Corporate Governance

CHAPTER 2

During the hacking scandal that engulfed British society in 2011, News International – the company at the centre of the storm – was in the midst of a takeover attempt of BSkyB, the satellite media firm, to buy the remaining 61 per cent of equity that it didn't own. Although the British government gave permission for News International to proceed with the takeover, it was highly controversial with many commentators believing that a fully owned BSkyB would be a dangerous monopoly with too much power in global media.

BSkyB and News International already had a fairly complex and intertwined ownership structure before the takeover attempt. News International Ltd was a wholly owned (100 per cent) subsidiary of News Corporation. BSkyB's major shareholder (39.14 per cent) was News UK Nominees Ltd, who itself was a wholly owned (100 per cent) subsidiary of News Corporation.

Outside the offices of News International on Pennington Street, London, UK

Source: © Michael Kemp / Alamy

Who owns News Corporation? A look at the company's financial accounts shows that the largest shareholder is Cede & Co., which is a company that holds shares on behalf of another person, family, brokerage firm or investment fund. The nominated shareholder in News Corporation's case is the Murdoch Family Trust and they owned 1 per cent of Class A Shares (no votes per share) and 38.4 per cent of Class B Shares (these have votes per share). So, although the Murdoch Family Trust owned only 12 per cent of the total shares in News Corporation, because of the differential voting rights, they had effective control of the company.

Further evidence of Murdoch dominance in News Corporation was the membership of the various boards of the firm. Rupert Murdoch was the chairman and chief executive officer of the group and his son, James, was chairman and chief executive office of the firm's European and Asian arm. James Murdoch was also chairman of BSkyB, the target of the takeover.

Does this information matter to how a company is run and the decisions it makes? Many people believe that it definitely does matter. By indirectly controlling News Corporation and BSkyB, the Murdoch family has enormous power in the flow of information through the media. This could drive decision-making at the firms directly and indirectly controlled by the Murdoch family. Moreover, the media hacking scandal of 2011 fully illustrated the power of ownership and corporate governance on firm value and decisions. Although the Murdoch family had no direct involvement in the hacking itself, they were severely tarnished by the scandal and all firms that were indirectly linked to the family saw very large share price falls during the hacking controversy.

As a result of the events of 2011, News Corporation had to postpone its takeover of BSkyB. Elisabeth Murdoch, the daughter of Rupert Murdoch, who sold her media company, Shine, to News Corporation, was expected to join the parent company's board but was unable to do so. Finally, both Rupert and James Murdoch were forced by other shareholders to step down from the board of News International as a result of the scandal.

This News Corporation case illustrates many issues relating to corporate governance: ownership, board structure, family firms, voting rights and dual class shares. In this chapter we cover all these topics and more.

2.1 The Corporate Firm

A firm is a way of organizing the economic activity of many individuals. A basic problem faced by a firm is how to raise cash. The corporate form of business – that is, organizing the firm as a corporation – is the standard method for solving problems encountered in raising large amounts of cash. However, businesses can take other forms. In this section we consider the three basic legal forms of organizing firms, and we see how firms go about the task of raising large amounts of money under each form.

The Sole Proprietorship

A **sole proprietorship** is a business owned by one person. Suppose you decide to start a business to produce bagpipes. Going into business is simple: you announce to all who will listen, 'Today, I am going to build better bagpipes.'

A sole proprietorship is the most common form of business structure in the world. From London to Dar Es Salaam, from Bangkok to Amsterdam, from Bahrain to Madrid, you will see people doing their business in the streets and roadsides. These are all businesses owned by one person. Possibly, you, the reader, may come from a family that has a sole proprietorship business.

In many countries, you need a business licence to run a sole proprietorship but it is also common for sole proprietorships to be set up without any paperwork. Once started, a sole proprietorship can hire as many people as needed and borrow whatever money is required. At year-end, all the profits and losses will belong to the owner and this becomes his or her annual income.

Here are some factors that are important in considering a sole proprietorship:

1. The sole proprietorship is the cheapest business to form. No formal charter, articles or memoranda of association are required. Very few government regulations must be satisfied for most industries.
2. A sole proprietorship pays no corporate income taxes. All profits of the business are taxed as individual income.
3. The sole proprietorship has unlimited liability for business debts and obligations. No distinction is made between personal and business assets. This means that if a sole proprietorship owes money to creditors and cannot pay, the owner's own possessions must be used to pay off the firm's debts.
4. The life of the sole proprietorship is limited by the life of the owner of the firm.
5. Because the only money invested in the firm is the proprietor's, the cash that can be raised by the sole proprietor is limited to the proprietor's own personal wealth.

Example 2.1

JonMac Builders

JonMac Builders is a Glasgow building contractor, owned as a sole proprietorship by John McAfee. Started in 1987 by a fresh-looking 24-year-old with his own savings, John leased a small van for £200, used his own tools, and began working on jobs garnered through word of mouth. The firm still exists as a sole proprietorship and now has four employees, all family members. All income from the company's activities is taxed at John's income tax rate and the firm's liabilities are secured by John's personal assets, such as his house.

The Partnership

Any two or more people can get together and form a **partnership**. Partnerships fall into two categories: (1) general partnerships and (2) limited partnerships.

In a *general partnership* all partners agree to provide some fraction of the work and cash and share the profits and losses of the firm. Each partner is liable for the debts of the partnership.

A partnership agreement specifies the nature of the arrangement. The partnership agreement may be an oral agreement or a formal document setting forth the understanding.

Limited partnerships permit the liability of some of the partners to be limited to the amount of cash each has contributed to the partnership. Limited partnerships usually require that (1) at least one partner be a general partner, and (2) the limited partners do not participate in managing the business. Here are some things that are important when considering a partnership:

1. Partnerships are usually inexpensive and easy to form. Written documents are required in complicated arrangements, including general and limited partnerships. Business licences and filing fees may be necessary.
2. General partners have unlimited liability for all debts. The liability of limited partners is usually limited to the contribution each has made to the partnership. If one general partner is unable to meet his or her commitment, the shortfall must be made up by the other general partners.
3. The general partnership is terminated when a general partner dies or withdraws (but this is not so for a limited partner). It is difficult for a partnership to transfer ownership without dissolving. Usually all general partners must agree. However, limited partners may sell their interest in a business.
4. It is difficult for a partnership to raise large amounts of cash. Equity contributions are usually limited to a partner's ability and desire to contribute to the partnership. Many companies start life as a sole proprietorship or partnership, but at some point they choose to convert to corporate form.
5. Income from a partnership is taxed as personal income to the partners.
6. Management control resides with the general partners. Usually a majority vote is required on important matters, such as the amount of profit to be retained in the business.

It is difficult for large business organizations to exist as sole proprietorships or partnerships. The main advantage to a sole proprietorship or partnership is the cost of getting started. Afterward, the disadvantages, which may become severe, are (1) unlimited liability, (2) limited life of the enterprise, and (3) difficulty of transferring ownership. These three disadvantages lead to (4) difficulty in raising cash.

The Corporation

Of the forms of business enterprises, the **corporation** is by far the most important. It is a distinct legal entity. This means that a corporation can have a name and enjoy many of the legal powers of natural persons. For example, corporations can acquire and exchange property. Corporations can enter contracts and may sue and be sued. For jurisdictional purposes the corporation is a citizen of its country of incorporation (it cannot vote, however).

Starting a corporation is more complicated than starting a proprietorship or partnership. The incorporators must prepare articles of incorporation and a memorandum of association (the terms differ from country to country but the general requirements are the same). The articles of incorporation must include the following:

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

The memorandum of association contains the rules to be used by the corporation to regulate its own existence, and they concern its shareholders, directors and officers. The rules can range from the briefest possible statement of rules for the corporation's management to hundreds of pages of text.

A corporation will normally start off as a private limited corporation, in which the shares of the firm are not permitted to be traded or advertised in the public arena. The directors of the company will very likely also be the major shareholders. Private limited companies are usually very small with employees ranging between three and several thousand. Families are regularly the major shareholders in private limited companies.

In closely held corporations with few shareholders, there may be a large overlap among the shareholders, the directors and the top management. However, in larger corporations, the shareholders, directors and the top management are likely to be separate groups. At this point, the corporation will comprise three sets of distinct interests: the shareholders (the owners), the directors and senior management, and the firm's stakeholders (e.g. lenders, employees, local community).

The senior executives of a corporation make up the board of directors. On the board, someone will have the chairperson's role, and be responsible for ensuring that the interests of shareholders are actively considered in corporate decision-making. The chairperson is the most senior member of a corporation and leads all general meetings of the firm. The chief executive officer is the most senior manager of the corporation and is in ultimate charge of the day-to-day running of the firm. In many companies, the same person takes on the role of both chief executive and chairperson (see the opening vignette). The board also has other directors, and these are made up of two distinct categories. Executive directors are senior managers that work in the company on a day-to-day basis and non-executive directors are independent and are not involved in management. Non-executives usually attend monthly board meetings and will be individuals with significant business experience and possible political importance.

In countries (e.g. Belgium, Ireland, Italy, Portugal, Spain, Sweden, the UK and US) with single-tier, or unitary, board structures, the shareholders control the corporation's direction, policies and activities. The shareholders elect the board of directors, who in turn select top management. Members of top management serve as corporate officers and manage the operations of the corporation in the best interest of the shareholders.

In countries with two-tier board structures, a corporation's executive board (that is made up of directors and senior management) report to, and is elected by, a supervisory board which may consist of major shareholders, creditors, trade union representatives, major lenders and other important stakeholders. There are no non-executive directors on the executive board since the supervisory board has the responsibility of monitoring the actions of executive directors. Countries with two-tier boards include Austria, Denmark, Germany and the Netherlands. Countries where both unitary and two-tier boards can exist include Finland, France, Norway and Switzerland. However, things are never straightforward and there will always be country-specific differences. Belgium, for example, has a unitary board system but banks and insurance companies are allowed to have two-tier board structures.

The potential separation of ownership from management gives the corporation several advantages over sole proprietorships and partnerships:

1. Because ownership in a corporation is represented by shares of equity, ownership can be readily transferred to new owners. Because the corporation exists independently of those who own its shares, there is no limit to the transferability of shares as there is in partnerships.
2. The corporation has unlimited life. Because the corporation is separate from its owners, the death or withdrawal of an owner does not affect the corporation's legal existence. The corporation can continue on after the original owners have withdrawn.
3. The shareholders' liability is limited to the amount invested in the ownership shares. For example, if a shareholder purchased €1,000 in shares of a corporation, the potential loss would be €1,000. In a partnership, a general partner with a €1,000 contribution could lose the €1,000 plus any other indebtedness of the partnership.

