An Overview of Key Corporate Governance Concept

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Abstract

Corporate governance is a set of mechanisms that ensure the controllers (management) of the firm who have the decision-making authority make well- informed and prudent decisions that will lead to maximizing the value of the firm and/or the returns for the owners (providers of finance).

The literature review of seminal papers in corporate governance in the field of economics and finance has identified the important concepts to understand in order to the field of corporate governance. In this paper, fundamental concepts of corporate governance have been examined relating to: agency theory; contracts; management discretion; role of the board of directors; executive compensation; agency costs; private and shared benefits of control; debt versus equity; shareholder and creditor rights; legal protection and investors; concentrated ownership and large investors; consequent ownership; and control implications.

Corporate governance is fundamentally based on the concept of separation of ownership and control in firms. There are, however costs incurred in the monitoring of the agency relationship as management seeks to protect and increase their flow of rewards from private benefits of control. The most effective governance structure for corporations will have to be one which provides sufficient protection of dispersed minority shareholder rights. Further research and refining of the corporate governance mechanisms and the interrelationships between them can lead a firm to devise an optimal firm-specific governance model. This will enable increased investment in value-enhancing projects with a resultant increase in firm valuation and/or the returns to the owners.

Introduction

The fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment: the suppliers of finance to corporations need the managers to return some of the profits to them; they need to ensure that managers do not steal the capital they supply or invest in bad projects. Corporate governance thus refers to the manner in which suppliers of finance control managers (Shleifer & Vishny, 1997).

Corporate governance is a set of mechanisms that ensure the controllers (management) of the corporation, who have the decision-making authority, make well-informed and prudent decisions that will lead to maximizing the value of the firm and/or returns for the owners (providers of finance) (Denis & McConnell, 2003).

Key Concepts in Corporate Governance

A literature review of seminal papers by leading academic scholars in the area of corporate governance in the discipline of economics and finance leads to the description of concepts integral to the enforcement of corporate governance systems and codes in countries around the world. In this paper, fundamental concepts of corporate governance have been examined relating to: agency theory; contracts; management discretion; role of the board of directors; executive compensation; agency costs; private and shared benefits of control; debt versus equity; shareholder and creditor rights; legal protection and investors; concentrated ownership and large investors; consequent ownership; and control implications such as tunnelling via pyramid structures.

Agency Theory and Related Concepts

According to Ross (1973, p. 134), '... an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems'.

Jensen and Meckling (1976, p. 5) have defined an agency relationship as 'a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent'. The agent may not always act in the best interests of the principal. The principal has to thus offer incentives to the agent and incur monitoring costs in trying to limit the agent's activities.

In other words, there is separation of ownership and control. Much of agency theory as related to corporations is set in the context of separation of ownership and control as described in the 1932 work of Berle and Means. In this context, the agents are the managers and the principals are the shareholders, and this is the most commonly cited agency relationship in the corporate governance context. However, the agency relationship can also cover various other relationships including those of company and creditor and of employer and employee (Mallin, 2010).

Contracts

The financiers and the manager sign a contract that specifies what the manager does with the funds, and how the returns are divided between him and the financiers. Ideally a complete contract should be signed which takes into account all possible scenarios and outcomes. However, as it is impossible to foresee and describe most future contingencies, a complete contract is not feasible. Due to the problems in designing a contract, the manager and the financier have to allocate residual control rights, that is, the rights to make decisions in circumstances not fully foreseen by the contract. As a consequence, the manager ends up with substantial residual control rights and, therefore, discretion to allocate funds as he chooses. Much of corporate governance deals with the limits on this discretion as specified in the contract (Shleifer & Vishny, 1997).

