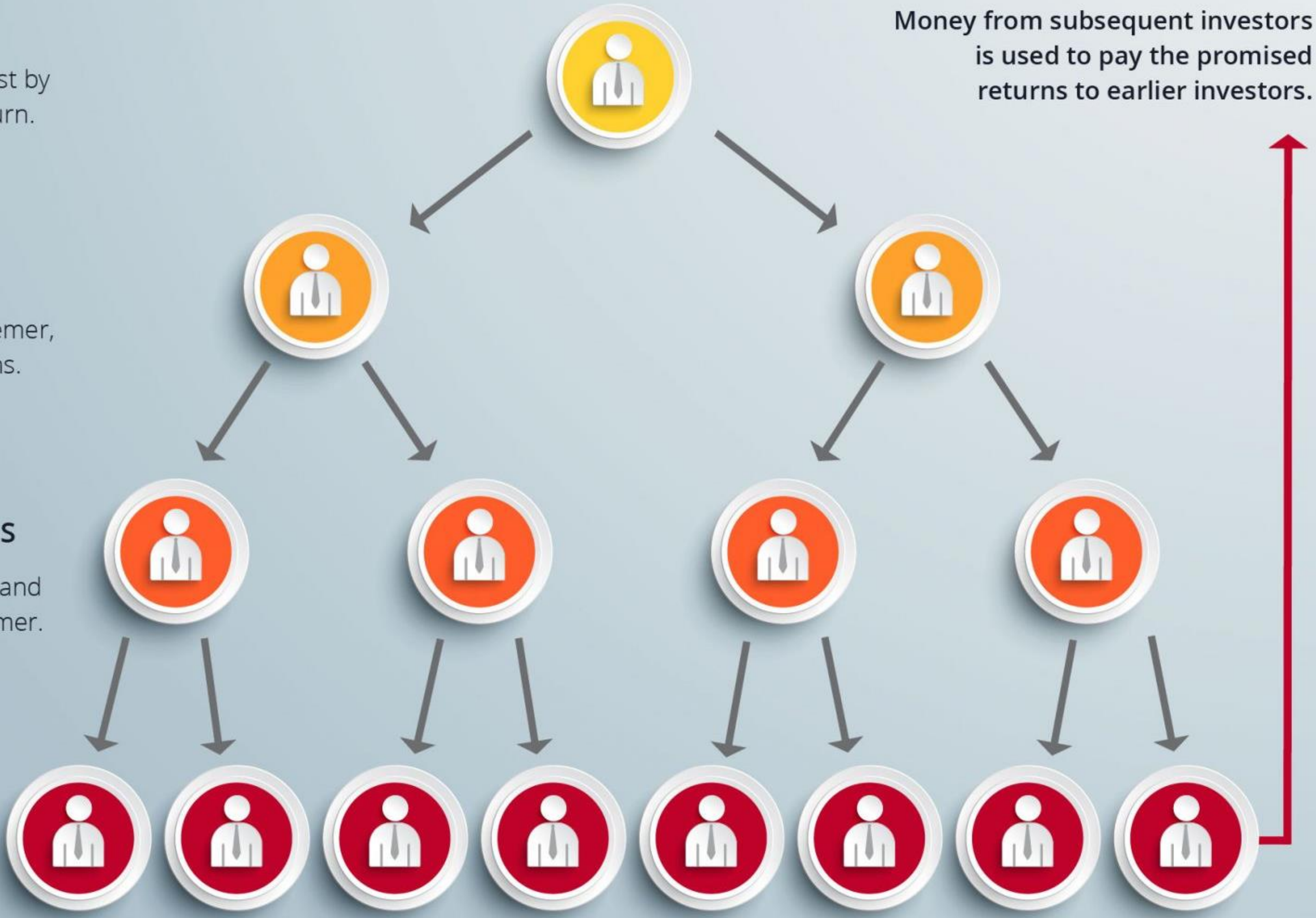
Investors place their money with the schemer, initially receiving the investment returns.

THIRD LEVEL / MORE INVESTORS

More people see the operation working and decide to join in, investing with the schemer.

