**BUS 499, Week 8: Corporate Governance**

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| **Slide #** | **Topic** | **Narration** |
| 1 | Introduction | Welcome to Senior Seminar in Business Administration.  In this lesson we will discuss Corporate Governance.  Please go to the next slide. |
| 2 | Objectives | Upon completion of this lesson, you will be able to:  Describe how corporate governance affects strategic decisions.  Please go to the next slide. |
| 3 | Supporting Topics | In order to achieve these objectives, the following supporting topics will be covered:  Separation of ownership and managerial control;  Ownership concentration;  Board of directors;  Market for corporate control;  International corporate governance; and  Governance mechanisms and ethical behavior.  Please go to the next slide. |
| 4 | Separation of Ownership and Managerial Control | To start off the lesson, **corporate governance** is defined as a set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organizations. Corporate governance is concerned with *identifying ways to ensure that decisions* *are made effectively* and that they *facilitate strategic competitiveness*. Another way to think of governance is to *establish* and *maintain* harmony between parties.  Traditionally, U. S. firms were managed by founder- owners and their descendants. As firms became larger the *managerial revolution* led to a separation of ownership and control in most large corporations. This control of the firm shifted from *entrepreneurs* to *professional* managers while ownership became dispersed among unorganized stockholders. Due to these changes modern public corporation was created and was based on the *efficient separation of ownership and managerial control*.  The separation of ownership and managerial control allows shareholders to purchase stock. This in turn entitles them to income from the firm’s operations after paying expenses. This requires that shareholders *take a risk* that the firm’s expenses may exceed its revenues.  Shareholders specialize in managing their investment risk. Those managing small firms also own a significant percentage of the firm and there is often less separation between ownership and managerial control. Meanwhile, in a large number of family owned firms, ownership and managerial control *are not separated at all*. The primary purpose of most large family firms is to *increase the family’s wealth*.  The separation between owners and managers creates an *agency* *relationship***.** An agency relationship exists when one or more persons hire another person or persons as *decision- making specialists* to perform a service. As a result an agency relationship exists when one party delegates decision- making responsibility to a second party for compensation. Other examples of agency relationships are *consultants* and *clients* and *insured* and *insurer*. An agency relationship can also exist between managers and their employees, as well as between top- level managers and the firm’s owners.  The separation between ownership and managerial control can be *problematic*. Research has shown a variety of agency problems in the modern corporation. Problems can surface because the principal and the agent have *different interests* and *goals*. Problems also surface when an agent makes decisions that result *in pursuing goals that conflict with those of the principals*.  **Managerial opportunism** is the seeking of self- interest with guile. *Opportunism* is both an attitude and a set of behaviors. Principals do not know beforehand which agents will or will not act opportunistically. As a result, principals establish governance and control mechanisms to prevent agents from acting opportunistically. The agency relationship suggests that any time principals delegate decision- making responsibilities to agents; the *opportunity for conflicts of interest exists*.  The potential conflict between shareholders and top- level managers shown along with the fact that principals cannot easily predict which managers might act opportunistically, demonstrates why principals *establish governance mechanisms*. However, the firm incurs costs when it uses one or more governance mechanisms. **Agency costs** are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals.  Please go to the next slide. |
| 5 | Ownership Concentration | **Ownership concentration** is defined by the number of *large- block shareholders* and *the total percentage of the firm’s shares they own.* *Large- block shareholders* typically own at least five percent of a company’s issued shares. However, in recent years, the number of individuals who are large- block shareholders has *declined*. *Institutional owners* have replaced individuals as large- block shareholders.  Ownership of many modern corporations is now concentrated in the hands of *institutional investors* rather than *individual shareholders*. **Institutional owners** are financial institutions such as *mutual funds* and *pension funds* that control large- block shareholder positions. Due to these prominent owner-ship positions, institutional owners, as large- block shareholders, have the potential to be a *powerful governance mechanism*. Research has shown that *institutional* and *other* *large- block shareholders* are becoming more active in their efforts to influence a *corporation’s strategic decisions*. This is unless they have a business relationship with the firm.  Please go to the next slide. |