Limited liability, ease of ownership transfer and perpetual succession are the major advantages of the corporation form of business organization. These give the corporation an enhanced ability to raise cash.

There is, however, one great disadvantage to incorporation. Many countries tax corporate income in addition to the personal income tax that shareholders pay on dividend income

Table 2.1

	Corporation	Partnership
Liquidity and marketability	Shares can be exchanged without termination of the corporation. Shares can be listed on a stock exchange.	Shares are subject to substantial restrictions on transferability. There is usually no established trading market for partnership shares.
Voting rights	In single-tier board structures, usually each share of equity entitles the holder to one vote per share on matters requiring a vote and on the election of the directors. Directors determine top management.	Some voting rights by limited partners. However, general partners have exclusive control and management of operations.
Taxation	Corporations may have double taxation: corporate income is taxable, and dividends to shareholders are also taxable. Each country has its own approach to how it deals with double taxation and may give a full or partial rebate on the corporate tax payment.	Partnerships are not taxable. Partners pay personal taxes on partnership profits.
Reinvestment and dividend payout	Corporations have broad latitude on dividend payout decisions.	Partnerships are generally prohibited from reinvesting partnership profits. All profits are distributed to partners.
Liability	Shareholders are not personally liable for obligations of the corporation.	Limited partners are not liable for obligations of partnerships. General partners may have unlimited liability.
Continuity of existence	Corporations may have a perpetual life.	Partnerships have limited life.

Table 2.1 A Comparison of Partnerships and Corporations

they receive. Although there are normally tax rebates given to shareholders, this is, in effect, a double taxation when compared to taxation on sole proprietorships and partnerships. Table 2.1 summarizes our discussion of partnerships and corporations.

A Corporation by Another Name . . .

The corporate form of organization has many variations around the world. The exact laws and regulations differ from country to country, of course, but the essential features of public ownership and limited liability remain. These firms are often called *joint stock companies*, *public limited companies* or *limited liability companies*, depending on the specific nature of the firm and the country of origin.

Table 2.2 gives the names of a number of corporate abbreviations, their countries of origin, a translation of the abbreviation, and a description of its meaning.

2.2 The Agency Problem and Control of the Corporation

We have seen that the financial manager acts in the best interests of the shareholders by taking actions that increase the value of the company's equity. However, in many large corporations, particularly in the UK, Ireland and the US, ownership can be spread over a huge number of shareholders. This dispersion of ownership arguably means that management effectively controls the firm. In this case, will management necessarily act in the best interests of the shareholders? Put another way, might not management pursue its own goals at the shareholders' expense?

A different type of problem exists in many European firms. Whereas large British and American firms have a dispersed ownership structure, many businesses in Europe have a dominant shareholder with a very large ownership stake. Primarily, these shareholders are family

Table 2.2

Type of Corporation	Country of Origin	In Original Language	Description
Pty Ltd.	Australia	Proprietary Limited	Private Limited
Limited	Australia	Limited	Publicly Listed
AG	Austria, Germany	Aktiengesellschaft	Publicly Listed
GmbH	Austria, Germany	Gesellschaft mit Beschränkter Haftung	Private Limited
NV	Belgium, Netherlands	Naamloze Venootschap	Publicly Listed
BV	Belgium, Netherlands	Besloten Vennootschap	Private Limited
SA	Belgium, France, Luxembourg, Portugal, Spain	Société Anonyme/Sociedade Anónima	Publicly Listed
AD	Bulgaria	акционерно дружество	Publicly Listed
OOD	Bulgaria	дружество с ограничена отговорност	Private Limited
股份有限公司	China Mainland	股份有限公司	Publicly Listed
有限公司	China Mainland	有限公司	Private Limited
ApS	Denmark	Anpartsselkab	Private Limited
A/S	Denmark	Aktieselskab	Publicly Listed
SE	European Union	Societas Europaea	Publicly Listed
Oy	Finland	Osakeyhtiö	Private Limited
Oyj	Finland	Julkinen Osakeyhtiö	Publicly Listed
AB	Finland, Sweden	Aktiebolag	Private Limited
Abp	Finland	Publikt Aktiebolag	Publicly Listed
SARL	France, Luxembourg	Société à Responsibilité Limitée	Private Limited
Ltd	Hong Kong	Limited	Private/Public
Pvt. Ltd	India	Private Limited Company	Private Limited
Plc	India, Ireland, Thailand, UK	Public Limited Company	Publicly Listed
Srl	Italy	Società a Responsabilità Limitata	Private Limited
SpA	Italy	Società per Azioni	Publicly Listed
AS	Norway	Aksjeselskap	Private Limited
ASA	Norway	Allmennaksjeselskap	Publicly Listed
OOO	Russia	Общество с ограниченной ответственностью	Private Limited
AO	Russia	Акционерное общество	Publicly Listed
(Pty) Ltd	South Africa	Privaat Maatskappy	Private Limited
LTD	South Africa	Publieke Maatskappy	Publicly Listed
S.L.	Spain	Sociedad Limitada	Private Limited
Ltd	Ireland, UK, US	Limited	Private Limited
Inc., Corp.	US	Incorporated, Corporation	Publicly Listed

Table 2.2 International Corporations

groups, banks or governments. In firms with a dominant shareholder (see, for example, the News Corporation vignette at the beginning of this chapter), it is possible that corporate objectives will be directed by only one individual or group at the expense of other, smaller, shareholders. In this case, managers are acting in the interests of only a subset of the company's owners.

The issues we have discussed above are caused by what we call agency relationships. In the following pages, we briefly consider some of the arguments relating to this issue.

Type I Agency Relationships

The relationship between shareholders and management is called a Type I agency relationship. Such a relationship exists whenever someone (the principal) hires another (the agent) to represent his or her interests. For example, you might hire a company (the agent) to sell a car you own while you are away at university. In all such relationships, there is the possibility there may be a conflict of interest between the principal and the agent. Such a conflict is called a Type I agency problem.

Suppose you did hire a company to sell your car and agree to pay a flat fee when the firm sells the car. The agent's incentive in this case is to make the sale, not necessarily to get you the best price. If you offer a commission of, say, 10 per cent of the sales price instead of a flat fee, then this problem might not exist. This example illustrates that the way in which an agent is compensated is one factor that affects agency problems.

Management Goals

To see how management and shareholder interests might differ, imagine that the firm is considering a new investment. The new investment is expected to favourably impact the share value, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the share value will rise), but management may not because there is the possibility that things will turn out badly and management jobs will be lost. If management do not take the investment, then the shareholders may lose a valuable opportunity. This is one example of a Type I agency cost.

In general, an *agency cost* is the cost of a conflict of interest between shareholders and management (we will consider later another agency relationship between controlling and minority shareholders). These costs can be indirect or direct. An indirect agency cost is a lost opportunity, such as the one we have just described.

Direct agency costs come in two forms. The first type is a corporate expenditure that benefits management but costs the shareholders. Perhaps the purchase of a luxurious and unneeded corporate jet would fall under this heading. The second type of direct agency cost is an expense that comes from the need to monitor management actions. Paying outside auditors to assess the accuracy of financial statement information could be one example.

It is sometimes argued that, left to themselves, managers would tend to maximize the amount of resources over which they have control or, more generally, corporate power or wealth. This goal could lead to an overemphasis on corporate size or growth. For example, sometimes management are accused of overpaying to acquire another company just to increase the business size or to demonstrate corporate power. Obviously, if overpayment does take place, such a purchase does not benefit the shareholders of the purchasing company.

Our discussion indicates that management may tend to prioritize organizational survival to protect job security. Also, executives may dislike outside interference, so independence and corporate self-sufficiency may be important managerial goals.

Do Managers Act in the Shareholders' Interests?

Whether managers will, in fact, act in the best interests of shareholders depends on two factors. First, how closely are management goals aligned with shareholder goals? This question relates, at least in part, to the way managers are compensated. Second, can managers be replaced if they do not pursue shareholder goals? This issue relates to control of the firm. As we will discuss, there are a number of reasons to think that even in the largest firms, management has a significant incentive to act in the interests of shareholders.

Managerial Compensation

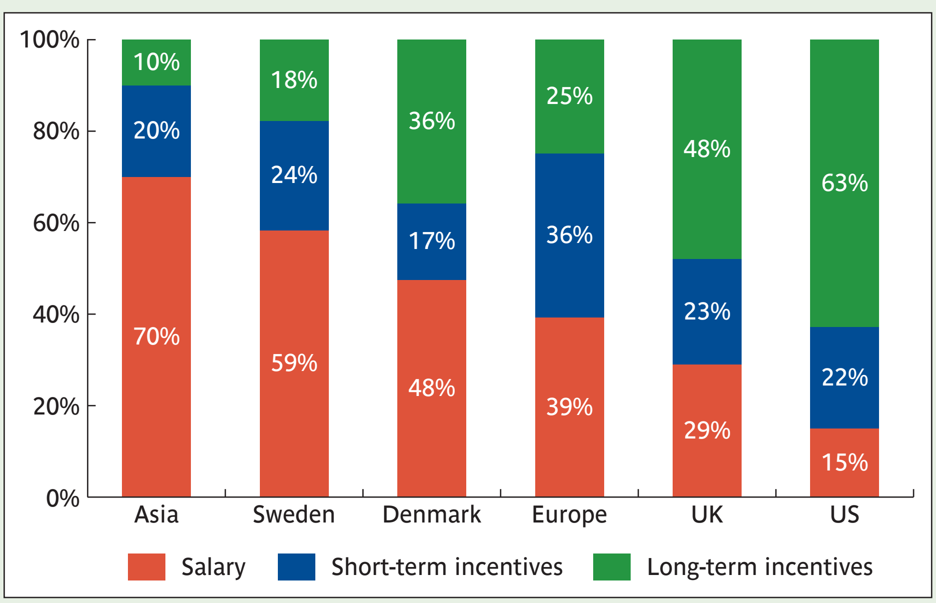
Executives will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance and often specifically to share value. For example, managers are frequently given the option to buy equity at a bargain price. The more the equity is worth, the more valuable is this option. In fact, options are often used to motivate employees of all types, not just top managers. For example, in 2007, Google announced that it was issuing new share options to all of its 16,000 employees, thereby giving its workforce a significant stake in its share price and better aligning employee and shareholder interests. Many other corporations, large and small, have similar policies.