FOURTH LEVEL / EVEN MORE INVESTORS

The scheme gets more popular and more people invest.



Money from subsequent investors is used to pay the promised returns to earlier investors.

Why do we have corporate governance?

Separation of ownership and managerial control:

Two major reasons why the *owners* of the companies are not necessarily the *managers*

SEPARATION OF OWNERSHIP AND MANAGEMENT - REASON #1

- Historically, firms are managed by founder-owners and his/her descendants (i.e. family businesses).
  - Less or no separation between ownership and management control
  - When the firm increases, owners need to expand their management responsibilities
  - Issues of family-owned businesses: lacking skills, capital, time

Firm expands → Owners do not have enough resources to manage bigger expansion → **Need to hire external manager**



LARD LAD
DONUTS


DONUTS



Koyuki222


SEPARATION OF OWNERSHIP AND MANAGEMENT – REASON #2

- When a firm expands, it may require **capital** from investors to fund the expansion
- Shareholders purchase **stocks** (that is, investment), becoming *residual claimants.*
- However, from the perspective of shareholders, to only invest money **in one company** is very risky
- Therefore, shareholders reduce risks by holding diversified portfolios.
  - → shareholders hold little control over a single company
- Professional managers are contracted to provide decision making.
- Therefore, the owners of the company are **not** necessarily the managers

Money for new offices, new employees,

Firm receives money from shareholders to use in growing the company, shareholders receive a portion of ownership (ownership means an ability to share in the profits (residuals) of the company

"putting your eggs in one basket" – too risky

Shareholders buy **fewer** stocks in **many** companies to spread out their investment risks – this means, they have **less ownership/control in one single company**

Because no single shareholder owns the majority of a company, all of the shareholders must vote to hire a professional manager (i.e. CEO) to run the company.

Firm expands

Shareholders buy stocks

Shareholders diversify to reduce risk

Shareholders hold little control in single company

Need to hire external manager



AGENCY RELATIONSHIP

Owner

(Principal)

Manager

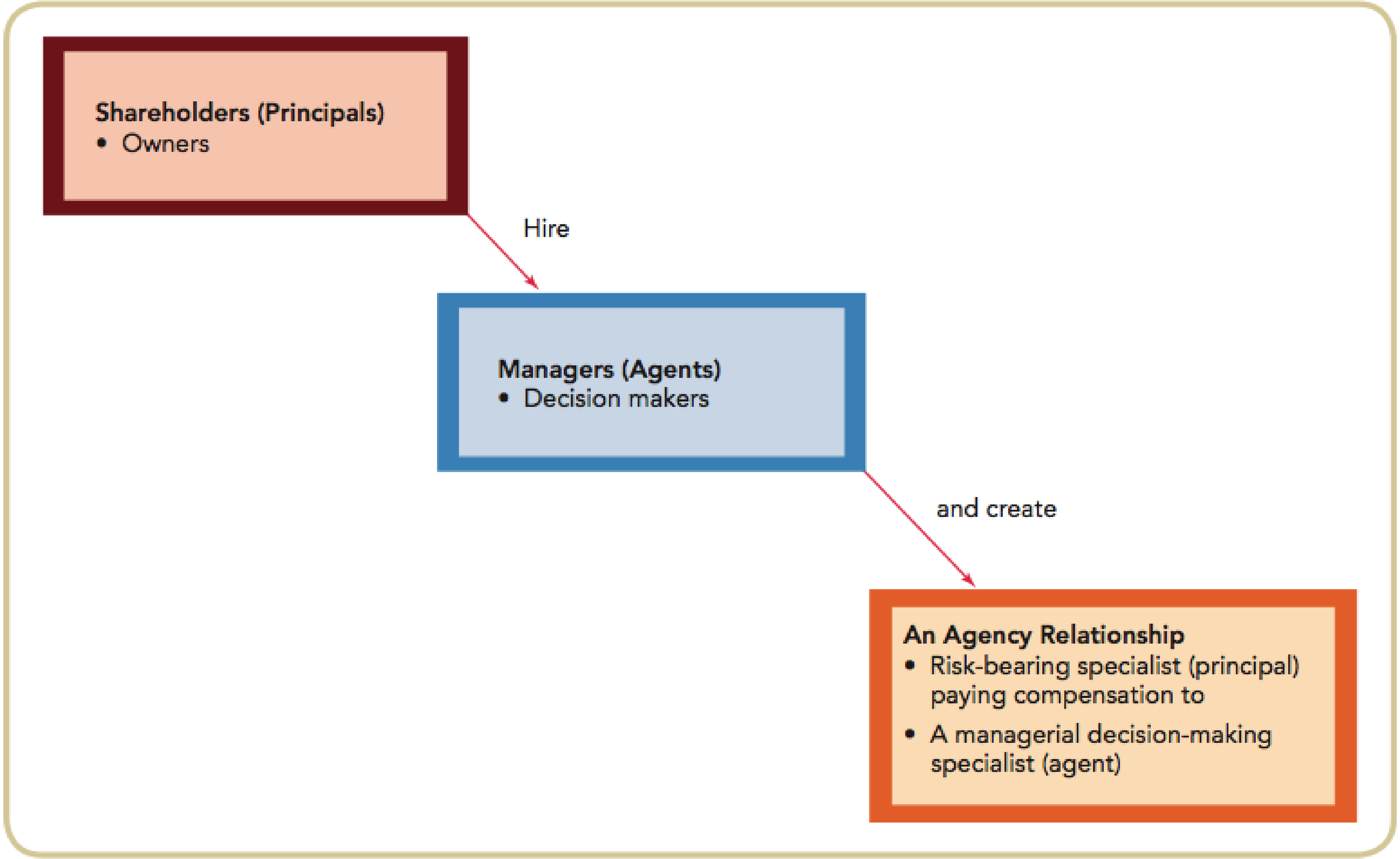
(Agent)