| 6 | Board of Directors | *Shareholders* elect the members of a firm’s board of directors. The **board of directors** is a group of elected individuals whose primary responsibility is to act in the owners’ best interests by formally monitoring and controlling the firm’s top- level managers. Those elected to a firm’s board of directors are expected to *oversee managers* and ensure that the corporation operates in ways that will best serve the *stakeholders*’ and *owners’* interests. Evidence has shown however that boards have *not been highly effective in monitoring and controlling top- level managers’ decisions and subsequent actions*.  In addition to their monitoring role, board members increasingly are expected to *provide resources to the firms they serve*. These resources might include personal knowledge, expertise or relationships with a wide variety of organizations. Generally, board members are classified into one of three groups. **Insiders** are active top- level managers in the company who are elected to the board because they are a source of information about the firm’s day- to-day operations. **Related outsiders** have some relationship with the firm that may create questions about their independence. However, these individuals are not involved with the corporation’s day- to- day activities. **Outsiders** provide independent counsel to the firm and may hold top- level managerial positions in other companies or may have been elected to the board prior to the beginning of the current CEO’s tenure.  A situation in which an individual holds both the CEO and chair of the board title is called **CEO duality**. Yet, having a board that actively monitors top- level managers’ decisions and actions does *not ensure high performance*. The value that the directors bring to the company also influences the outcomes. Having a large number of outside board members can also create some problems. Outsiders can, however, obtain valuable information through frequent interactions with inside board members and during board meetings to enhance their understanding of managers and their decisions. Because they work with and lead the firm daily, insiders have access to information that facilitates forming and implementing appropriate strategies. Evidence shows that boards with a *critical mass of insiders* typically are better informed about intended strategic initiatives, the reasons for the initiatives, and the outcomes expected from pursuing them.  Because of the importance of boards of directors in corporate governance and as a result of increased scrutiny from shareholders, the performances of individual board members and of entire boards are being evaluated more *formally* and with *greater intensity*. The demand for *greater accountability* and *improved performance* is stimulating many boards to voluntarily make changes. Some of these changes in clued the following:  Increase in the diversity of the backgrounds of board members;  Strengthening of internal management and accounting control systems;  Establishing and consistently using formal processes to evaluate the board’s performance;  Modifying the compensation of directors; and  Creating the lead director role.  Please go to the next slide. |
| 7 | Board of Directors, continued | The compensation of top- level managers, and especially of CEOs, generates a great deal of interest and strongly held opinions. Some believe that top- management team members and certainly CEOs have a great deal of responsibility for a firm’s performance and that they should be rewarded accordingly. On the other hand some think that these individuals are greatly overpaid and that their compensation is not as strongly related to firm performance. There are three internal governance mechanisms that seek to deal with these issues. **Executive compensation** is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long- term incentives. **Long- term incentive plans** are an increasingly important part of compensation packages for top- level managers, especially those leading U. S. firms. Using long- term incentives facilitates the firm’s efforts to avoid potential agency problems by linking managerial compensation to the wealth of common shareholders. **Effectively designed long- term incentive plans** have the potential to prevent large- block stockholders from pressing for changes in the composition of the board of directors and the top- management team. Effectively using executive compensation as a governance mechanism is particularly challenging for firms implementing international strategies.  As an *internal governance mechanism*, executive compensation is complicated. The strategic decisions top- level managers make are *complex* and *nonroutine*, meaning that direct supervision is likely to be *ineffective* as a means of judging the quality of their decisions. The result is a tendency to *link* top- level managers’ compensation to *outcomes* the board can easily evaluate. Another issue is that the effects of top- level man-agers’ decisions are *stronger* on the firm’s *long- term* than its *short- term* performance. This makes it hard to assess the effects of their decisions on a regular basis. Lastly, a number of other factors affect a firm’s performance besides top- level managerial decisions and behavior. *Unpredictable changes in segments* in the firm’s general environment can make it difficult to separate out the effects of top- level managers’ decisions and the effects of changes in the firm’s performance. Properly designed and used incentive compensation plans for top- level managers may increase the value of a firm in line with shareholder expectations, but such plans are subject to managerial manipulation.  Please go to the next slide. |
