Session 08: Corporate Governance & Organizational Structure & Controls

MGCR 423 Strategic Management

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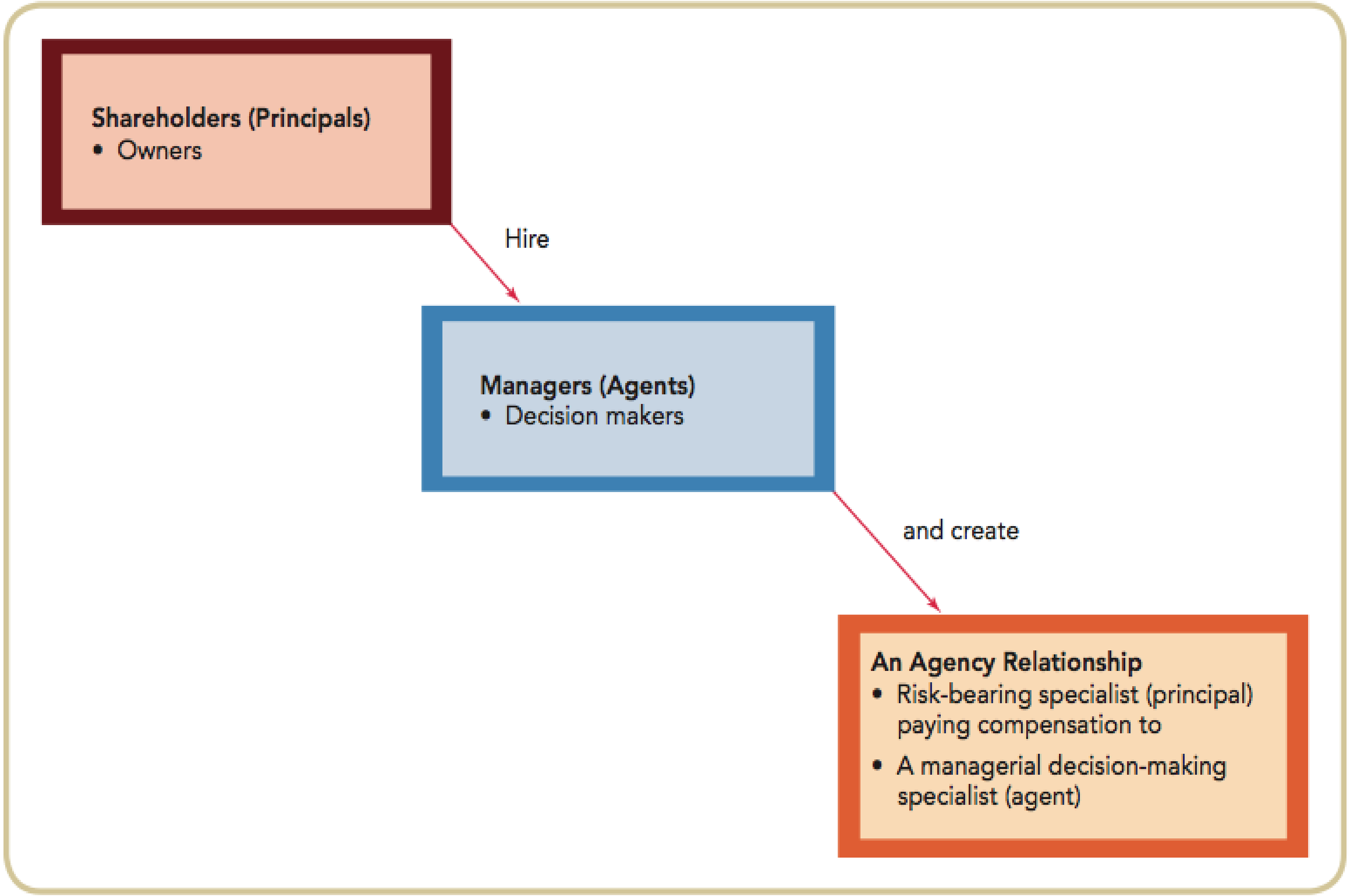
Corporate Governance

- Corporate governance is:
  - the set of mechanisms used to manage relationships among stakeholders and to determine and control the strategic direction and performance of organizations. [can apply to non-profits and foundations]
  - concerned with identifying ways to ensure that strategic decisions are made more effectively. [can apply to non-profits and foundations]
  - used in corporations to establish harmony between the firm's owners and its top-level managers whose interests may be in conflict.