Agency relationship:

exists when one party delegates decision-making responsibility to a second party for compensation

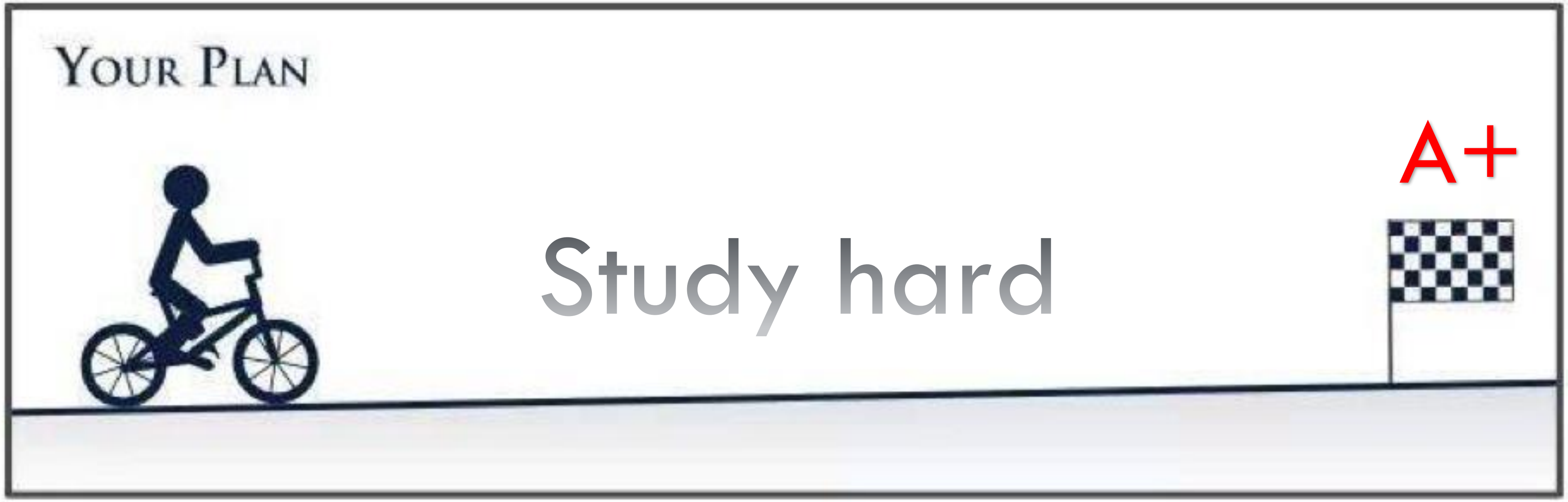
Risk-bearing principal (owner) pays compensation to agent (manager) to make decisions and run the company