| 8 | Market for Corporate Control | The **market for corporate control** is an external governance mechanism that is active when a firm’s internal governance mechanisms fail. The market for corporate control is composed of *individuals* and *firms* that buy ownership positions. They may also purchase potentially undervalued corporations for the purpose of *forming new divisions* in *established companies* or *merging two separate firms*. An effective market for corporate control ensures that *ineffective or opportunistic* top- level managers are *disciplined*.  **A hedge fund** is a fund that can pursue many different investment strategies such as the following:  Taking long and short positions;  Using arbitrage; and  Buying and selling undervalued securities for the purpose of maximizing investors’ returns.  **Activist pension funds**, on the other hand, are *reactive* in nature, taking actions when they conclude that a firm is underperforming. In contrast**, activist hedge funds** are *proactive*, identifying a firm whose performance could be *improved* and then *investing* in it. You could say that *hedge funds* are better at identifying *undervalued companies*, *locating potential acquirers for them*, and *removing opposition to a takeover*.  Please go to the next slide. |
| 9 | Market for Corporate Control, continued | Hostile takeovers are the major activity in the market for corporate governance mechanism. Not all hostile takeovers are prompted by poorly performing targets, and firms targeted for hostile takeovers may use multiple defense tactics to fend off the takeover attempt. Historically, the increased use of the market for corporate control has enhanced the sophistication and variety of managerial defense tactics that are used to reduce the influence of this governance mechanism.  The table on the slide lists a number of defense strategies.  Please go to the next slide. |
| 10 | International Corporate Governance | Corporate governance is an increasingly important issue in economies around the world, including *emerging economies*. The globalization of trade, investments, and equity markets increases the *potential value* of firms using similar mechanisms to govern corporate activities. Because of globalization, major companies want to *attract foreign investment*. This occurs when foreign investors are *confident* that adequate corporate governance mechanisms are in place to protect their investments. *Recognizing* and *understanding* differences in various countries’ governance systems along with *noting changes* taking place within those systems improves the chances that a firm will be able to compete successfully in the international markets.  In many private German firms, the owner and manager may be the same individual. In these instances, *agency problems* are not present. Even in publicly traded German corporations, a single shareholder is *often dominant*. Traditionally banks occupied the *center of the German corporate governance system*. This is the case in other European countries as well. German firms with more than two thousand employees are required to have a *two- tiered board structure* that places the responsibility for monitoring and controlling managerial decisions and actions in the hands of a *separate group*. All the functions of strategy and management are the responsibility of the *management board*; however, appointment to the board is the responsibility of the *supervisory tier.* Corporate governance practices used in Germany are changing. A manifestation of these changes is that a number of German firms are beginning to gravitate toward *U. S. governance mechanisms*. German firms with listings on U. S. stock exchanges have increasingly adopted *executive stock option compensation* as a long- term incentive pay policy.  The concepts of *obligation*, *family*, and *consensus* affect attitudes toward corporate governance in Japan. In Japan, an *obligation* may be to return a service for one rendered or it may derive from a more general relationship. As part of a *company family*, individuals are *members of a unit* that envelops their lives. Many critics however believe that relationships like this slow decision making. *Consensus*, another important influence in Japanese corporate governance, calls for the expenditure of significant amounts of energy to win the hearts and minds of people whenever possible. Consensus is *highly valued*, even when it results in a slow and cumbersome decision- making process. Like in Germany, *banks* in Japan have an important role in *financing* and *monitoring* large public firms. The main bank has the closest relationship with a firm’s top-level managers because it owns the largest share of stocks and holds the largest amount of debt. The main bank provides *financial advice* to the firm and also closely *monitors* managers. Due to this, Japan has a *bank- based financial* and *corporate governance structure* whereas the United States has a *market- based financial* and *governance structure*.  China has a unique and *large*, *socialist*, *market- oriented economy*. The government has done much to improve the corporate governance of listed companies. The corporate governance practices in China are changing and the country is experiencing increasing *privatization of businesses* and the *development of equity markets*. However, the stock markets in China remain young and underdeveloped. There has been a gradual decline in China in the *equity* held in state owned enterprises. However the number and percentage of private firms has grown, but the state still relies on *direct and/ or indirect controls* to influence firms. Some research has suggested that corporate governance in China may be moving toward the *Western model*. Corporate governance in Chinese companies will continue to evolve and interact to form governance mechanisms that are best for their nation, business firms, and citizens.  Please go to the next slide. |