Management Discretion

The business judgement rule prevents the courts from interfering too much in the running of a firm unless it an outright and serious fraud or violation of rights. Due to the free rider problem faced by smaller and more dispersed investors, investors do not make an effort to inform themselves about the firm and do not participate in the governance of the firm. Due to these restrictions or inhibitions on contract enforcement, managers end up with far more control and discretion over the allocation and use of funds (Shleifer & Vishny, 1997).
As managers end up with significant control rights (discretion) over allocation of investors' funds, the problem of managerial theft becomes significant. This can take more elaborate forms than just taking the cash out, such as selling the output and even the assets of the company to firms owned by managers at significantly discounted prices. Managers can also misuse investor funds by consumption of perquisites such as plush carpets and company planes which are not as costly to investors as when managers reinvest free cash flows into pet projects that benefit them rather than the investors (Jensen, 1986). These benefits can be described as the *private benefits of control* (Grossman & Hart, 1988).

Thus, to a great extent, corporate governance deals with 'constraints that managers put on themselves, or that investors put on managers, to reduce the ex post misallocation and thus induce investors to provide more funds ex ante' (Shleifer & Vishny, 1997, p. 742).

Agency Costs

The potential problems of the separation of ownership and control were identified in the eighteenth century by Smith (1843, p. 331), 'the directors of such companies [joint stock companies] however being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance [as if it were their own]'.

Corporate governance is looked at from an agency perspective by Shleifer and Vishny (1997). The essence of the agency problem is the separation of management (the agent) and the providers of finance (the principal) in the context of separation of ownership and control. The owners, being the suppliers of finance and control, being exercised by the managers in putting the funds to productive use, in order to generate a return on the funds provided by the owners. 'The agency problem in this context refers to the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects' (Shleifer & Vishny, 1997, p. 741).

There is a considerable amount of evidence that has documented the prevalence of managerial behaviour that does not serve the interests of investors, particularly shareholders. Managerial investment decisions may reflect their personal interests rather than those of the investors. In his free cash flow theory, Jensen (1986) argues that managers choose to reinvest the free cash flow rather than return it to investors. As per Jensen (1986) the worst agency problems occur in firms with poor investment opportunities and excess cash. There is evidence pointing to the dominance of managerial rather than shareholder motives in firms' acquisition decisions.

Even clearer evidence of agency problems is revealed by the studies that focus on managers directly threatened with the loss of private benefits of control. Walking and Long (1984, as cited in Denis & McConnell, 2003) find that management resistance to value-increasing takeovers is less likely when top managers have a direct financial interest in the deal going through via share ownership or golden parachutes, or when top managers are more likely to keep their jobs. Evidence suggests that managers resist takeovers to protect their private benefits of control rather than to serve shareholders. Poor managers who resist being replaced and stay on in jobs even if they are no longer competent or qualified to run the firm, is the costliest manifestation of the agency problem (Jensen & Ruback, 1983; Shleifer & Vishny, 1989).

There is also a great deal of evidence that control is valued. The evidence on the voting premium in Israel (45.5 per cent) (Levy, 1982, as cited in Shleifer & Vishny, 1997) and Italy (82 per cent) (Zingales, 1994, as cited in Shleifer & Vishny, 1997) suggest that agency costs must be very large in some countries. It indicates that managers in these countries have significant opportunities to divert profits to themselves and not share them with nonvoting shareholders (Zingales, 1994; Barca, 1995, as cited in Shleifer & Vishny, 1997).

Mitigating Agency Costs

Corporate governance mechanisms provide shareholders with some assurance that managers will strive to achieve outcomes that are in the shareholders' interests (Shleifer & Vishny, 1997). Shareholders have available both internal and external governance mechanisms to help bring the interests of the managers in line with their own (Walsh & Seward, 1990, as cited in Daily, Dalton, & Canella Jr, 2003). Internal mechanisms include an effectively structured board, compensation contracts that encourage a shareholder orientation and concentrated ownership holdings that lead to active monitoring of executives. The market for corporate control serves as an external mechanism that is typically activated when internal mechanisms for controlling managerial opportunism have failed.

Executive Compensation

Due to incomplete contracts and due to the fact that managers possess more inside knowledge than shareholders, managers typically end up with the residual rights of control, giving them numerous opportunities for self-interested behaviour. This usually results in highly inefficient actions which cost investors far more than the personal benefits to the managers (Shleifer & Vishny, 1997).