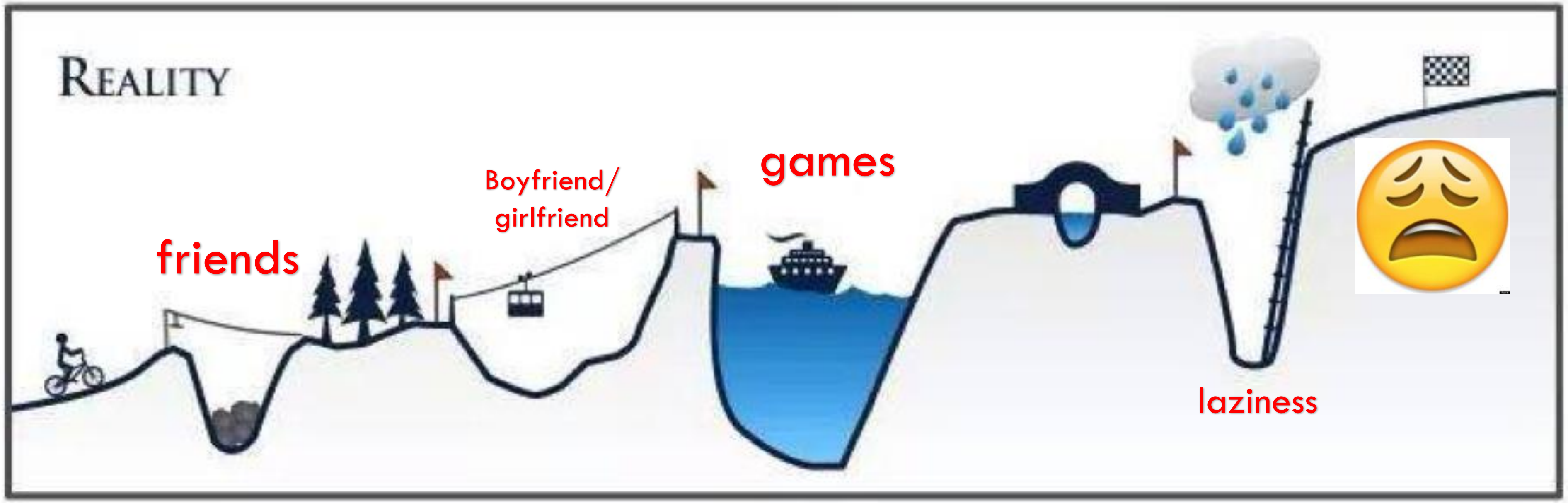
Figure 10.1 An Agency Relationship



AGENCY RELATIONSHIP

- Ideally, agents have identical interests as principals and act in principals' best interests to maximize principal's benefits.
- In reality: agency problem occurs when the interests and goals of the principal and agent are in conflict and it is difficult or costly for the principal to verify that the agent has behaved appropriately.


Your Plan
Study hard
A+


Reality
friends
Boyfriend/
girlfriend
games
laziness

AGENCY PROBLEMS

- **Managerial opportunism:** seeking self-interest with guile
  - Shareholders lack direct control of large, publicly traded corporations.
  - The agents may act detrimentally to principles.
- **Agency costs:** the sum of incentive costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent
- Hence corporate governance are systems and mechanisms which intends to **minimize** agency problems and costs.

PRODUCT DIVERSIFICATION AS AGENCY PROBLEM

- *Managerial motives to diversify:*
- **Managerial risk reduction** – unexpected lower performance in one business unit will be offset by higher performance of the other units
- **Desire for increased compensation** – particularly unrelated diversification assuming more capabilities and responsibilities
- **Build personal performance reputation** – broader business portfolio enhancing their reputation and opportunities in the external labor market.