Agency relationship

Figure 10.1 An Agency Relationship



Managerial Opportunism

- The seeking of self-interest with guile (cunning or deceit)
- Managerial opportunism is:
  - an attitude (inclination)
  - a set of behaviors (specific acts of self-interest)
- Managerial opportunism prevents the maximization of shareholder wealth (the primary goal of owner/principals).

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Agency relationship problems

- Principal and agent have divergent interests and goals.
- Shareholders lack direct control of large, publicly traded corporations.
- Agent makes decisions that result in the pursuit of goals that conflict with those of the principal.
- It is difficult or expensive for the principal to verify that the agent has behaved appropriately.
- Agent falls prey to managerial opportunism.

Agency costs and governance mechanisms

- Agency Costs
  - The sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals, because governance mechanisms cannot guarantee total compliance by the agent.

- Principals may engage in monitoring behavior to assess the activities and decisions of managers.
  - However, dispersed shareholding makes it difficult and inefficient to monitor management's behavior.

- Boards of directors have a fiduciary duty to shareholders to monitor management.
  - Board links the organization to its external environment, to secure critical resources and to build prestige and legitimacy (Roche 2008)
  - Board's 3 key functions
    - monitoring the managers' actions on behalf of shareholders
    - advising the managers on strategic direction and key strategic decisions
    - interfacing with stakeholders/ institutions in external environment to help provide legitimacy, expertise and access to critical resources

Ways of addressing problems arising from separation of ownership and managerial control:

- Ownership Concentration
  - Relative amounts of stock owned by individual shareholders and institutional investors.
- Board of Directors
  - Individuals responsible for representing the firm's owners by monitoring
    top-level managers' strategic decisions.
- Executive Compensation
  - The use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests.
- Market for Corporate Control
  - The purchase of a firm that is underperforming relative to industry rivals in order to improve its strategic competitiveness.

Ownership concentration

Ownership Concentration

- Large block shareholders have a strong incentive to monitor management closely
  - Their large stakes make it worth their while to spend time, effort and expense to monitor closely
  - They may also obtain board seats which enhances their ability to monitor effectively
- The increasing influence of institutional owners (stock mutual funds and pension funds):
  - have the size (proxy voting power) and incentive (demand for returns to funds) to discipline ineffective top-level managers.
  - can affect the firm's choice of strategies.
- Shareholder activism
  - Shareholders can convene to discuss corporation's direction
  - If a consensus exists, shareholders can vote as a block to elect their candidates to the board
  - Proxy fights
  - There are limits on shareholder activism available to institutional owners in responding to activists' tactics

Board of Directors

Ownership Concentration

Board of Directors (a)

- Board of directors
  - Group of elected individuals that acts in the owners' interests to formally monitor and control the firm's top-level executives
- Board has the power to:
  - direct the affairs of the organization
  - punish and reward managers
  - protect owners from managerial opportunism

Board of Directors (cont'd)

Ownership Concentration

Board of Directors (b)

- Composition of Boards
  - Insiders: the firm's CEO and other top-level managers.
  - Related Outsiders: individuals uninvolved with day-to-day operations, but who have a relationship with the firm.
    - non-independent
    - Affiliated directors (e.g. suppliers, including banks, legal, accounting services); Ex-officers or ex CEO; Family members
  - Outsiders: individuals who are independent of the firm's day-to-day operations and other relationships.
    - no significant financial or other tie to corporation

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Board of Directors (cont'd)

Ownership Concentration

Board of Directors (c)

- Criticisms of Boards of Directors
  - Too readily approve managers' self-serving initiatives
  - Exploited by managers with personal ties to board members
  - Not vigilant enough in hiring and monitoring CEO behavior
  - Lack of agreement about the number of and most appropriate role of outside directors

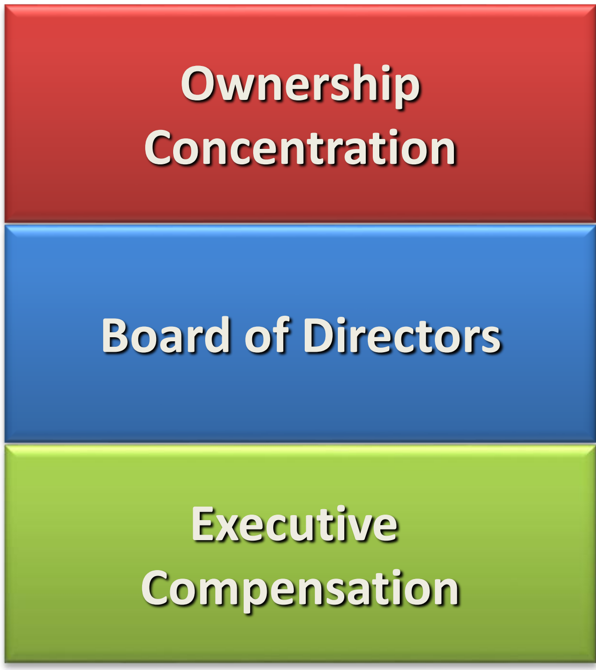
Board of Directors (cont'd)