In order to align the manager's interests with those of the investors, the manager should be granted a long-term incentive contract dependant on clear goals to be accomplished for the advancement of the firm (Shleifer & Vishny, 1997). Incentive contracts can be offered in various forms such as share ownership, stock options or a threat of dismissal if performance is not up to par (Fama, 1980; Jensen & Meckling, 1976).

The problem with incentive contracts is that they create opportunities for managers

to serve only their interests, especially if their contracts are negotiated with a poorly informed board of directors rather than with large investors. Managers are able to manipulate accounting numbers and investments in projects in order to increase their compensation (Shleifer & Vishny, 1997).

Board of Directors

Corporations in most countries of the world have boards of directors. In the Anglo-US model, the board of directors is specifically charged with representing the interests of shareholders. The board exists primarily to hire, fire, monitor and compensate management, all with an eye towards maximizing shareholder value. The primary board-related issues that have been studied in the US are board composition and executive compensation. Board compensation characteristics of interest include the size and structure of the board: the number of directors that comprise the board, the fraction of these directors that are outsiders, and whether the CEO and chairperson are held by the same individual. Executive compensation research is fundamentally concerned with the degree to which managers are compensated in ways that align their interests with those of their companies' shareholders (Denis & McConnell, 2003).

Hermalin and Weisbach (2000) summarize the US evidence as follows: (1) Higher proportions of outside directors are not associated with superior firm performance, but are associated with better decisions concerning such issues as acquisitions, executive compensation, and CEO turnover. (2) Board size is negatively related to both general firm performance and the quality of decision-making. (3) Poor firm performance, CEO turnover, and changes in ownership structure are often associated with changes in the membership of the board.

Wymeersch (1998, as cited in Denis & McConnell, 2003) details the makeup of European boards of directors. As the role of the board of directors has not been prescribed in law, shareholder wealth maximization has not only been the only—or even necessarily the primary—goal of the board of directors. In some European countries, boards are two—tiered. Two-tiered boards generally consist of a managing board, composed of executives of the firm, and a supervisory board. In Germany, representation of employees on the supervisory board, termed co-determination, is mandatory.

Boards that represent varied stakeholder interests instead of only serving shareholder wealth maximization objectives are actually shown to negatively affect the financial performance of a corporation. It is also shown to reduce the entrepreneurship of the board and management of the corporation leading to reduced risk taking resulting in foregoing possibly profitable investment opportunities. This in turn contributes to reduced levels of profit for the corporation (see, for example, Milton & Raviv, 1990; Myers, 1977; (Shleifer & Summers, 1988)Shleifer & Summers, 1988).

Skill- Set of Directors from Different Professions and Risk-Taking Behaviour

We posit that an area of future research is the skill-set of directors from various professions, such as lawyers and entrepreneurs—especially in relation to their risk-taking behaviour. Directors from different professions may have differing levels of risk averseness. They differ in their attitude to risk-taking. For example, lawyers may be

more risk-averse than accountants, with entrepreneurs being more tolerant of higher levels of risk. As a result of their training, lawyers may be aware of more facets involved in decision-making, probably pertaining to exposure to potential liabilities which could make them conservative in their approach to decision-making and risk-taking as they seek to minimize the risk from exposure to potential liabilities. With a focus on compliance with regulations imposed by various industry regulatory bodies, lawyers and accountants may be more risk-averse by nature.

Entrepreneurs, by nature, are risk-takers and are usually experts in their field with extensive knowledge of an industry or sector. They may be more willing to take up business opportunities when they arise or explore investment opportunities with a view to expansion of the business; these attributes may flow on to their standpoints and levels of risk averseness as directors.

Investment bankers, being more focused on investment strategy and firm performance, are liable to be less risk-averse by nature. Their main aim is to increase shareholder value through increases in the share prices of the firm and by maintaining or increasing the dividend stream to shareholders. Hence they tend to be more aggressive in pursuing investment opportunities to maximize shareholder wealth. It is posited that commercial bankers are more risk-averse than investment bankers, because directors' fiduciary responsibilities extend beyond shareholders to depositors and to regulators as well.