How does corporate governance work? That is, how can it ensure managers act in the right way?

GOVERNANCE MECHANISMS

External
- Market for corporate control

Agents (Managers)
- Executive compensation

Principals (shareholders)
- Board of directors
- Ownership concentration

A. OWNERSHIP CONCENTRATION

- **Large block shareholders:** individual and/or institutional investors owning relatively large amount of stocks (e.g. >5%).
  - Their large stakes offers strong incentives to spend time, effort and expense to monitor the management closely.
  - They may also obtain Board seats, or appoint board members which enhance their ability to monitor effectively.
  - **Institutional owners:** Financial institutions such as stock mutual funds that have the size and incentive to discipline ineffective top-level managers, and hence affect firms' strategies.

Companies grow, shareholders buy stocks to input capital

→

Many shareholders diversify their portfolio, spreading or diffusing their risks into many companies

→

Diffuse ownership: a large number of shareholders with small holdings and few, if any, large block shareholders produces weak monitoring of managerial decision making

→

As shareholders have less investments and power within the company, they do not have the resources to monitor mangers

→

Large block shareholders have more ownership, power and therefore interest to monitor managers

→

Therefore, large block shareholders can be an effective form of corporate governance

B. BOARD OF DIRECTORS

Ownership concentration | **Board of directors (BOD)** | Executive compensation | Market for corporate control

- **Board of Directors (BoD, or simply directors)** are group of shareholder-elected individuals whose primary responsibility is to act in the owners' rights and interests by formally monitoring and controlling the corporation's top-level executives.
  - Direct the affairs of the organization
  - Punish and reward managers
  - Protect owners from managerial opportunism

Shareholders and owners can hire a board of directors to hire and oversee the manager

An independent board of directors focus on monitoring the manager

More accountability

An effective board of directors will be an effective corporate governance mechanism

WHO ARE ON THE BOARD OF DIRECTORS?

- **Insiders:** Large shareholders and top-level managers (e.g. CEO, CFO, COO…)
- **Related outsiders:** individuals uninvolved with day-to-day operations, but who have a relationship with the firm
  - Representatives of other stakeholders (e.g. institutional investors)
- **Outsiders:** individuals independent of the firm's day-to-day operations and other relationships
  - Managers or executives in other companies

ENHANCING BOARD OF DIRECTORS EFFECTIVENESS

- **Increased diversity** in board members' backgrounds
- Creation of a **"lead director"** role that has oversight powers
- Formal **processes to evaluate** the board's performance
- Changes in **compensation** of directors
- Stronger **internal management and accounting control systems**
- Directors **owning significant stakes** in the company in order to keep focused on shareholder interests

C. EXECUTIVE COMPENSATION

Ownership concentration | Board of directors (BOD) | **Executive compensation** | Market for corporate control

- **Executive compensations:** The use of salary, bonuses, and long-term incentives compensation, such as stock awards and stock options, to align managers' interests with shareholders' interests.
  - Alignment of pay and performance is a complicated board responsibility
  - *Suspect effectiveness* of compensation plans as a governance mechanism (compensation plans may not be that effective in governing top managers)

EFFECTIVENESS OF EXECUTIVE COMPENSATION

- The effectiveness of pay plans as a governance mechanism is complicated, especially long-term incentive compensation
  - Executive decisions are **complex and non-routine**
  - Decisions affect financial outcomes over an extended period, making it **difficult to assess** the effect of current decisions.
  - Many **external factors intervene** making it difficult to establish how managerial decisions are directly responsible for outcomes

UNDER ARMOUR

"Nobody wants to play in under armours"

EFFECTIVENESS OF EXECUTIVE COMPENSATION

- Performance-based compensation used to motivate decisions that best serve shareholder interest are imperfect in their ability to monitor and control managers.
  - Stock options make managers more susceptible to market changes which are partially beyond their control.
  - Unintended and unrealized consequences of stock options
  - Firm performance not as important than firm size