Ownership Concentration

Board of Directors (d)

- Enhancing the effectiveness of boards and directors
  - More diversity in the backgrounds of board members
  - Stronger internal management and accounting control systems
  - More formal processes to evaluate the board's performance
  - Adopting a "lead director" role
  - Changes in compensation of directors.

Executive Compensation



- Forms of compensation
  - Salaries, bonuses, long-term performance incentives, stock awards, stock options
- Factors complicating executive compensation
  - Strategic decisions by top-level managers are complex, non-routine and affect the firm over an extended period
  - Other variables affecting the firm’s performance over time

Market for Corporate Control

- Ownership Concentration
- Board of Directors
- Executive Compensation
- Market for Corporate Control

- Individuals and firms buy or take over undervalued firms
  - Ineffective managers are usually replaced in such takeovers.
- Threat of takeover may lead firm to operate more efficiently
- Changes in regulations have made hostile takeovers difficult

Organizational controls

- Purposes of organizational controls
  - Guide the use of strategy
  - Indicate how to compare actual results with expected results
  - Suggest corrective actions to take when the difference between actual and expected results is unacceptable
- Two types of organizational controls
  - Strategic controls
  - Financial controls

Organizational controls

- Strategic Controls: Subjective criteria
  - Concerned with examining the fit between:
    - what the firm *might do* (opportunities in its external environment).
    - what the firm *can do* (competitive advantages).
  - Evaluate the degree to which the firm focuses on the requirements to implement its strategy

Organizational controls

- Financial Controls: Objective criteria
  - Accounting-based measures
    - Return on investment
    - Return on assets
  - Market-based measures
    - Economic Value Added (EVA)

Matching control to strategy

- Relative use of controls varies by type of strategy.
  - Large diversified firms using a <u>cost leadership</u> strategy emphasize <u>financial controls</u>.
  - Firms and business units using a <u>differentiation</u> strategy emphasize <u>strategic controls</u>.

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Organizational structure

- Organizational structure specifies:
  - the firm's formal reporting relationships, procedures, controls, and authority and decision-making processes
  - the work to be done and how to do it, given the firm's strategy or strategies.
- It is critical to match organizational structure to the firm's strategy.

Evolutionary patterns of structure and organizational structure

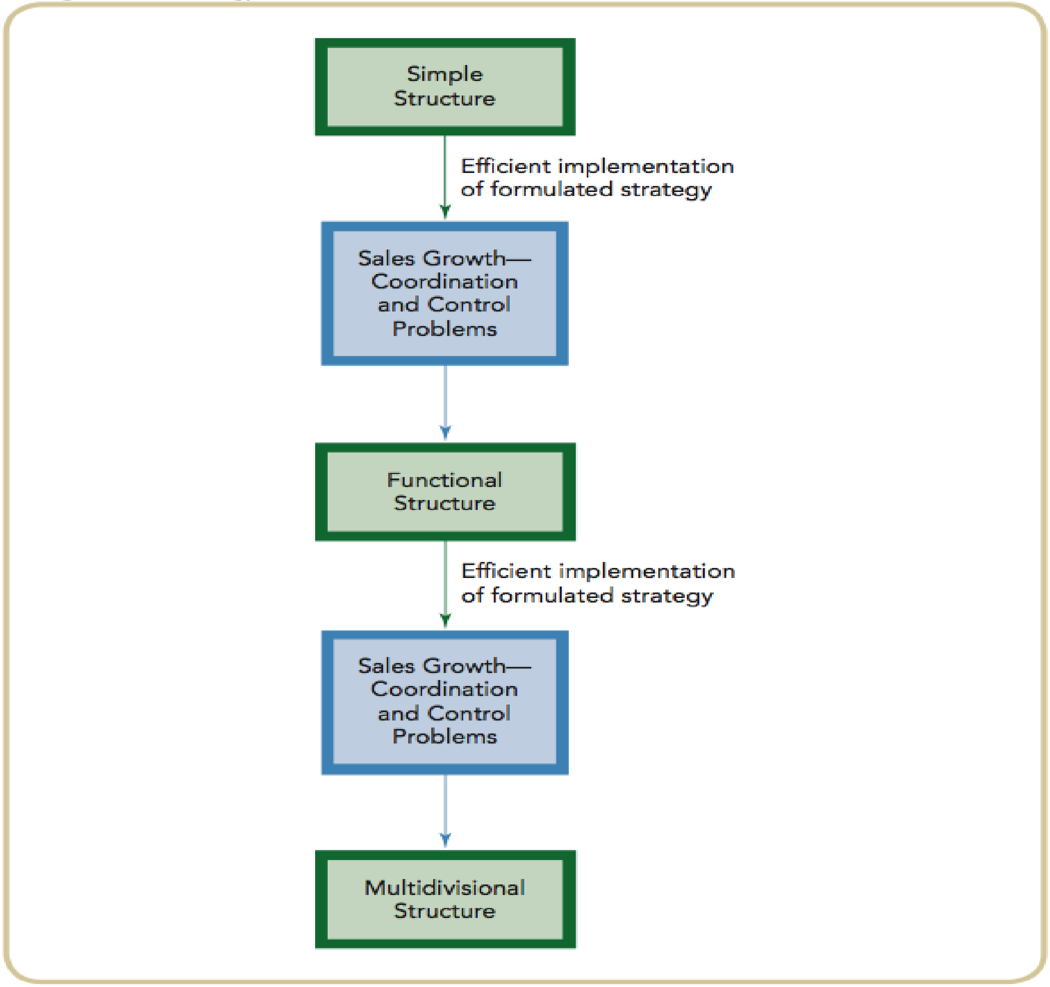
- All organizations require some form of organizational structure to implement and manage their strategies.