The second incentive that managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, managers who are successful in pursuing shareholder goals will be in greater demand in the labour market and thus command higher salaries.

In fact, managers who are successful in pursuing shareholder goals can reap enormous rewards. In Table 2.3, the best paid executives in 2010 for top US firms are presented together with a breakdown of their salaries. As can be seen, annual remuneration is comprised of a number of different income streams. Annual salary is the executive's base wage. Incentives are typically bonuses paid on the previous year's performance. A stock option grant is an award of executive share options. This is not actual cash but instead an offer (but not an obligation) to buy shares at some date in the future for a specified price. Executive share options are discussed in Chapter 23. A restricted stock grant is equity that is issued to the executive but is not allowed to be traded before a stated date. Finally, performance awards consist of all other benefits including perquisites and personal benefits, tax benefits, discounted equity purchases, company contributions to a corporate pension plan, or corporate payment of insurance premiums.

The structure of executive pay is markedly different across the world. Whereas from Table 2.3 it can be seen that incentive plans make up a very large part of US executive pay, this is not the case in other countries. Figure 2.1 presents a breakdown of executive remuneration

Figure 2.1



Source: Mercer European Executive Remuneration Trends: Insights for 2012 Presentation.

Figure 2.1 CEO Target Pay Mix in 2011 for Various Regions

Table 2.3

Company	Executive	2010 Annual Salary	2010 Annual Incentives	Stock Option Grants	Restricted Stock grants	Performance Awards	Total Direct Compensation
Viacom	Philippe P. Dauman	$2,625.0	$11,250.0	$28,620.0	$27,127.5	$14,705.8	$84,328.3
Oracle	Lawrence J. Ellison	$250.0	$6,453.3	$61,946.5	$0	$0	$68,649.8
CBS	Leslie Moonves	$3,513.5	$27,500.0	$14,868.0	$4,000.0	$4,000.0	$53,881.4
Jarden	Martin E. Franklin	$2,034.7	$4,069.5	$0	$39,065.6	$0	$45,169.8
DIRECTV	Michael White	$1,448.1	$4,000.0	$12,497.2	$0	$14,690.4	$32,635.7
Stanley Black & Decker	John F. Lundgren	$1,208.4	$4,342.8	$1,255.5	$20,278.8	$5,069.0	$32,154.5
Freeport-McMoRan Copper & Gold	Richard C. Adkerson	$2,500.0	$17,770.0	$10,300.0	$0	$0	$30,570.0
Disney	Robert A. Iger	$2,000.0	$13,460.0	$4,400.0	$0	$7,359.1	$27,219.1
Visteon	Donald J. Stebbins	$1,218.0	$4,382.1	$0	$21,241.0	$0	$26,841.1
Time Warner	Jeffrey L. Bewkes	$2,000.0	$14,420.0	$4,073.6	$2,592.0	$2,927.1	$26,012.7
Ford Motor	Alan Mulally	$1,400.0	$9,450.0	$7,500.0	$0	$7,492.5	$25,842.5
Comcast	Brian L. Roberts	$2,800.8	$10,923.0	$5,917.4	$0	$5,309.0	$24,950.1
McKesson	John H. Hammergren	$1,580.0	$4,728.2	$7,647.8	$0	$10,508.8	$24,464.8
IBM	Samuel J. Palmisano	$1,800.0	$9,000.0	$0	$0	$13,319.5	$24,119.5
Honeywell	David M. Cote	$1,800.0	$4,300.0	$8,483.5	$0	$9,500.0	$24,083.5
BlackRock	Laurence D. Fink	$500.0	$23,150.0	$0	$0	$0	$23,650.0
JPMorgan Chase	James Dimon	$1,000.0	$5,000.0	$5,000.0	$12,000.0	$0	$23,000.0
Emerson Electric	David N. Farr	$1,187.5	$2,200.0	$0	$3,083.2	$15,998.4	$22,469.1
CVS Caremark	Thomas M. Ryan	$1,475.0	$2,200.0	$4,375.0	$4,375.0	$9,500.0	$21,925.0
ExxonMobil	Rex W. Tillerson	$2,207.0	$3,360.0	$0	$15,465.4	$0	$21,032.4
Aon	Gregory C. Case	$1,500.0	$3,000.0	$0	$0	$16,230.7	$20,730.7
American Express	Kenneth I. Chenault	$1,942.3	$5,125.0	$2,193.0	$6,057.0	$5,125.0	$20,442.3

Source: Research by Hay Group/The Wall Street Journal, 2010. © 2012 Dow Jones & Company. Inc.

Table 2.3 Best Paid US CEOs in 2010 ($million) into three different components for various parts of the world. Long-term incentives (LTI) represent stock and option based compensation and short-term incentives (STI) are annual bonuses and performance awards. In Asia, base salary is the largest component of an executive's pay with only 30 per cent of income coming from incentive plans. In Europe, the breakdown is roughly equal across all compensation categories. Even within Europe, there are significant differences in executive pay. The UK is similar to the US with a large proportion of executive remuneration in incentive plans compared to Sweden and Denmark, where salary is much more important.

Example 2.2

Cable & Wireless Communications

Executive share options are very controversial and often attract the ire of major shareholders. A good case study is Cable & Wireless Communications (CWC) who faced a shareholder revolt in 2011 because of its executive share option award to the firm's executives. The terms of the incentive scheme were for senior management to receive restricted stock units equivalent to three times their annual basic salary as well as a bonus equivalent to 150 per cent of their basic salary.

This would have been fine if the share price of CWC had stayed at the same level or increased since the time the contract was drawn up in 2006. Unfortunately (or fortunately for the executives!), share prices in CWC had declined by 20 per cent and basic executive salaries had grown substantially, meaning that the CWC executives would have received significantly more shares than would have been expected in 2006. Since the executives would have to hold their restricted shares for a number of years, the expected bonus would have been massive.

Control of the Firm

Control of the firm ultimately rests with shareholders. They elect the board of directors, who in turn hire and fire managers. The fact that shareholders control the corporation was made abundantly clear by Steve Jobs's experience at Apple. Even though he was a founder of the corporation and was largely responsible for its most successful products, there came a time when shareholders, through their elected directors, decided that Apple would be better off without him, so out he went. Of course, he was later rehired and helped turn Apple into the largest company in the world with great new products such as the iPod, iPhone and iPad.

Shareholder Rights

The conceptual structure of the corporation assumes that shareholders elect directors who, in turn, hire managers to carry out their directives. Shareholders, therefore, control the corporation through the right to elect the directors. In countries with single-tier boards, only shareholders have this right and in two-tier board countries, the supervisory board undertakes this task.

In two-tier board systems, the supervisory board (which consists of the main shareholder representatives, major creditors and employee representatives) chooses the executive board of directors. In companies with single-tier boards, directors are elected each year at an annual meeting. Although there are exceptions (discussed next), the general idea is 'one share, one vote' (not one shareholder, one vote). Directors are elected at an annual shareholders' meeting by a vote of the holders of a majority of shares who are present and entitled to vote. However, the exact mechanism for electing directors differs across companies. The most important difference is whether shares must be voted cumulatively or voted straight.

Example 2.3

Cumulative and Straight Voting

VanMore Ltd is considering two different voting procedures for four directors to be elected to the board. The firm has two shareholders: Smith with 20 shares and Jones with 80 shares. Both want to be a director. There are also three applicants from within the firm who are not shareholders. The key issue facing the company is that Jones does not want Smith to be a director!

Their first option is cumulative voting, which facilitates more minority shareholder participation. If cumulative voting is permitted, the total number of votes that each shareholder may cast is determined first. This is usually calculated as the number of shares (owned or controlled) multiplied by the number of directors to be elected. With cumulative voting, the directors are elected all at once. For VanMore Ltd, this means that the top four vote-getters will be the new directors. Each shareholder can distribute votes however he or she wishes.

Will Smith get a seat on the board? If we ignore the possibility of a five-way tie, then the answer is yes. Smith will cast $20 \times 4 = 80$ votes, and Jones will cast $80 \times 4 = 320$ votes. If Smith gives all his votes to himself, he is assured of a directorship. The reason is that Jones cannot divide 320 votes among four candidates in such a way as to give all of them more than 80 votes, so Smith will finish fourth at worst.

The second option is straight voting. With straight voting, the directors are elected one at a time. Each time, Smith can cast 20 votes and Jones can cast 80. As a consequence, Jones will elect all of the candidates.

In general, with cumulative voting, if there are N directors up for election, then $1/(N + 1)$ per cent of the shares plus one share will guarantee you a seat. In Example 2.3, this is $1/(4 + 1) =$ 20 per cent. So the more seats that are up for election at one time, the easier (and cheaper) it is to win one. With straight voting, the only way to guarantee a seat is to own 50 per cent plus one share. This also guarantees that you will win every seat, so it is really all or nothing with this method.

Example 2.4

Buying the Election

Shares in Sole SpA sell for €20 each and feature cumulative voting. There are 10,000 shares outstanding. If three directors are up for election, how much does it cost to ensure yourself a seat on the board?

The question here is how many shares of equity it will take to get a seat. The answer is 2,501, so the cost is 2,501 × €20 = €50,020. Why 2,501? Because there is no way the remaining 7,499 votes can be divided among three people to give all of them more than 2,501 votes. For example, suppose two people receive 2,502 votes and the first two seats. A third person can receive at most 10,000 − 2,502 − 2,502 − 2,501 = 2,495, so the third seat is yours.

As we have illustrated, straight voting can 'freeze out' minority shareholders; that is why many companies have mandatory cumulative voting. In companies where cumulative voting is mandatory, devices have been worked out to minimize its impact.

One such device is to stagger the voting for the board of directors. With staggered elections, only a fraction of the directorships are up for election at a particular time. Thus if only two directors are up for election at any one time, it will take $1/(2 + 1) = 33.33$ per cent of the equity plus one share to guarantee a seat.