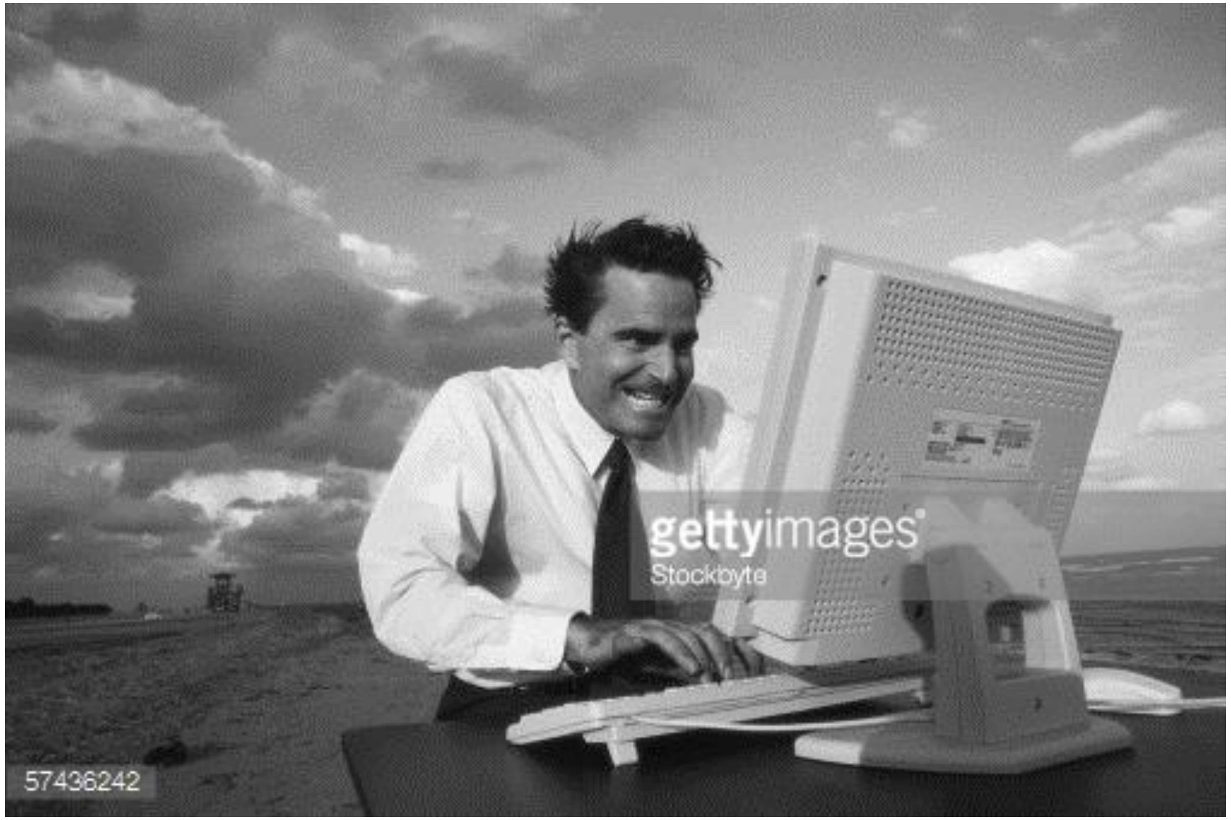
D. MARKET FOR CORPORATE CONTROL

Ownership concentration | Board of directors (BOD) | Managerial compensation | **Market for corporate control**

- **Market for corporate control:** the purchase of a firm that is *underperforming* relative to industry rivals in order to improve its strategic competitiveness
  - There are a set of **potential owners** seeking to acquire **undervalued** firms and earn above-average returns on their investments.
  - Ineffective managers are then usually replaced in such takeovers.

D. MARKET FOR CORPORATE CONTROL

- **Threat of takeover** may lead firm and managers to operate efficiently.
  - Being targeted implies weak internal corporate governance, needs to improve poor performance relative to competitors, ineffective discipline or opportunistic managers.
  - Managerial defense tactics increases the costs of mounting a takeover.
  - External mechanism is less precise than internal mechanisms.