There is vast existing literature on directors serving on boards with occupations as diverse as investment bankers, commercial bankers, insurance executives, academics, consultants, business executives and professional directors. They use their diverse experience and specialized skills in the setting of corporate strategy and the effective governance of the firm (see, for example, Agrawal & Chadha, 2005; Akhigbe & Martin, 2008; B. Baysinger & Hoskisson, 1990; B. D. Baysinger & Butler, 1985; Beasley, 1996; Bhagat & Black, 1999; Booth & Deli, 1999; Dionne & Triki, 2005;A Guner, Malmendier, & Tate, 2008; B. Guner, Malmendier, & Tate, 2004; Kang, Cheng, & Gray, 2007; Kesner, 1988; Klein, 1998; Lawrence & Stapledon, 1999; Lee, Rosenstein, & Wyatt, 1999).

Contractual Mechanisms

There are specific contractual mechanisms used to address the agency problem through which investors are assured of obtaining a return on their investment (Shleifer & Vishny, 1997).

Debt Governance

The debt contract can be a mechanism for solving agency problems. The defining feature of debt is the ability of creditors to exercise control. Specifically, debt is a contract in which a borrower gets some funds from the lender, and promises to make a pre-specified stream of future payments to the lender. In addition, the borrower typically promises not to violate a range of covenants (Smith & Warner, 1979, cited in Shleifer & Vishny, 1997), such as maintaining the value of assets inside the firm. If the borrower violates any covenant, and especially if he defaults on a payment, the lender gets certain rights, such as the ability to repossess some of the firm's assets (collateral) or the opportunity to throw the firm into bankruptcy.

There are, however, costs and benefits of the debt contract. The benefit is usually the reduction in the agency cost, such as preventing the manager from investing in negative net present value projects. The main costs of debt are that firms may be prevented from undertaking good projects because debt covenants keep them from raising additional funds, or else they may be forced by creditors to liquidate when it is not efficient to do so (Shleifer & Vishny, 1997).

Equity Governance

Unlike creditors, individual shareholders are not promised any payments in return for their financial investment in the firm, although often they receive dividends at the discretion of the board of directors. Unlike creditors, individual shareholders have no claim to specific assets of the firm, and have no right to claim back the collateral. Unlike creditors, shareholders do not even have a final date at which the firm is liquidated and the proceeds are distributed. In principle, they may never get anything back at all (Shleifer & Vishny, 1997).

The principal right that equity holders typically get is the right to vote for the board of directors. However, having multiple classes of common stock can dilute this control right as equity holders with inferior voting rights get proportionately fewer votes than their financial investment in the company. Because concerted action by a large group of shareholders is required to take control via the voting mechanism, voting rights are of limited value unless they are concentrated. However when votes are concentrated, they become extremely valuable, since the party that controls the concentrated votes can make virtually all corporate decisions. Concentrated equity in this respect is more powerful than concentrated debt (Shleifer & Vishny,1997).

Equity ownership by insiders can align insiders' interests with those of the other shareholders, thereby leading to better decisions and/or higher firm value. Insiders are defined as the officers and directors of a firm. However, higher ownership by insiders may result in a greater degree of managerial control, potentially entrenching managers. Similarly, the greater control that block holders have by virtue of their equity ownership positions may lead them to take actions that increase the market value of the firm's shares, benefiting all shareholders. These are the *shared benefits of control*. A block holder is any entity that owns at least 5 per cent of the firm's equity. However, that same control can provide block holders with *private benefits*, that is, benefits that are not available to other shareholders. The private benefits enjoyed by block holders potentially reduce observed firm value (Holderness, 2002, cited in Denis & McConnell, 2003).

Legal/Regulatory System

The view that securities are inherently characterized by some intrinsic rights is incomplete. It ignores the fact that these rights depend on the legal rules of the jurisdictions in which securities are issued. Law and the quality of its enforcement are potentially important determinants of what rights security holders have and how well these rights are protected (Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998).

