

Week 2

Overview of corporate governance

Lecture outline

- Corporate firms
- Agency theory
- The governance structure of corporations
- The OECD principles of good governance

Learning outcomes

- Be able to differentiate different types of corporations
- Be able to understand the agency theory
- Gain a basic understanding of the governance structure of corporations
- Understand the OECD principles of good governance

Uber broke laws, duped police and secretly lobbied governments, leak reveals

- More than 124,000 confidential documents leaked to the Guardian
- Files expose attempts to lobby Joe Biden, Olaf Scholz and George Osborne
- Emmanuel Macron secretly aided Uber lobbying in France, texts reveal
- Company used 'kill switch' during raids to stop police seeing data
- Former Uber CEO told executives 'violence guarantees success'

by Harry Davies, Simon Goodley, Felicity Lawrence, Paul Lewis and Lisa O'Carroll

Finance

Factbox: Credit Suisse's scandals - spies, lies and money laundering

Reuters

October 3, 2022 6:57 PM GMT+1 - Updated 10 months ago



Aa



WIRELESS

Ericsson investigates in-house bribery scandal tied to ISIS

By **Monica Allevén** • Feb 16, 2022 12:52pm

Types of corporations

Sole Proprietorship

- Owned and managed by one person
- Very easy to form
- Unlimited liability
- Amount of funding is limited by owner's personal wealth
- Profits taxed as personal income
- Life of company linked to life of owner

Partnership

- Controlled by general partners
- Easy to form
- Requires a partnership agreement
- Difficult to raise cash
- Profits taxed as personal income
- Partnership is terminated when a partner dies or leaves the firm

Limited Corporation

- Board of directors
- Articles and memorandum of incorporation required
- Limited liability
- Profits taxed at corporate tax rate
- Life of company hypothetically unlimited