Overall, staggering has two basic effects:

1 Staggering makes it more difficult for a minority to elect a director when there is cumulative voting because there are fewer directors to be elected at any one time.

2 Staggering makes takeover attempts less likely to be successful because it makes it more difficult to vote in a majority of new directors.

We should note that staggering may serve a beneficial purpose. It provides 'institutional memory' – that is, continuity on the board of directors. This may be important for corporations with significant long-range plans and projects.

Proxy Voting

A proxy is the grant of authority by a shareholder to someone else to vote his or her shares. For convenience, much of the voting in large public corporations is actually done by proxy. As we have seen, with straight voting, each share of equity has one vote. The owner of 10,000 shares has 10,000 votes. Large companies have hundreds of thousands or even millions of shareholders. In single-tier board environments, shareholders can come to the annual meeting and vote in person, or they can transfer their right to vote to another party.

Obviously, management always tries to get as many proxies as possible transferred to it. However, if shareholders are not satisfied with management, an 'outside' group of shareholders can try to obtain votes via proxy. They can vote by proxy in an attempt to replace management by electing enough directors. The resulting battle is called a proxy fight.

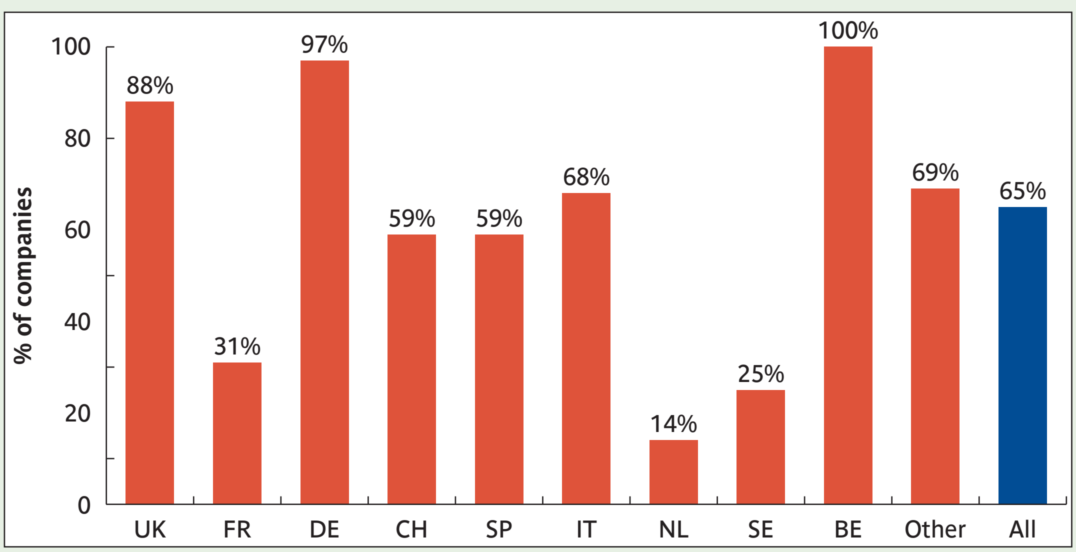
Classes of Shares

Some firms have more than one class of ordinary equity. Often the classes are created with unequal voting rights. Google, for example, has two classes of shares. The co-founders, Larry Page and Sergey Brin, own Class B shares, which have ten votes for each share. Other shareholders have Class A shares, which are entitled to one vote per share. So, although the founders only own 5.7 per cent of Google, they have 57 per cent of the voting power. News Corporation is another example of a firm with two classes of shares.

A primary reason for creating dual or multiple classes of equity has to do with control of the firm. If such shares exist, management can raise equity capital by issuing non-voting or limited-voting shares while maintaining control. The subject of unequal voting rights is controversial, and the idea of one share, one vote has a strong following and a long history. Interestingly, however, shares with unequal voting rights are quite common in Europe.

Figure 2.2 presents the percentage of firms in each country (the sample is Europe's 30 largest firms) that have only one class of shares with one vote per share. As can be seen, there is a

Figure 2.2



Source: 'Application of the One Share One Vote System in Europe', Deminor-Rating commissioned by the Association of British Insurers (2005).

Figure 2.2 Percentage of Companies with a 'One-Share-One-Vote' Structure by Country lot of heterogeneity in practice around Europe. In the UK, Germany and Belgium most firms have only one class of shares, which is substantially different to the situation in France, the Netherlands and Italy.

Investigating firms with multiple class shares further, there are a number of structures that firms can use to limit the power of any single shareholder. For example, *voting rate ceilings* restrict voting power for an investor to a specified percentage of shares irrespective of the actual shareholding. The actual ceiling percentage can vary but is usually between 5 and 20 per cent of total shares outstanding. *Ownership ceilings* forbid any shareholder from taking a holding of greater than a specified percentage of shares. *Priority shares* give the holders certain rights, such as being able to appoint a representative to the board of directors or veto a proposal at an annual general meeting. *Golden shares* are found in former state-owned enterprises and they give the government beneficial powers such as veto-capability against new shareholders. Finally, *depositary receipts* are securities that have an equity ownership stake without the voting rights. Common in the Netherlands, a company's shares are held in a foundation which then issues depositary receipts to investors that mimic the cash flows of the underlying shares but have no voting rights. Frequently, the foundation's board of directors is linked to the underlying firm.

Table 2.4 presents detailed statistics on the different type of share characteristics of firms that have more than one type of share class. It is clear that, even within the Eurozone, there are broad differences in the way in which ownership is distributed across firms. In Germany, Italy and the UK, non-voting preference shares (see Chapter 5) are relatively common, whereas in France, the Netherlands and Sweden, there are a number of firms that have differential voting rights across share classes.

Other Rights

The value of a share of equity in a corporation is directly related to the general rights of shareholders. In addition to the right to vote for directors, shareholders usually have the following rights:

1. The right to share proportionally in dividends paid.
2. The right to share proportionally in assets remaining after liabilities have been paid in a liquidation.

	Non-voting Preference Shares (%)	Multiple Voting Rights (%)	Voting Right Ceilings (%)	Ownership Ceilings (%)	Priority Shares (%)	Golden Shares (%)	Depositary Receipts (%)
UK	20	1	3	5	4	3	-
France	2	64	19	2	5	-	-
Germany	24	-	3	-	-	-	-
Switzerland	-	12	35	-	-	-	-
Spain	-	-	41	-	-	-	-
Italy	36	-	8	28	-	-	-
Netherlands	-	67	-	-	29	10	24
Sweden	-	75	6	-	-	-	-
Other	8	8	11	8	-	3	-

Source: 'Application of the One Share One Vote System in Europe', Deminor-Rating commissioned by the Association of British Insurers (2005).

Table 2.4 Percentage of Dual Class Share Characteristics by Country (FTSE Eurofirst 300 Companies)

Table 2.4

3 The right to vote on shareholder matters of great importance, such as a merger. Voting is usually done at the annual meeting or a special meeting.

In addition, shareholders sometimes have the right to share proportionally in any new equity sold. This is called the pre-emptive right (see Chapter 19 for more information).

Essentially, a pre-emptive right means that a company that wishes to sell equity must first offer it to existing shareholders before marketing it to the general public. The purpose is to give shareholders the opportunity to protect their proportionate ownership in the firm.

Dividends

A distinctive feature of corporations is that they have shares of equity on which they are authorized by law to pay dividends to their shareholders. Dividends paid to shareholders represent a return on the capital directly or indirectly contributed to the corporation by the shareholders. The payment of dividends is at the discretion of the board of directors.

Some important characteristics of dividends include the following:

1 Unless a dividend is declared by the board of directors of a corporation, it is not a liability of the corporation. A corporation cannot default on an undeclared dividend. As a consequence, corporations cannot become bankrupt because of non-payment of dividends. The amount of the dividend and even whether it is paid are decisions based on the business judgement of the board of directors.

2 The payment of dividends by the corporation is not a business expense. Dividends are not deductible for corporate tax purposes. In short, dividends are paid out of the corporation's after-tax profits.

3 Dividends received by individual shareholders are taxable.

There is a common belief that shareholders prefer companies to issue dividends because it imposes a form of discipline on incumbent managers. If a company has high levels of cash, managers may invest in projects that will not normally be chosen simply because they can. By transferring the company's cash to shareholders through dividends, managers have less scope to squander resources.

The discussion so far has concerned the agency relationship between professional managers and outside shareholders. We will now discuss a different type of agency relationship, which is more subtle and complex, and is known as a Type II agency relationship. A Type II agency relationship exists between shareholders who own a significant amount of a company's shares (controlling shareholders) and other shareholders who own only a small proportional amount (minority shareholders).

Type II Agency Relationships

The relationship between a dominant or controlling shareholder and other shareholders who have a small proportional ownership stake is known as a Type II agency relationship. Such a relationship exists whenever a company has a concentrated ownership structure, which is common in many countries. When an investor owns a large percentage of a company's shares, they have the ability to remove or install a board of directors through their voting power. This means that, indirectly, they can make the firm's objectives aligned to their own personal objectives, which may not be the same as that of other shareholders with a smaller proportionate stake.

It may seem strange that one set of shareholders can have a different objective to a different set of shareholders in the same company. Surely, all shareholders want to maximize the value of their firm? Agency theory recognizes that everyone has personal objectives and these may not be congruent with other groups in an organization. Thus, for example, a dominant shareholder may benefit more from having one of her firms trading at advantageous prices with another firm she owns. This is known as a related party transaction.

Alternatively, a controlling shareholder may need cash for an investment in, for example, Company A and wish to take the cash from Company B through an extraordinary dividend. This will obviously not be in the interests of Company B's other shareholders, but in aggregate the action may be more profitable for the controlling shareholder of Company B if it stands to make more money from an investment in Company A.

Example 2.5

Ownership Structure of Fiat SpA

The ownership structure of Italian automaker, Fiat, as of 2011 is presented in Figure 2.3.

