Corporate governance

Corporate governance is concerned with how firms manage themselves, and the way in which this performance is monitored.

The corporation is the most important form of business organisation in the world. A corporation is a legal “person” separate and distinct from its owners, and it has limited liability. Profits are taxed at corporate tax rate. Hypothetically, the life of company is unlimited. It can sell new shares and attract new investors.
The ownership and control are separated. Shareholders own firms and represented by board of directors or supervisory board. Managers run firms and selected by boards.

Corporation has two types of agency problem. One is between managers and shareholders. The other is between dominant and minority shareholders.

For the first type problem, shareholders are more interested than managers to pursue a investment which will improve share value but also risky. If investment is made but turns out bad, managers may lose job. If the investment is not made, shareholders may lose a valuable opportunity to gain wealth.

For the second type problem, when an investor owns a large percentage of firms’ shares, they have ability to remove or install board of directors through their voting power. This means that indirectly they can make firm’s objective align to their own objectives, which may not be the same as that of other shareholders with a smaller proportionate stake.

Variations in economic, social and religious culture can lead to difference in the way that companies are run. The legal environment provides the investor protection. Corporations in countries with very well-developed financial markets find it easer to raise money by issuing debt and equity to the public than through bank borrowing. Ownership of companies can affect business decision-making and corporate objectives.

The basis of all good corporate finance decisions is a sound framework of corporate governance. Most of the problems that companies experience can usually identified by failings in the way in which they are governed. When a company does not have strong corporate governance, it may make decisions that do not maximise share value.

Behavioural finance

The area of research know as behaviour finance attempts to understand and explain how reasoning errors influence financial decisions. Errors in reasoning are often called cognitive errors which includes 1)biases, 2)framing dependence, and 3)heuristics.

Biases include 1)overconfidence, 2)over-optimism, and 3)confirmation bias. Overconfidence is the belief that your abilities are better than you really are. Most business decisions require judgements about the unknown future. For example, the belief that you can forecast the future with precision is a common form of overconfidence. Over-optimism leads to overestimating the likelihood of a good outcome and underestimating the likelihood of a bad outcome. Over-optimism and overconfidence are related, but they are not the same thing. An overconfident individual could (overconfidently) forecast a bad outcome, for example. Confirmation bias is a such phenomenon: when you are evaluating a decision, you collect information and opinions. A common bias in this regard is to focus more on information that agrees with your opinion, and to downplay or ignore information that doesn't agree with or support your opinion.

Framing dependence is the tendency of individuals to make different (and potentially inconsistent) decisions, depending on how a question or problem is framed. Loss aversion is also know as the break-even effective, because it frequently shows up as individuals and companies hang on to bad investments and projects, hoping that something will happen that will allow them to break even and thereby escape without a loss. It may seem natural for you to feel that some money is precious, because you earned it through hard work, whereas other money is less precious, because it came to you as a windfall. That is house money effect. But these feelings are plainly irrational, because any cash you have buys the same amount of goods and services.

Heuristics is shortcuts or rules of thumb used to make decisions. And affect heuristic is the reliance on instinct instead of analysis in making decisions.

Market inefficiencies can be difficult for arbitrageurs to exploit because of firm-specific risk, noise trader risk, and implementation costs. All these difficulties limits to arbitrage, and the implication is that some inefficiencies may only gradually disappear, and smaller inefficiencies can persist if they cannot be profitably exploited.

In summary, biases can lead to bad decisions, because they lead to unnecessary poor estimates of future outcomes. Over-optimism, for example, leads to overly favourable estimates and options. Frame dependence leads to narrow framing, which is focusing on the smaller picture instead of the bigger one. The use of heuristics as shortcuts ignores potentially valuable insights that more detailed analysis would reveal.