LaPorta, Lopez-de-Silanes, Shleifer and Vishny (1998) have hypothesized in their seminal paper *Law and Finance* that the extent to which a country's laws protect investor rights—and the extent to which those laws are enforced—are fundamental

determinants of the ways in which corporate finance and corporate governance evolve in that country. The differences in legal protection of investors might help explain why firms are financed and owned so differently in different countries. In countries with a code of civil law as opposed to common law, the protection of minority shareholders is not effective and so there has been less impetus for a broad shareholder base.

The civil legal tradition is the oldest, the most influential, and the most widely distributed around the world. It originates in Roman law, uses statutes and comprehensive codes as a primary means of ordering legal material, and relies heavily on legal scholars to ascertain and formulate its rules (Merryman, 1969, cited in Porta, et al., 1998). Legal scholars typically identify three currently common families of laws within the civil-law tradition: French, German, and Scandinavian. The common-law family includes the law of England and those laws modelled on English law. The common law is formed by judges who have to resolve specific disputes. Precedents from judicial decisions, as opposed to contributions from scholars, shape common law. Common law has spread to the British colonies and is practiced in the United States, Canada, Australia, India, and many other countries (Porta, et al., 1998).

A comparison of the two legal systems is provided by Wessel (2001, cited in Mallin, 2010), who states that common law countries, which includes former British colonies, rely on independent judges and juries and legal principles supplemented by precedent-setting case law, which results in greater flexibility, whilst in civil-law countries, which include much of Latin America, judges often are life-long civil servants who administer legal codes packed with specific rules, which hinders them in their ability to cope with change. In countries with a civil law system, there is therefore more codification but weaker protection of rights, hence there is less encouragement to invest (Mallin, 2010).

Concentrated Ownership

If legal protection does not give enough control rights to small investors to induce them to part with their money, then investors can gain more effective control rights by being large. When control rights are concentrated in the hands of a small number of investors, then collective action by these large investors is more effective in getting results than the action of many smaller and more dispersed investors. In effect, concentration of ownership leverages up legal protection. Concentrating ownership thus can address the agency problem (Shleifer & Vishny, 1997).

Large Shareholders

The most direct way to align cash flow and control rights of outside investors is to concentrateshare holdings. Large shareholders have the incentive to collect information and monitor management, thereby avoiding the free rider problem. They have sufficiently large voting rights to put pressure on the management and perhaps even remove the management through a takeover (Shleifer & Vishny 1986b cited in Shleifer & Vishny, 1997). Large shareholders thus address the agency problem in that they both have a general interest in profit maximization, and enough control over the assets of the firm to have their interest's respected (Shleifer & Vishny, 1997).

Large Creditors

Significant creditors, such as banks, are also large and potentially active investors. Like the large shareholders, they have large investments in the firm, and want to see the returns on their investments materialize. Their power comes in part of a variety of control rights they receive when firms default or violate debt covenants (Smith & Warner 1979 cited in Shleifer & Vishny, 1997) and in part because they typically lend short term, so borrowers have to come back at regular, short intervals for more funds.

Porta et al. (1998), in their study measuring the average and the median ownership stake of the three largest shareholders for each country in the study for its ten largest publicly traded companies, show that, in the world as a whole, the average ownership of the three largest shareholders is 46 per cent, and the median is 45 per cent. Dispersed ownership in large public companies is simply a myth. On that basis, if smaller companies were examined, the concentration of ownership would be even larger. The finance textbook model of management faced by multitudes of dispersed shareholders is an exception and not the rule.

Ownership and Control Costs as a Consequence of Concentrated Ownership

Highly concentrated ownership can potentially lead to an equity agency conflict between dominant shareholders and minority shareholders (Porta, et al., 1998). Controlling shareholders can extract value from the firm by way of *tunnelling*, defined by Johnson, Porta, Lopez-de- Silanes and Shleifer (2000) as transfers of assets and profits out of firms for the benefit of those who control them. Tunnelling is prevalent in firms in which excess control rights are achieved by *pyramid ownership structures*. In a pyramid structure, one firm owns 51 per cent (for example) of a second firm, which owns 51 per cent of a third firm, and so on. The owner at the end of the pyramid thereby has effective control of all of the firms in the pyramid, with an increasingly small investment in each firm down the line. The controlling shareholder can extract value from the firms that are farther down the line by transferring resources of those lower-level companies to the firms that are higher in the pyramid. This can be done in a variety of ways, for example by selling goods from higher-level firms to lower-level firms at inflated prices, or by selling goods from lower-level firms to higher-level firms at below-market prices (Denis & McConnell, 2003).