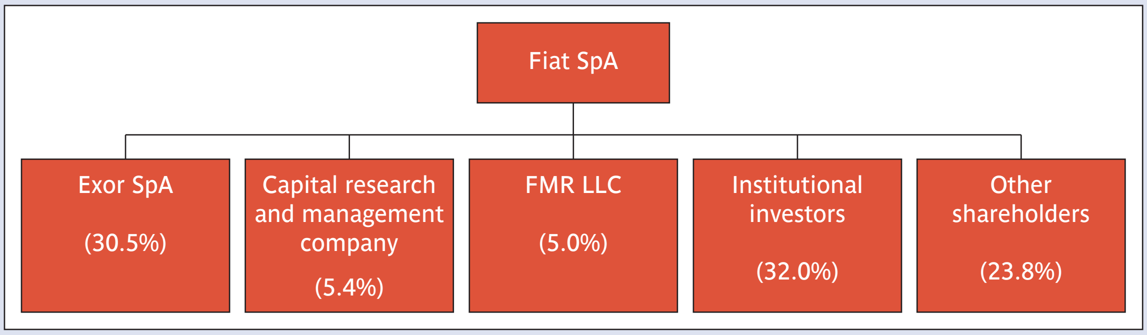


Figure 2.3 Ownership Structure of Fiat, 2011

The dominant or controlling shareholder of Fiat SpA is Exor SpA, who owns 30.5 per cent of the company's outstanding shares. The next question is who owns Exor SpA? Exor is 59.1 per cent owned by Giovanni Agnelli e C. S.a.p.az, which is the investment company of the Agnelli family in Italy. Thus, although the Agnelli family only owns 30.5 per cent × 59.1 per cent = 18.03 per cent of Fiat, it is the dominant shareholder and effectively has control of the firm.

International Ownership Structure

Ownership structure varies considerably across the world. In the UK and US, most large companies are widely held, which means that no single investor has a large ownership stake in a firm. In such environments, Type I agency relationships tend to dominate. The rest of the world is characterized by closely held firms, where governments, families and banks are the main shareholders in firms. Type II agency relationships are more important in closely held firms and their corporate governance structure should reflect this.

Table 2.5 presents a breakdown of the ownership structure of the 20 largest corporations in a number of selected companies across the world. It is very clear from the table that no two

Country	Widely Held (%)	Family (%)	State (%)	Other (%)	Country	Widely held (%)	Family (%)	State (%)	Other (%)
Austria	5	15	70	10	Japan	90	5	5	0
Belgium	5	50	5	40	Netherlands	30	20	5	45
Denmark	40	35	15	10	Norway	25	25	35	15
Finland	35	10	35	20	Portugal	10	45	25	20
France	60	20	15	5	Spain	35	15	30	20
Germany	50	10	25	15	Sweden	25	45	10	20
Greece	10	50	30	10	Switzerland	60	30	0	10
Italy	20	15	40	25	UK	100	0	0	0
Ireland	65	10	0	25	US	80	20	0	0

Source: La Porta et al. (2000). The table presents the percentage of firms in a country that have a controlling shareholder with a greater than 20 per cent stake in the company. If no controlling shareholder exists, the firm is deemed to be widely held.

Table 2.5 Ownership Structure of 20 Largest Companies in Each Country countries are exactly the same. For example, the UK is characterized by a widely held ownership structure, whereas most of the large firms in Greece are run by families. Governments have a major role to play in many European countries with the Austrian government being the most involved in firms.

The identity of controlling owners will influence managerial objectives and whereas all shareholders wish to maximize the value of their investment, how value is assessed differs according to the individual. For example, if a firm is widely held in a market-based economy, such as the UK, corporate objectives are likely to be focused on maximizing share price performance. Family firms have slightly different objectives because not only do managers have to consider current shareholders but also the descendants of those shareholders. This would suggest that managers of family firms would have a longer-term perspective than other firms, which would influence the types of investments and funding they choose. Firms with the government as a major shareholder would have to consider political objectives in addition to maximizing share value.

The available theory and evidence are consistent with the view that shareholders control the firm and that shareholder wealth maximization is the relevant goal of the corporation. Even so, there will undoubtedly be times when management goals are pursued at the expense of some or all shareholders, at least temporarily.

Stakeholders

Our discussion thus far implies that management and shareholders are the only parties with an interest in the firm's decisions. This is an oversimplification, of course. Employees, customers, suppliers and even the government all have a financial interest in the firm.

Taken together, these various groups are called stakeholders. In general, a stakeholder is someone, other than a shareholder or creditor, who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners. In countries with two-tier boards, such as the Netherlands and Germany, stakeholders are formally included in the decision-making activities of a firm, through its supervisory board to which the executive board must report.

2.3 The Governance Structure of Corporations

In this section, we review in more detail the different ways in which corporations can be governed. Because of cultural and regulatory differences, a variety of governance structures can be seen operating successfully across companies in many different countries. Moreover, company size is very important. The largest companies may have more than ten directors, a chairperson, a chief executive and other individuals on their executive board. Compare this with a private limited company, where the shareholders are also likely to be running the company, or, even more extreme, in a sole proprietorship where the manager is the owner. Some firms may be run by a family with many family members involved in the firm's management, or it may be state-owned and executive appointments made through political decisions.

In all businesses, there are a number of duties or responsibilities that must be carried out by corporate executives. For example, a firm must know and form its long-term business strategy. It must be in control of its financial affairs and actively seek out new and profitable investment opportunities. It should seek the most appropriate new financing when required and ensure it has complied with all relevant regulation.

As companies grow, these respective responsibilities become too large to be undertaken by only one individual and, consequently, must be delegated to a team or even a large department. Executives need to know what is happening in every sphere of their company's business activities and ensure that all aspects of business are operating at peak efficiency. Corporate governance is primarily concerned with ensuring that businesses are operating well, that business decisions are made rationally and that the appropriate individuals who make these decisions are held accountable when things go wrong.

Not all organizations are governed well. Just because a firm is listed on a stock exchange does not mean that correct business decisions are being made or that shareholder wealth is being maximized. In many companies, governance culture lags behind the growth of the firm. Small, successful companies are likely to have very different governance structures from large successful firms in the same industry. In many countries, individuals with political links are placed on corporate boards and their objectives are very different to that of shareholders.

While it is impossible to cover all the governance structures that exist in the business world, it is useful to see examples of the way in which different firms are governed.

The Sole Proprietorship

Let us return to JonMac Builders, the sole proprietorship that was introduced in Example 2.1. These types of firms are the easiest to understand since all the business activities are concentrated in one individual – the owner/manager. Business decisions, long-term strategy, short-term cash management and financing decisions are all made by John McAfee, the owner of JonMac Builders. John has no skill whatsoever in accounting, so he hires an accountant to draw up his financial accounts for the year. The main reason for hiring an accountant is to determine the amount of tax John has to pay based on the company's profits.

With the exception of the accounting function, everything in JonMac Builders is done informally and on a day-to-day basis. In these types of organizations, there is no real need for formal governance structures since there is nothing really to be governed. The only important formal aspect of the business, the financial accounting, has been outsourced to another company that specializes in the accounting function. It is hopefully clear that it is neither sensible nor cost-effective for JonMac builders to employ its own accountant or to introduce formal governance structures within the firm. This is the general position for most sole proprietorships.

Partnerships

A partnership is, in many ways, very similar to that of a sole proprietorship. Generally, partners will have unlimited liability, which means that they are personally liable for all of their firm's debts. Every partnership will have some form of formal agreement that governs the financial affairs of the firm, such as apportioning of profits among partners. Senior partners may receive a higher proportion of the company's profits than junior partners and this will be enshrined within the partnership agreement. Rules on partners resigning, new partners joining and major corporate decisions may also be included.

Partnership agreements need not be complicated or filled with legal jargon. They can also be quite short. Example 2.6 shows an actual partnership agreement for Twiga Export Partners, a partnership that sources materials, automobiles and electrical appliances from around the world and exports them to Sub-Saharan Africa. There are five partners in the firm, all concerned with different aspects of the business. Three of the partners are based in East Africa and two are based in Europe.

Example 2.6

Partnership Agreement of Twiga Export Company

This partnership agreement relates wholly, entirely and only to Twiga Export Partners, hereafter known as 'the business'. It does not convey rights or claim (partial, incidental or whole) towards any other activity or association to which any partner is involved.

This agreement applies as follows:

1. Each partner is due an equal share of all profits or losses accruing to the business. That is, each partner has claim to 20 per cent of profits or losses in any financial period.
2. Any injection of loan funds into the business will result in interest being paid, amounting to 8 per cent per annum compounded on an annual basis. Interest will be allocated against the partner's capital account.
3. Any withdrawal of funds from the business, not including any salary, will be charged interest at 8 per cent per annum compounded on an annual basis. Interest on drawings will be charged against the partner's capital account.

4. Any capital contributed by a partner must be agreed upon by all partners beforehand.
5. A partner will be paid a salary only on agreement by all partners. The level of salary must be agreed upon by all partners.
6. Before admission of any new partners, agreement and consent must be reached by all partners in business.
7. Upon leaving or retiring from business, a partner will be paid in cash their total capital invested in business as well as any goodwill owned by partner. Goodwill will be calculated as 20 per cent of average net profit over previous 5 years.
8. Changes in any of the points above must be agreed upon in writing by all partners.

Upon signing this document in the presence of two other partners, a partner will be deemed to accept the points in this document in full.

The partnership agreement only partially deals with the governance structure of a partnership. The firm must also have procedures in place for ensuring that all partners are carrying out their responsibilities fully. Normally, a partners' meeting will be held regularly to discuss business strategy and other long-term issues facing the business. They will also report on their own activity since the last partners' meeting. These may take place on a monthly basis or more frequently. In the case of Twiga Export Partners, the meeting takes place every 6 months because of the geographical distance between partners. More regular meetings would not be cost effective for Twiga, a trade-off that all companies must bear in mind when assessing the importance of better governance procedures.

Because the owners are also managers of the firm, partnerships do not normally require outside or independent individuals in the partners' meetings. In addition, they are also likely to appoint auditors and accountants to take care of the financial reporting of the firm.

Corporations

Because a corporation is a separate legal entity, the informality that is common in sole proprietorships and partnerships is substituted by formal corporate governance structures that are commonly seen in large organizations. Formal structures are necessary because the owners of the firm are less likely to be involved in management. As stated earlier, corporations must have articles of incorporation that govern the allocation and issuance of shares, the number of directors in the firm, as well as procedures for appointment and resignation from the board.