Poor management → company value decreases → stock prices decrease or become “cheaper”

Other investors buy cheap → restructure to increase company value → sell for profit → return on investment

Increase company value → **address corporate governance and restructure management** (poor performance often comes from poor management)

Poor company performance → threat of takeover → threat of loss of job for manager

↓

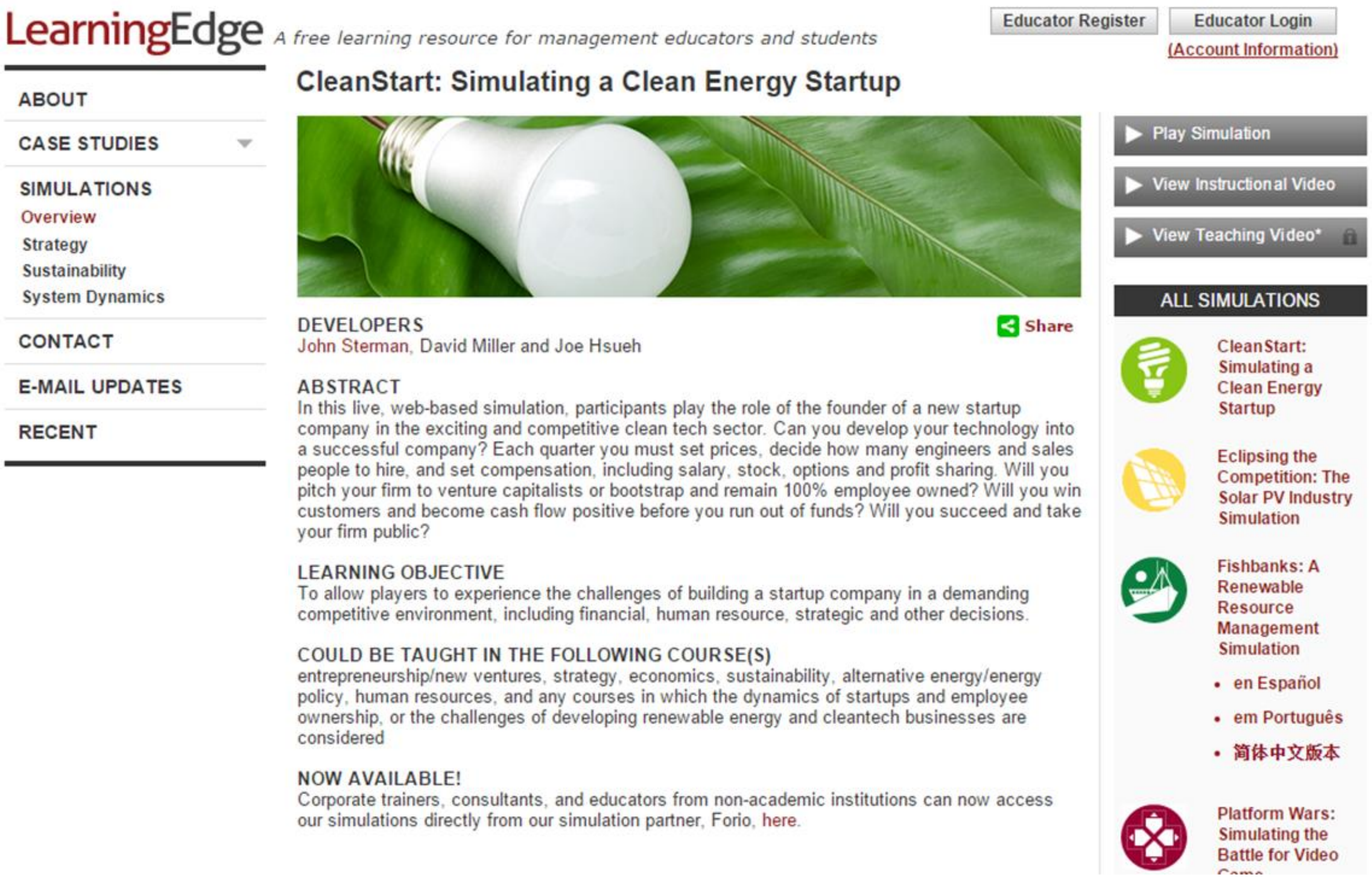
Manager and firm have incentive to perform better