- Firms frequently alter their structure as they grow in size and complexity.

- Three basic structure types
  - Simple structure
  - Functional structure
  - Multidivisional structure (M-form)

Strategy and structure growth pattern

Figure 11.1 Strategy and Structure Growth Pattern



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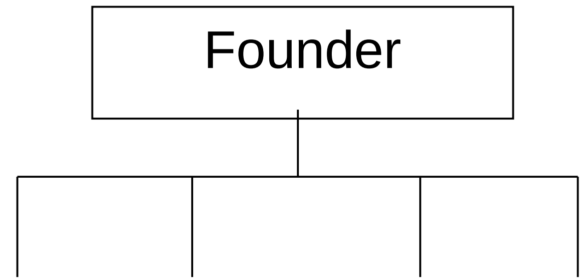
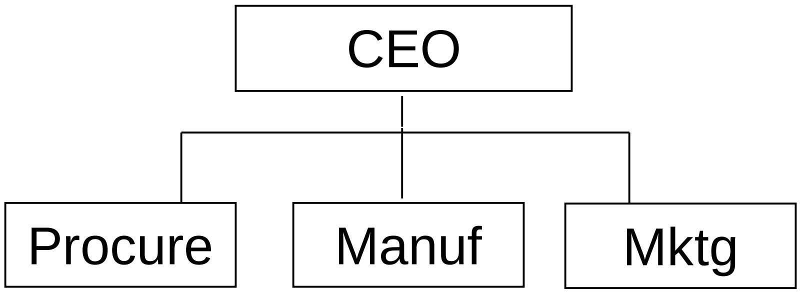
Strategy and structure: Simple structure

- Owner-manager
  - Makes all major decisions directly
  - Monitors all activities
- Staff
  - Serves as an extension of the manager's supervisor authority
- Matched with focus strategies and business-level strategies
  - Commonly complete by offering a single product line in a single geographic market



Strategy and structure: Functional structure

- Chief Executive Officer (CEO)
  - Limited corporate staff
- Functional line managers in dominant organizational areas of:
  - production
  - marketing
  - engineering
  - human resources
  - accounting
  - R&D
- Supports use of business-level strategies and some corporate-level strategies
  - Single or dominant business with low levels of diversification



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Strategy and structure: Multidivisional structure

- Strategic Control
  - Operating divisions function as separate businesses or profit centers.
- Top corporate officer delegates responsibilities to division managers:
  - for day-to-day operations.
  - for business-unit strategy.
- Appropriate as firm grows through diversification
- Three Major Benefits
  1. Corporate officers are able to more accurately monitor the performance of each business, which simplifies the problem of control.
  2. Facilitates comparisons between divisions, which improves the resource allocation process.
  3. Stimulates managers of poorly performing divisions to look for ways of improving performance.