| 11 | Governance Mechanisms and Ethical Behavior | The three internal and single external governance mechanisms are designed to ensure that the agents of the firm’s owners make strategic decisions that best serve the *interests of all stakeholders*. In the United States, *shareholders* are commonly recognized as the company’s most significant stakeholders. Top- level managers however are expected to lead their firms in ways that will also serve the *needs of product market stakeholders* and *organizational stakeholders*. As a result, the firm’s actions and the outcomes should result in at *least minimal satisfaction* of the interests of all stakeholders. Without achieving a minimal satisfaction of its interests, an unsatisfied stakeholder will withdraw their support from the firm and provide it to another.  The *decisions* and *actions* of the board of directors can be an *effective deterrent* to unethical behaviors by top- level managers. Research suggests that the most effective boards *set boundaries for their firms’ business ethics and values*. Once the boundaries for ethical behavior are determined the *board’s ethics- based expectations* must be clearly communicated to the firm’s top- level managers and to other stakeholders. As agents of the firm’s owners, *top- level managers* must understand that the board, acting as an *internal governance mechanism*, will hold them fully accountable for developing and supporting an organizational culture in which ethical behaviors are permitted. Through *effective* governance, top- level managers are able to help their firm select and use strategies with a high probability of resulting in strategic competitiveness and earning above- average returns.  Please go to the next slide |
| 12 | Check Your Understanding |  |
| 13 | Summary | We have reached the end of this lesson. Let’s take a look at what we have covered.  First, we discussed separation of ownership and managerial control. We defined corporate governance as a set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organizations. We learned that originally U. S. firms were managed by founder- owners and their descendants. It wasn’t until firms became larger that the managerial revolution led to a separation of ownership and control in most large corporations. We saw that the separation of ownership and managerial control allows shareholders to purchase stock. We later discussed the importance of managing investment risk and agency relationships. We also took a closer look at some issues that may arise from the separation between ownership and managerial control.  Next, we went over ownership concentration. We saw that ownership concentration is defined by the number of large- block shareholders and the total percentage of the firm’s shares they own. We noted that large- block shareholders typically own at least five percent of a company’s issued shares. We also learned that the ownership of many modern corporations are now concentrated in the hands of institutional investors rather than individual shareholders.  Then we looked at the board of directors. We saw that shareholders elect the members of a firm’s board of directors. The board of directors has the responsibility to act in the owners’ best interests by formally monitoring and controlling the firm’s top- level managers. In addition to their monitoring role, board members increasingly are expected to provide resources to the firms they serve. We went over some various types of resources and three group classifications of board members. We then talked about changes that are trying to be implemented to enhance board member accountability as well as compensation of top-level managers and CEOs.  Later we focused our attention on the market for corporate control. We saw that the market for corporate control is an external governance mechanism that is active when a firm’s internal governance mechanisms fail. We noted that the market for corporate control is composed of individuals and firms that buy ownership positions. We later talked about different types of funds such as a hedge fund. We also discussed the occurrence of hostile takeovers and defense strategies.  We then discussed international corporate governance. We looked at German, Japanese, and Chinese corporation structure along with how they function. We noted different characteristics of each and gained a better understanding of how each country completes its business.  Finally to conclude the lesson we looked at governance mechanisms and ethical behavior. We learned about three internal and one external governance mechanisms that are designed to ensure that the agents of the firm’s owners make strategic decisions that best serve the interests of all stakeholders.  This completes this lesson. |