↓

Therefore, external forces can also ensure effective corporate governance

https://mitsloan.mit.edu/LearningEdge/simulations/cleanstart/Pages/default.aspx

NEXT WEEK…SIMULATION GAME!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CleanStart: Simulating a Clean Energy Startup

DEVELOPERS
John Sterman, David Miller and Joe Hsueh

Share

ABSTRACT
In this live, web-based simulation, participants play the role of the founder of a new startup company in the exciting and competitive clean tech sector. Can you develop your technology into a successful company? Each quarter you must set prices, decide how many engineers and sales people to hire, and set compensation, including salary, stock, options and profit sharing. Will you pitch your firm to venture capitalists or bootstrap and remain 100% employee owned? Will you win customers and become cash flow positive before you run out of funds? Will you succeed and take your firm public?

LEARNING OBJECTIVE
To allow players to experience the challenges of building a startup company in a demanding competitive environment, including financial, human resource, strategic and other decisions.

COULD BE TAUGHT IN THE FOLLOWING COURSE(S)
entrepreneurship/new ventures, strategy, economics, sustainability, alternative energy/energy policy, human resources, and any courses in which the dynamics of startups and employee ownership, or the challenges of developing renewable energy and cleantech businesses are considered

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Platform Wars: Simulating the Battle for Video

CleanStart:
Simulating a Clean Energy Startup

https://mitsloan.mit.edu/LearningEdge/simulations/cleanstart/Pages/default.aspx

SIMULATION

- **Group:** Your presentation group members
- **Time:** 75 minutes (15-minute trial + 60-minute real game)
- **Simulation time horizon:** 10 years (10X4 quarters)
- **Assessment:** Performance =

  50% Cumul. Net Income + 50% Market Value

MITSloan MANAGEMENT

CleanStart: Simulating a Clean Energy Startup

Log out

Logged in as L01_trial Admin in L01_trial

Settings Users Results

Summary Cumul. Net Income Product Sales Market Value Founders Net Worth ($) VC Ownership Employee Ownership

2 runs found

Copy to Clipboard

Date	Name	Sim Year	Cumul. Net Income ($)	Sales (Units/Year)	Market Value ($)	Founders Net Worth ($)	VC Ownership (%)	Employee Ownership (%)		
11-08-15 3:09 PST	Frank5 Ng	Y2Q1	-1,323,424	0	652.89K	475.4K	27.19	0.00		
11-08-15 3:03 PST	Frank4 Ng	Y2Q2	-2,476,336	0	0.00	0.0	27.06	0.00		

View Run Delete Run

https://mitsloan.mit.edu/LearningEdge/simulations/cleanstart/Pages/default.aspx

IN THE REAL GAME, YOU ONLY HAVE ONE CHANCE

- Grades will be given **at the end of the 10th year:**

  1st group: 5 marks
  2nd group: 4.5 marks
  3rd & 4th group: 4 marks
  5th & 6th group: 3.5 marks
  7th group: 3 marks
  8th group: 2.5 marks
  bankrupt: 1 marks

- <u>**You will complete a questionnaire before and after the simulation.**</u>

SOME NOTES:

- You must run the trial version at home before the actual simulation. In the past, those who did not know what to do went bankrupt very early!
- Your role in the simulation is to make business decisions such as prices, employment, etc. of your startup company
- You should use the news that is allocated to you periodically
- You can also access the financial and income statements to aid your decisions

SOME NOTES:

- You will work in the groups that you have marked down on the group sheet. You must finalize a **group name** by the end of this class
- I will show the results of the group performances **LIVE** during the class
- You will be competing against the other groups in the class
- Your final ranking **will** determine your score for the simulation (which is worth 5% of your total grade)