However, shareholders also require formal and explicit assurances that managers are running their company to maximize shareholder wealth. This is normally exhibited through the inclusion of external, non-executive and independent board members who attend all of the company's executive board meetings. In addition, there are usually a number of other governance structures ensuring that individuals do not have too much power within a firm, which could otherwise make them entrenched and less likely to pursue shareholder objectives over their own.

Whereas regulatory requirements can force board structures into a two-tier or unitary board structure, there are a number of principles to which all corporations are recommended to adhere in order to minimize governance failures. Individual countries have their own specific approach to corporate governance, but all follow the direction of the 2004 OECD Principles of Corporate Governance, published by the Organization for Economic Co-operation and Development. The principles themselves are not legally binding, but are recommendations on best governance practice within corporate organizations.

2.4 The 2004 OECD Principles of Corporate Governance

The principles are centred on six major areas and concern all aspects of corporate governance. These are detailed below.

I. Ensuring the Basis for an Effective Corporate Governance Framework

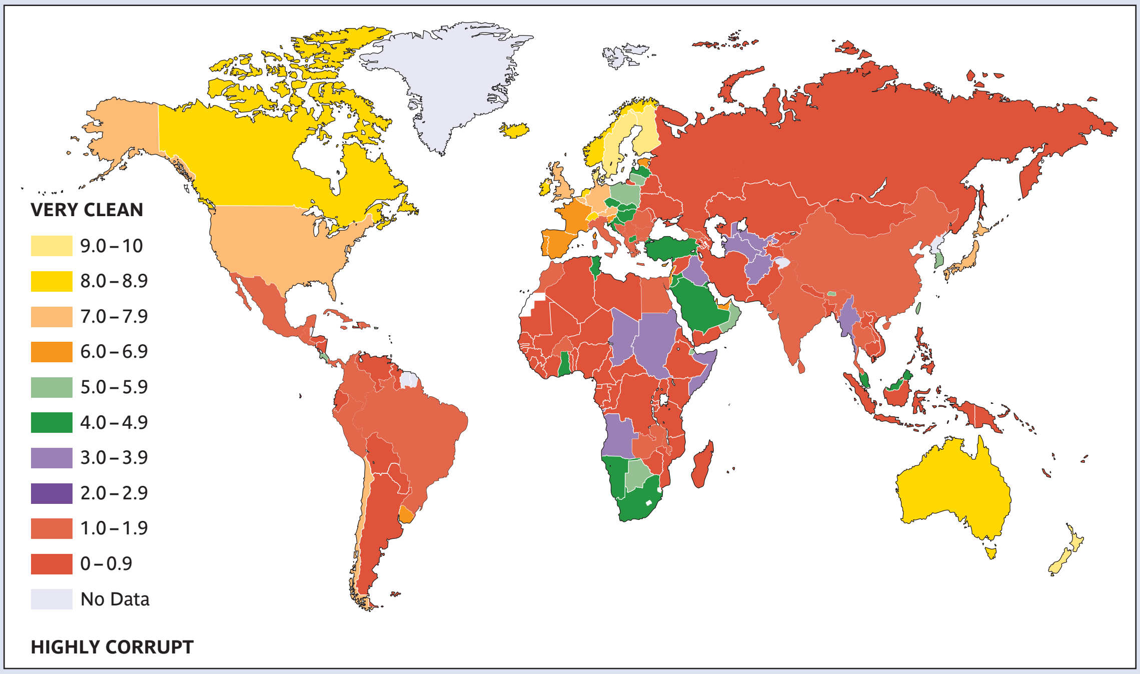
The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

This principle emphasizes the need to recognize that corporations are fundamentally geared towards making money and corporate governance structures must be designed to ensure that this primary objective is not adversely affected. It also states that any governance regulation must be consistent with the legal and regulatory environment in which the firm operates. Finally, the principle argues that there should be a strict and transparent delineation of responsibilities in setting, monitoring and managing the governance of corporations.

Example 2.7

Corruption

One of the major challenges facing regulators around the world is endemic corrupt practices by public servants, businesses, politicians and any intermediary. Corruption is believed to reduce competitiveness and can make business decisions less profitable because of bribery and inefficient allocation of resources. Figure 2.4 is a map of the 2010 Corruption Perceptions Index produced by Transparency International. The index is graded between 1 and 10, with a score of 1 (darker shade) indicating that a country is exceptionally corrupt. Scandinavian countries have very little corruption, but this tends to get worse as one goes further south through Europe. Consistent with their lack of economic development, emerging markets tend to have more corruption than developed countries. Notably, China and India are perceived to be exceptionally corrupt countries even with their incredible growth over the past 15 years.



Source: Transparency International. © Transparency International, 2012.

Figure 2.4 Corruption Around the World

II. The Rights of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

The second principle focuses on the most important stakeholder of corporations – the shareholder. As owner, the shareholder is entitled to basic rights such as being able to register ownership of their shares, selling their shares to other parties, having access to important information about the company, being able to participate at general shareholder meetings, being able to elect and remove members from the board of directors, and to share in the profits of the corporation.

Shareholders should also be notified of, and participate in, their company's major decisions such as increasing the long-term financing of the company through debt or equity offerings, or when the company management decide to sell off a major proportion of the company's assets. Giving shareholders power to influence the direction of their company is the basic rationale underlying this principle and, as such, much of its discussion relates to putting in a framework that allows shareholders to vote and participate at general meetings. The principle recommends that structures should be put in place to allow shareholders to appoint the senior management and stop them from pursuing business objectives that are not consistent with maximizing shareholder wealth.

Example 2.8

Shareholder Activism at Aberdeen Ethical World Fund

In recent years, there has been a substantial growth in investment funds having a social, ethical, environmental or governance agenda. The funds have two main approaches: *voice* and *exit*. A *voice strategy* will mean that managers of funds that hold the equity of a firm will become directly and proactively involved in the management of the company. Managers with a voice strategy are called institutional shareholder activists. An *exit strategy* simply means that if a fund manager is unhappy with a company's behaviour, it will simply exit from the investment.

An example of an activist fund is Aberdeen Ethical World Fund. The fund has positive and negative screening investment criteria regarding the companies in which they will invest in addition to a proactive engagement policy. The following is an overview of the fund's voice strategy (*source*: EIRIS Green & Ethical Funds Directory):

Engagement Aberdeen Asset Management (AAM) 'aims to visit all companies held within its ethical fund at least once every two years to discuss the socially responsible investment (SRI) issues covered by its SRI criteria. AAM maintains a dialogue on these topics with companies and follows up on issues to check to see if progress (if any) has been made'.

Methods of engagement AAM communicates with company managers, investor relations representatives, and those responsible for policy making and/or policy implementation regarding SRI/ethical issues through visits, telephone conferences, letters and emails. AAM also collaborates with other shareholders on SRI issues and meets with other groups, such as non-government organizations, etc.

Examples of recent engagement AAM states it has engaged with Asian, European and North American companies on SRI topics.

What further steps taken when engagement is considered unsuccessful? AAM's stated policy is one of 'continued engagement with companies on important issues' with no cut-off period.

Voting AAM's voting policy seeks to support good corporate governance through good quality management, transparency of corporate affairs and intentions, and fair and equal treatment of shareholders. This policy is set out on AAM's website (see section 'Aberdeen's policy on corporate governance, voting and SRI').

Are voting practices disclosed? No.

The principle also encourages shareholder activism, especially for institutional shareholders who can exert significant pressure on the incumbent management of corporations because of the size of their shareholdings. The institutions themselves are recommended to publish their own governance structures and policies on voting in general meetings. They are also encouraged to consult with each other on issues concerning their basic shareholder rights.

III. The Equitable Treatment of Shareholders

The corporate governance framework should 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.

In many firms, there is one shareholder or a group of shareholders that own a very large fraction of the outstanding shares. It is important that dominant, or controlling, shareholders do not run the company in their interests at the expense of minority shareholders. There are several ways in which this could be done. For example, the controlling shareholder may vote for personal friends or family to be on the corporate board. Given that minority shareholders are not strong enough to force their view at general meetings, majority shareholders will always get their way.

The third OECD governance principle states that firms must ensure that minority shareholders are protected and that policies introduced by the company do not penalize them. Processes must ensure that the voice of minority and foreign shareholders is heard at company general meetings.

Corporate executive behaviour is also addressed in Principle III, where it is recommended that company insiders should be forbidden from trading when they have private specific and precise information that could be used to personally benefit themselves at the expense of other shareholders. This is known as insider dealing, which is illegal in most countries. Board members should also disclose any conflicts of interest or material interests in corporate decisions to shareholders.

Example 2.9

Minority Shareholder Rights at ENRC

The corporate world has evolved massively in the last 5 years and one of the biggest changes concerns the appearance of large dominant shareholders in companies that have previously been widely held. Some of the most striking changes have been in the UK and, as a result, existing corporate governance practices have come under scrutiny from shareholders and regulators. Minority shareholder protection (exacerbated by Type II agency relationships) is becoming an issue in the UK, as it already is in many parts of Europe. The Financial Reporting Council, which promulgates the UK governance code, has also recognized this issue and stated that (*source*: FT.com, 16 June 2011), *'If concentrated share ownership were to become more prevalent in the UK, then the question of minority shareholders' rights may need further consideration.'*

An example of minority shareholder rights being affected concerns ENRC, the closely held Kazakh mining firm that is listed on the London Stock Exchange. Since its listing in 2007, the company has suffered a series of corporate governance events with severe tensions between the three original founders of the firm, the board of directors and minority shareholders. One recent case related to the dismissal of two directors from the board and the resignation of two others. Afterwards, it was ascertained that the three original shareholders combined their votes to vote against re-election of the directors, with the largest shareholder (another mining firm) abstaining from the vote. This was the first time in 10 years that a FTSE 100 company had voted off a board member at an annual meeting, underlying the unusualness of the situation (FT.com, 8 June 2011). Whether this will become a more common event remains to be seen.

IV. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize 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.

Principle IV considers the other stakeholders of the corporation, such as employees and local communities. All rights of stakeholders that are enshrined in law should be respected by the corporation and if a firm violates any stakeholder rights, there should be a process or structure to allow them to seek redress from the firm. The principle also encourages the development of employee share ownership schemes and other performance-enhancing schemes.

If any stakeholder group feels that the company is not performing to its expectations or meeting its responsibilities to its stakeholders, they should be able to freely communicate their concerns to the company and expect the firm to proactively consider the concerns. Firms should also have a framework for dealing with insolvency procedures (to be used if needed) and effective enforcement of creditor rights.