The Arts and Memos

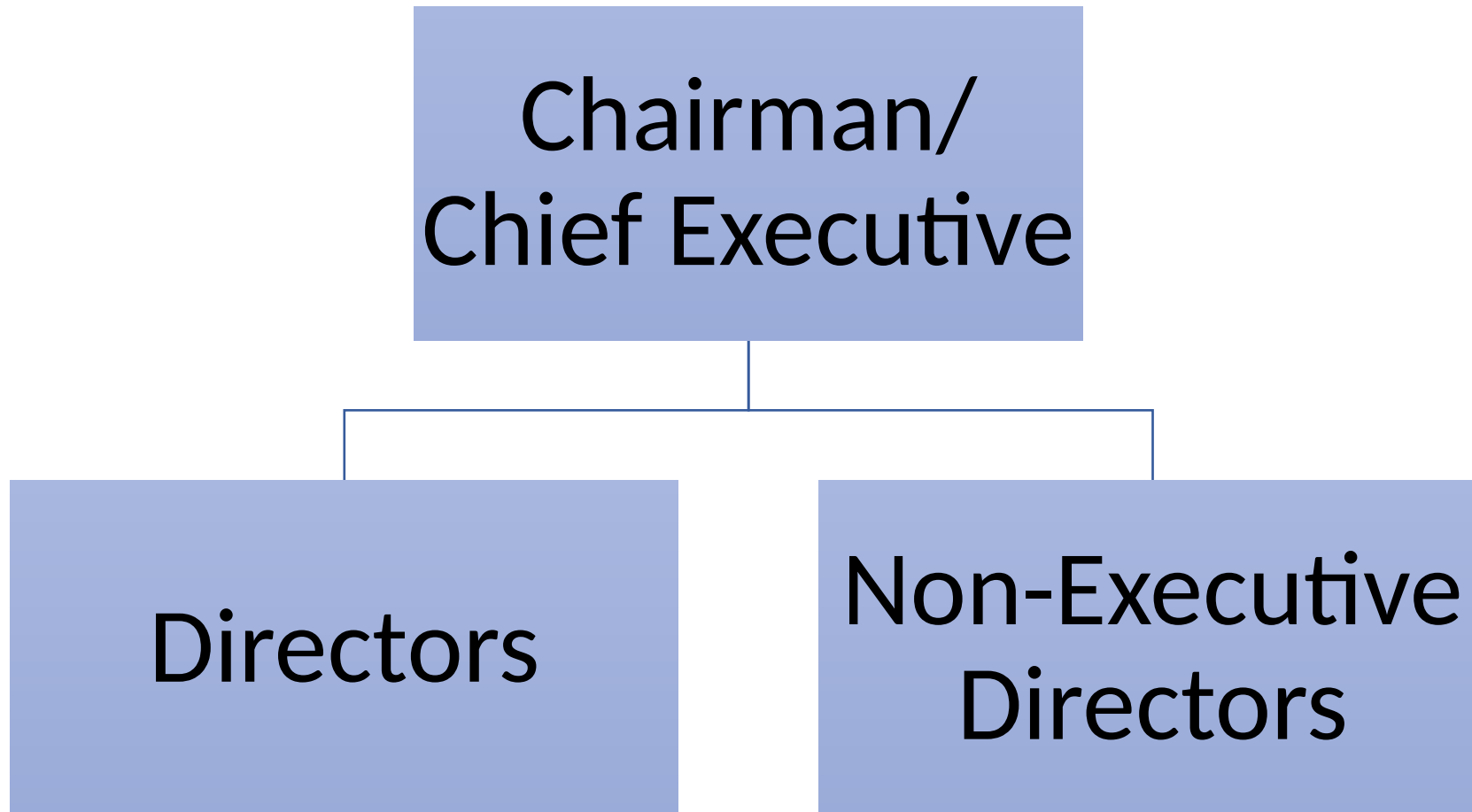
Articles of Incorporation

- Name of the corporation
- Intended life of the corporation (it may be forever)
- Business purpose
- Number of shares that the corporation is authorized to issue, with a statement of limitations and rights of different classes of shares
- Nature of the rights granted to shareholders
- Number of members of the initial board of directors

Memorandum of Association

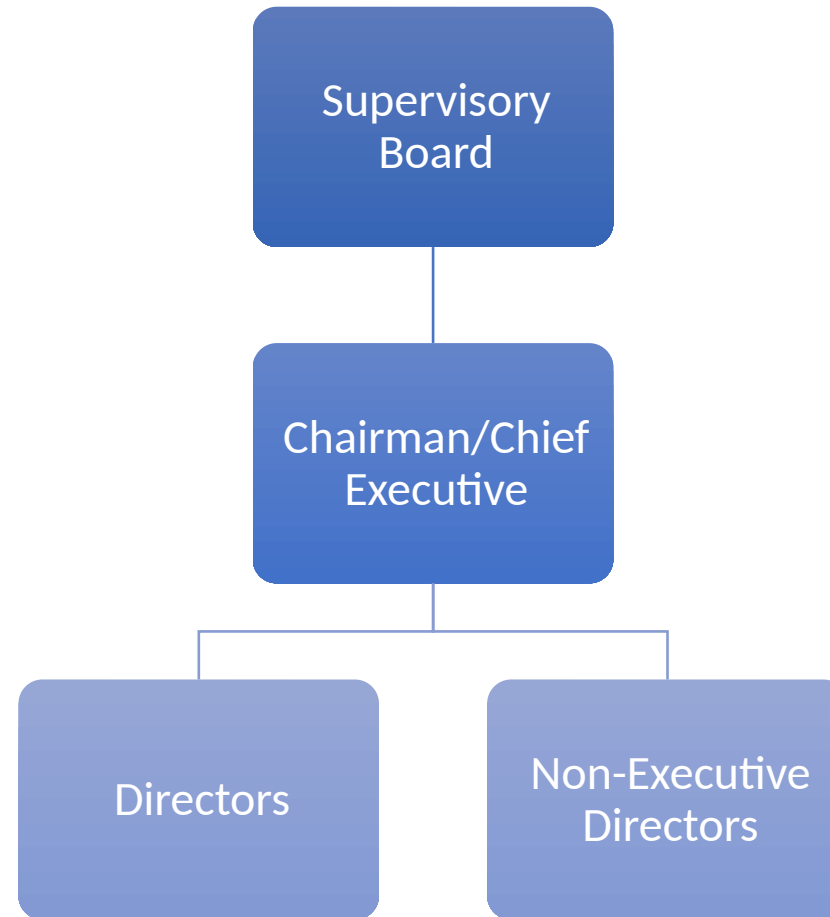
- The rules by which the corporation is organised

The Board of Directors (Single tier)



The Board of Directors (Two tiers)

Implementing
policy



Policymaking

Unitary vs Dual board structures



Unitary

- Board reports to shareholders
- Shareholders elect directors at AGM



Two-Tier

- Board reports to supervisory board
- Supervisory board elects directors
- Supervisory board consists of representatives from banks, government, trade unions, other stakeholders