The results of the study by Porta et al. (1998) show that the quality of legal protection of shareholders helps determine ownership concentrations, accounting for the higher concentration of ownership in the French-civil-law countries. Higher concentrated ownership results from, and perhaps substitutes for, weak protection of investors in a corporate governance system. Weak laws actually make a difference and may have costs. One of the costs of heavily concentrated ownership in large firms is that their core investors are not diversified and hence bear excessive risk. The other cost is that these firms probably face difficulty raising equity finance, since minority investors fear expropriation by managers and concentrated owners.

Conclusion

The literature review of seminal papers in corporate governance in the field of economics and finance has described the important concepts of which a critical understanding is required in approaching the study of the field of corporate governance.

Corporate governance is fundamentally based on the concept of separation of ownership and control in corporations: in other words, between the providers of finance who are the ultimate owners of the firm and the management who are entrusted with the able deployment of investor funds in order to earn sufficient return to compensate them for the risk they take as investors. The theory of contracts underlies this basic concept as it describes the duties and rights of both the parties in the governance of the firm. The resultant concept of management discretion highlights the need for the presence of the board of directors to protect the interest of the shareholders and the creditors by the effective oversight of management actions. The concept of executive compensation then describes the incentives required to align the interests of the managers and the owners in the proper and efficient investment of funds to maximize the value of the firm.

There are, however, costs incurred in the monitoring of the agency relationship as management seeks to protect and increase their flow of rewards from private benefits of control. Management entrenchment threatens to divert resources from the owners to the managers through poor investment choices and the consumption of perquisites. The voting premium highlights the value attached to control and the extent to which managers are able to divert resources to their own ends.

The governance arrangements to mitigate these agency problems are in the form of the debt contract and equity ownership. The attendant control rights that are acquired by the creditors and the shareholders allow them to ensure a return on their investment and to curtail diversion of firm resources into unproductive value-reducing activities by the management. However, the control rights of the shareholders and the creditors are only effective in controlling management actions if the legal environment protects their rights and allows the effective exercise of these rights in securing a return on their investment in the firm.

When the legal environment is not adequate in protecting the rights of the dispersed minority shareholders, then concentration of control rights in the form of large shareholdings or block holdings allows them to exercise effective control over management in protecting their rights.

However, there is ongoing debate about the effectiveness of concentrated ownership being a solution to address agency problems. It is an imperfect solution as there arises a potential for an agency conflict between the minority shareholder and the block holders as the block holders seek to divert firm resources for their private benefit at the expense of the minority shareholders. This is achieved through a variety of methods such as tunnelling—for example through pyramid ownership structures—leading to control rights in excess of cash flow rights. Concentrated ownership also has costs associated with it because owners' risks are not diversified and firms with concentrated owners also face difficulty raising equity finance since minority investors fear expropriation by managers and concentrated owners.

The most effective governance mechanism for corporations will have to be one which provides sufficient protection of dispersed minority shareholder rights. Some dispersion of ownership is desirable to diversify risk. Another effective governance mechanism which could be implemented is the two-tier board structure as practiced in European countries. This would take into account other stakeholder interests in the corporation as well and not just have shareholder wealth maximization as its key objective. However it is debatable if the implementation of such board structures will be encouraged in Australia because share price increases and the associated dividend streams remain the foremost concern of corporations; dividend stream assure shareholders of returns on their investment in the corporation.

Further research and refinement of the corporate governance mechanisms and the interrelationships between them can lead a firm to devise an optimal firm-specific governance model. This will enable increased investment in value-enhancing projects with a resultant increase in firm valuation and/or the returns to the owners.

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