V. 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.

Prompt disclosure of new information relating to the activities of a corporation is an absolute necessity for investors. If little is known about a company, it is almost impossible for outside shareholders to form an accurate estimate of the value of a firm or evaluate the performance of its management. Principle V states the main types of information that companies should disclose to the market.

These include the following:

(a) The main financial results, namely the profit and loss over the year, a statement of the firm's assets and liabilities (the balance sheet), and the cash flow position of the firm.

(b) Corporate objectives.

(c) The main shareholders and the various voting rights pertaining to different share classes.

(d) Information on the individuals that comprise the board of directors, their salaries and annual bonuses, and a statement on whether a director is an independent or executive director should be published regularly.

(e) Any trading of the company's shares undertaken by the firm's senior executives, their family, friends and other close associates.

(f) The major risks facing the firm's operations.

(g) Issues regarding employees and other stakeholders.

(h) The main governance structures and policies of the firm.

The principle maintains that all information disclosed by the firm should be made as rigorous and informative as possible. This means that financial statements should be prepared by qualified accountants and all the activities of a firm should be audited and assessed by an external professional firm, the auditor.

VI. 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.

The final OECD principle of corporate governance focuses on the corporate board itself. Board members are expected to make decisions on an informed and ethical basis and always take the company and shareholder objectives into account. The board must take all shareholders into account and act in their best interests whether they are minority shareholders, foreign shareholders or other groups that have little combined power to influence management. All of the firm's major stakeholders (e.g. lenders, employees, local community, creditors) must also be taken into account when making corporate decisions.

The principle states that a corporate board must fulfil a set number of functions, including:

(a) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

(b) Monitoring the effectiveness of the company's governance practices and making changes as needed.

(c) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

(d) Aligning key executive and board remuneration with the longer-term interests of the company and its shareholders.

(e) Ensuring a formal and transparent board nomination and election process.

(f) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

(g) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

(h) Overseeing the process of disclosure and communications.

It is expected that corporate boards approach the job of running a corporation in an objective and independent fashion. When there are conflicts of interest, non-executives should be used to manage potentially problematic situations. Sub-committees of the board, such as an audit committee, nomination committee and remuneration committee, should also be established to deal effectively with conflicts of interest.

Bringing it All Together

The basis of all good corporate finance decisions is a sound framework of corporate governance. This point cannot be emphasized too much because most of the problems that companies experience can usually be identified by failings in the way in which they are governed. When covering subjects in later chapters, the underlying assumption is that corporate executives are acting in the interests of shareholders and that the firm is well governed.

When a company does not have strong corporate governance, it may make decisions that do not maximize share value. For example, a firm may choose to invest in projects that maximize managerial wealth and not that of shareholders. They may also make financing decisions that minimize the risk of the firm for the management but not necessarily for the shareholders. This would lead them to make different investment and financing decisions to those that would be recommended in later chapters.

Transparency and timely information disclosure are major aspects of good governance. Without this, investors would find it extremely difficult to value a firm or assess the risk of its operations. Part Three of the textbook assumes that share prices efficiently incorporate information about a company. However, if the management of a firm do not see transparency and disclosure as an important part of their responsibilities, share prices will be uninformative and risk assessment would be meaningless.

Table 2.6

Country	Code
Australia	Corporate Governance Principles and Recommendations (2010)
Austria	Austrian Code of Corporate Governance (2009)
Belgium	The 2009 Belgian Code on Corporate Governance (2009)
China	The Code of Corporate Governance for Listed Companies in China (2001)
Denmark	Recommendations for Corporate Governance in Denmark (2010)
EU	EVCA Corporate Governance Guidelines (2005)
Finland	Finnish Corporate Governance Code (2008)
France	Recommendations on Corporate Governance (2011)
Germany	German Corporate Governance Code (2010)
Greece	SEV Corporate Governance Code for Listed Companies (2011)
India	Corporate Governance Voluntary Guidelines (2009)
Ireland	Corporate Governance, Share Option and Other Incentive Schemes (1999)
Italy	Codice di Autodisciplina (2006)
Netherlands	Dutch Corporate Governance Code (2008)
Norway	The Norwegian Code of Practice for Corporate Governance (2010)
OECD	OECD Principles of Corporate Governance (2004)
Pakistan	Code of Corporate Governance (2002)
Poland	Code of Best Practice for WSE Companies (2010)
Portugal	CMVM Corporate Governance Code (2010)
South Africa	King Code of Corporate Governance for South Africa (2009)
Spain	Unified Good Governance Code (2006)
Sweden	Swedish Code of Corporate Governance (2010)
Switzerland	Swiss Code of Best Practice for Corporate Governance (2008)
Thailand	The Principles of Good Corporate Governance for Listed Companies (2006)
UK	The Independent Banking Commission Final Report Recommendations (The Vickers Report) (2011)
	The AIC Code of Corporate Governance (2010)
	The Stewardship Code for Institutional Investors (2010)
	A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (The Walker Review) (2009)
	The UK Corporate Governance Code (2010)
US	Report of the NYSE on Corporate Governance (2010)
	Key Agreed Principles to Strengthen Corporate Governance for US Publicly Traded Corporations (2008)
	Final NYSE Corporate Governance Rules (2003)
	The Sarbanes – Oxley Act (2002)

Table 2.6 Country Codes of Corporate Governance

The 2004 OECD Principles of Corporate Governance set the basis by which individual countries set their own corporate governance codes. This has led to a proliferation of codes issued by regulators specific to individual countries. Table 2.6 lists the main corporate governance codes and their date of publication for different countries.

2.5 International Corporate Governance

Why do countries have their own code of corporate governance and not just follow one generic code? The reason is that institutional differences exist across regions. Even in the European Union, there is a wide range of corporate governance practices and this, in turn, affects the way managers behave and make decisions. In this section, we will discuss some differences in international corporate governance and how they may impact upon the business decisions of corporations.

Investor Protection: The Legal Environment

The legal environment in which a corporation does business can have a big impact on its decisions. In a common law system, the law evolves as a result of the judgement decisions of courts whereas in a civil law system, judges interpret the law, they cannot change it. With respect to commercial decisions, the UK and Ireland follow a common law system whereas the rest of Europe follows civil law.

The third form of legal system is based on religious principles: Canon Law for Christianity, Halakha for Judaism, and Sharia for Islam. Under religious law, specific religious principles form the basis of legal decisions. This can have a considerable impact on business activity, especially when religion forbids specific activities. For example, Islam forbids the use of interest in any economic transaction and so financial loans are not allowed.

Figure 2.5 presents a snapshot of countries that follow different legal systems. Many countries do not follow one system alone, and the exact legal environment can be a hybrid of two systems. For example, India's legal system is based on common law but personal laws are driven by religious law depending on an individual's religion. Scotland has a different legal system from the rest of the UK, with most laws based on continental or Roman civil law. Commercial law is an exception and it is similar to the rest of the UK in this regard.

Because the corporate environment must respond quickly to different economic events, common law systems are able to adapt faster to these changes. For example, if a company can identify a loophole in the law that allows them to legally expropriate wealth from shareholders, a common law system can quickly close this loophole through the courts. In a civil law system, any changes in regulation must be enacted through government statute, which can take a much longer time to process.

The inherent flexibility of common law legal environments ensures that shareholders and outside stakeholders are better protected than in civil law countries. This constrains the

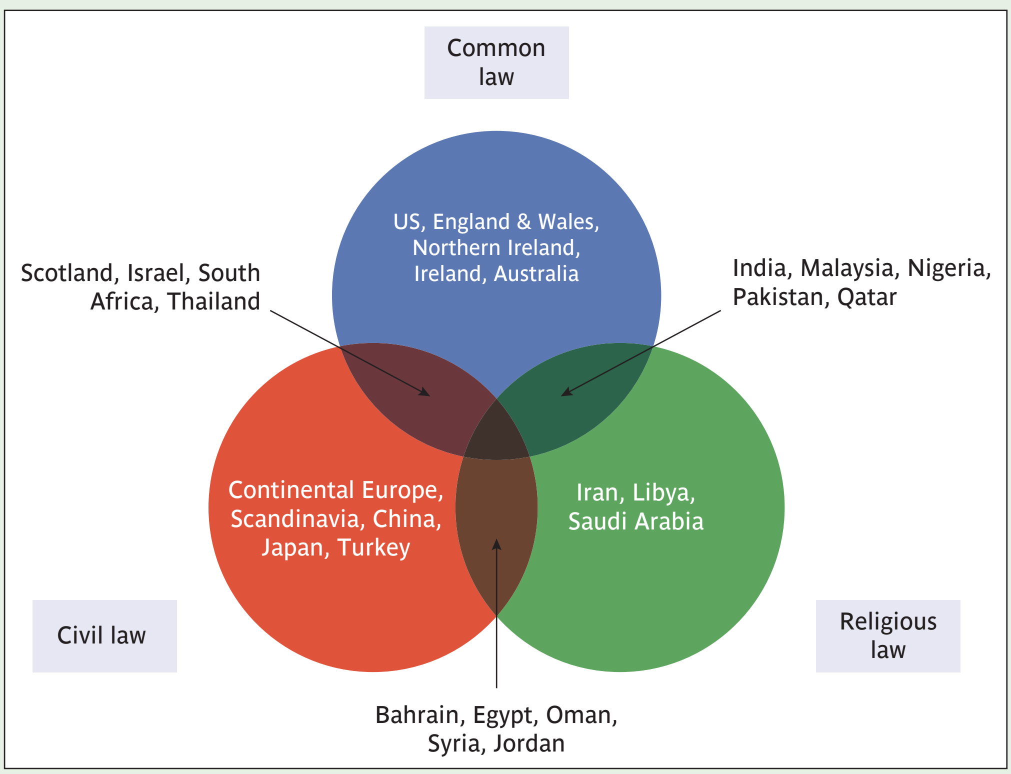


Figure 2.5 Legal Systems Around the World

Figure 2.5

activities of corporate managers and, as a result, they are held more accountable. In addition, because investor protection is better in common law environments, it would be expected that raising capital through the equity markets would be more popular in countries that follow this system.