Partnerships vs Corporations

	Partnership	Corporation
Liquidity and marketability	Restricted trading	Traded easily sometimes on exchange
Voting rights	Partners have control	Each share gives a voting right
Taxation	Personal tax rate	Corporate tax rate
Reinvestment and dividend payout	All profits allocated to partners	Total freedom in dividend decisions
Liability	General partners have unlimited liability	Shareholders have limited liability
Continuity of existence	Limited life	Unlimited life

Corporate governance across countries

- Investor protection
- The financial system
- Control mechanisms
- Firm corporate governance systems

Investor protection: Legal systems

Common law	Civil law
<ul style="list-style-type: none">• Law is developed through court rulings• Flexible and can adjust quickly to events ⇒ “Stronger” protection of outside investors	<ul style="list-style-type: none">• Law is developed through regulation and code of laws• Based on code of principles• Does not change ⇒ “Weaker” protection of outside investors

Investor protection: Shareholder legal protection

- What are the country-level legal rights of shareholders?
- Main characteristics:
 - Proxy vote by mail is allowed
 - Votes are not blocked before the annual general meeting
 - Cumulative voting or proportional representation exists
 - Oppressed minorities mechanisms exist
 - Pre-emptive rights exist
 - There is a minimum percentage to call an extraordinary shareholders' meeting

Investor protection: Law enforcement

- Many countries have strong regulations but very weak enforcement
- To what extent does a government enforce its laws?
- Two issues to consider:
 - The efficiency of the judicial system
 - Is the rule of law and order followed?
- Useful data source: [World Bank's Governance Indicators](#)

Bank- vs Market-based systems

Bank-based systems	Market-based systems
<ul style="list-style-type: none">• Banks are central to the process of moving funds between demanders and suppliers of capital• More active monitoring• Examples: Germany, Japan• Indicators of banking development:<ul style="list-style-type: none">• Bank liquid liabilities/GDP• Bank assets/GDP• Domestic bank deposits/GDP	<ul style="list-style-type: none">• Securities markets are as important and can even be significantly more important• External market discipline• Examples: US, UK• Indicators of market development:<ul style="list-style-type: none">• Market capitalisation/GDP• Total trading volume/GDP

Control mechanisms: Ownership structure

Widely held firms	Closely held firms
<ul style="list-style-type: none">• Separation between ownership and control• Agency issues between managers and shareholders• Exit investment strategies	<ul style="list-style-type: none">• Manager and shareholder incentives aligned• Agency issues between controlling and non-controlling shareholders• Voice investment strategies

Agency theory (1)

- Principal-agent relationship: an agent is hired by a principal to do a job for them
- Managers are hired by shareholders
- Do managers act in the interests of shareholders?
 - Not always the case
 - [Some real-life examples](#)

Agency theory (2)

- Agency problems (agency costs) = conflict of interest that occurs when agents don't fully represent the best interests of principals
 - Hidden action: agents make decisions to maximize their own interests at the expense of the principals' interests without being detected by the principal
 - Hidden information (asymmetric information): agents have access to all available information about the firm while principals typically only receive some summary reports (e.g., annual report) which could be manipulated

Mechanisms to mitigate the agency costs

- Direct managerial/financial incentives
 - Option to buy stock or opportunity for promotion
 - Tie management compensation to market performance, e.g., earning-per-share growth
 - Although incentives can be used to align management and stockholder interests, they need to be structured carefully to make sure that they achieve their intended goal
- Control: if managers perform poorly, they can lose their job
- Two tier systems: trade unions and other groups can make managers act in the interests of stakeholders as well as shareholders

The OECD Principles of Corporate Governance (2015)

- Ensuring the basis for an effective corporate governance framework
- The rights and equitable treatment of shareholders and key ownership functions
- Institutional investors, stock markets, and other intermediaries
- The role of stakeholders in corporate governance
- Disclosure and transparency
- The responsibilities of the board

Ensuring the basis for an effective corporate governance framework

- The corporate governance framework:
 - Should promote transparent and fair markets and the efficient allocation of resources
 - Should be consistent with the rule of law and support effective supervision and enforcement

The rights and equitable treatment of shareholders and key ownership functions

- The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders
- All shareholders should have the opportunity to obtain effective redress for violation of their rights

Institutional investors, stock markets, and other intermediaries

- The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance

The role of stakeholders in corporate governance

- The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises

Disclosure and transparency

- The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company

The responsibilities of the board

- The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders

Board of directors: Real world data