The type of legal system is not the only factor that affects corporate investors. Adherence to the rule of law and efficiency of law enforcement can have a major impact on corporate decision-making and regulatory compliance. Clearly, a country can have very comprehensive laws but if they are not enforced then their effect is meaningless. Even in Europe, law enforcement and corruption is exceptionally varied, as discussed in Example 2.7.

The Financial System: Bank and Market-based Countries

In a bank-based financial system, banks play a major role in facilitating the flow of money between investors with surplus cash and organizations that require funding. In market-based systems, financial markets take on the role of the main financial intermediary. Corporations in countries with very well-developed financial markets find it easier to raise money by issuing debt and equity to the public than through bank borrowing. Countries with bank-based systems have very strong banks that actively monitor corporations and are often involved in long-term strategic decisions.

It has been argued that corporations in market-based countries have a shorter-term focus than in bank-based countries because of the emphasis on share price and market performance. When banks are the major source of funding to a company, managers may have longer investment horizons and be less willing to take risks. On the other hand, market-based systems have been argued to be more efficient at funding companies than bank systems. There are many ways in which a country's financial system can be classified as bank or market-based. Table 2.7 shows, for a number of countries, the level of domestic deposits in banks divided by stock market size. A country with a high ratio would be regarded as a bank-based financial system.

Table 2.7

Country	Domestic Bank Deposits/ Stock Market Capitalization	Country	Domestic Bank Deposits/ Stock Market Capitalization	Country	Domestic Bank Deposits/ Stock Market Capitalization
South Africa	0.40	Denmark	1.40	Finland	2.71
Malaysia	0.41	Thailand	1.44	Israel	2.76
Singapore	0.70	Netherlands	1.63	Greece	2.78
Hong Kong	0.76	Japan	1.66	France	3.11
Sweden	0.86	New Zealand	1.73	Belgium	3.31
United States	0.91	Kenya	1.80	Cyprus	3.73
United Kingdom	1.03	Switzerland	1.80	Italy	4.45
Australia	1.08	Nigeria	1.88	Iceland	4.50
Canada	1.12	Pakistan	2.17	Germany	5.01
India	1.24	Indonesia	2.67	Portugal	5.84
Turkey	1.35	Norway	2.69	Egypt	6.10
Ireland	1.36	Spain	3.20	Austria	10.24

Source: Demirgüç-Kunt and Levine (1999) 'Bank-based and Market-based Financial Systems: Cross-country Comparisons', World Bank Working Paper.

Table 2.7 Bank versus Market-Based Financial Systems

2.6 Corporate Governance in Action: Starbucks

Starbucks, the international coffee retailer chain, is frequently under scrutiny regarding its corporate governance policies. This is because much of its raw materials (coffee beans) are created in very poor, developing countries. The scope for manipulation and exploitation of the coffee farmers is massive, and the company has to proactively ensure that one of its stakeholder groups (the farmers) is not adversely and unfairly treated by the board's strategic decisions.

To see how Starbucks adheres to the main OECD corporate governance principles, it is useful to examine its Corporate Governance Principles and Practices. The company's corporate governance policy is available on its website and you can easily find it by searching for 'Starbucks Corporate Governance' on the Internet.

Starbuck's corporate governance document states that the board

> *is responsible for overseeing the exercise of corporate powers and ensuring that the Company's business and affairs are managed to meet its stated goals and objectives. The Board recognizes its responsibility to engage, and provide for the continuity of, executive management that possesses the character, skills and experience required to attain the Company's goals and its responsibility to select nominees for the Board of Directors who possess appropriate qualifications and reflect a reasonable diversity of backgrounds and perspectives.*

The board consists of 12 members, including the chairman and chief executive officer. In addition, the majority of board members must be independent non-executive directors.

Board Meetings

The board meets a minimum of five times per year and one of these meetings is solely concerned with long-term strategic planning. The chairman and chief executive officer are responsible for distributing the agenda of each meeting beforehand in a timely manner. All members of the board are expected to make every effort to attend the board meetings.

Authority and Responsibilities of the Board

Naturally, the company sees its shareholders as the main stakeholder group of the company. The fundamental responsibility of the board is to *'promote the best interests of the Company and its shareholders by overseeing the management of the Company's business and affairs'*. This is the standard responsibility of a corporate board and translates itself into two basic legal obligations. Namely, *'(1) the duty of care, which generally requires that Board members exercise appropriate diligence in making decisions and in overseeing management of the Company; and (2) the duty of loyalty, which generally requires that Board members make decisions based on the best interests of the Company and its shareholders, without regard to any personal interest.'*

Policies and Practices

Starbucks is ahead of many other companies in that it has a corporate governance committee that reports directly to the board of directors. This places corporate governance at the same level of importance as the audit function, the remuneration of directors and their nomination to the board, which all have their separate committees.

The corporate governance document sets out detailed procedures for selecting new directorial candidates and their appointment to the board. It also describes the process by which agenda items are set for each board meeting.

Non-executive directors have time at each board meeting to meet on their own without any executive directors present. This is to ensure that a balanced discussion of the company's strategy can be carried out without the interference of the managers who are actually implementing the strategy.

Director Share Ownership

Starbucks insists that all its directors, whether they be executive or non-executive, hold shares in the company. This is important to the directors as it ensures some convergence of objectives of directors and shareholders. The minimum shareholding for directors, as of 2012, is $240,000.

New directors have four years from the date of appointment to purchase these shares and must hold them for the period of appointment to the board.

Assessing Board Performance

Starbucks carry out an annual evaluation of the directors' performance, the effectiveness of the board of directors and all its subcommittees. An evaluation of the chairman and chief executive is also carried out.

> *'Each year the chair of the Nominating and Corporate Governance Committee (based on such committee's annual review) and the chair of the Compensation and Management Development Committee will conduct a formal evaluation of the performance of the chairman of the Board and the president and chief executive officer based on appropriate quantitative and qualitative criteria. The Board believes that the compensation packages for the chairman of the Board and for the president and chief executive officer should consist of three components: (1) annual base salary; (2) incentive bonuses, the amount of which is dependent upon the Company's performance during the prior fiscal year; and (3) equity incentive awards designed to align their interests with those of the Company's shareholders. The independent members of the Board establish the objective performance measure upon which incentive bonuses are based, such as the achievement of an earnings per share target.'*

All the business and financing decisions of Starbucks are framed by the company's main corporate governance principles. By placing corporate governance at the very forefront of the Starbucks philosophy, shareholders and stakeholders know that their financial and human investment is governed in an appropriate manner.

Summary and Conclusions

All of the material in this textbook makes the assumption that firms are run properly, efficiently and ethically. Unfortunately, in practice, this may not be the case. Corporate governance is concerned with the way in which a firm is managed. There are a number of basic principles which should be followed to minimize the danger of firms getting into difficulty solely because of the way they are managed. The budding financial manager must be aware of and familiar with the basic principles underlying the way in which his or her company should be run. Without this knowledge, he or she will not be in a position to make the best financial decisions for the company's shareholders.

Questions and Problems

connect

CONCEPT 1–5

1 **The Corporate Firm** Differentiate between sole proprietorships, partnerships and corporations. What are the advantages and weaknesses of each?

2 **Agency Problems** Suppose you own shares in a company. The current share price is £25. Another company has just announced that it wants to buy your company and will pay £35 per share to acquire all the outstanding equity. Your company's management immediately begins fighting off this hostile bid. Is management acting in the shareholders' best interests? Why or why not?

3 **The Governance Structure of Corporations** Why do partnerships require formal agreements among the main shareholders when sole ownerships do not? Why are corporation articles and memoranda of understanding so complex compared to partnership agreements?

REGULAR 6–25

4 **The OECD Principles of Good Governance** Review the OECD principles of corporate governance. Which principle relates to the ability of corporate executives to trade in the shares of their own company?

5 **Corporate Governance in Action** Consider Starbucks' corporate governance document. Are there any OECD principles not covered? Explain.

6 **Private vs Public Companies** What are the main similarities and differences between private and public limited companies? Why are all firms not publicly listed?

7 **Macro Governance** Why do you think corporate behaviour in bank-based financial systems would be different from market-based financial systems? How do you think other differences in the macro environment can affect corporate objectives?

8 **Corporate Governance** Why is corporate governance important to the shareholders of a firm? Should the same corporate governance rules be applied to all companies? Why or why not?

9 **Corporate Governance** Explain why you think public listed companies have board subcommittees like the remuneration committee, audit committee and risk management committee. Why could this responsibility not simply be left to the board of directors? Explain.

10 **Corporate Governance across the World** Why is there no single code of corporate governance applied to all the countries of the world? Would emerging market firms have different issues to consider?

11 **Corporate Governance around the World** In the Middle East, many companies have a Sharia Supervisory Board to which the board of directors report. Evaluate the merits of such a governance structure and argue whether this approach to governance could be extended to other areas where the supervisory board guides on ethical, social or environmental matters.

12 **Partnerships** What are the differences between a general partnership and a limited partnership? Why do firms choose to be partnerships instead of limited liability corporations?

13 **Organizations** Review the differences between various corporate forms. Why would an owner move from being a sole owner to a partner to a controlling shareholder in a limited corporation?

14 **Corporate Governance Principles** In your opinion what is the most important corporate governance principle? Explain your answer.

15 **Corporate Governance Principles** Is it possible to improve one governance principle in a firm but weaken another at the same time? Use an illustration to explain your answer.

16 **Corporate Governance Policy** Explain what is meant by 'Corporate Governance'. In your opinion, is this a necessary function of business? Describe Starbucks' approach to corporate governance. In your opinion, is Starbucks serious about corporate governance? Do you have any criticism about its approach? Explain.

17 **Principles of Good Governance** In 2004, the OECD published its document, 'Principles of Good Governance'. Discuss this report in detail and the major principles that are contained in it. In your opinion, what is the most important (if any) principle. Use practical examples to illustrate your answer.

18 **Regulatory Governance** You have been appointed as a consultant for a very poor country in Africa, with no corporate governance regulations, and have been asked to formulate an appropriate corporate governance framework for the country's fledgling banking sector. Propose and justify five governance structures or systems that you would recommend to the country's regulators.

19 **Audit Committees** The audit committee of a firm is an integral part of its corporate governance. Explain what an audit committee is, why it is important, its main responsibilities, and how you can evaluate the audit process within a company. Your answer should refer to real life examples where the audit process was ineffective or flawed.

20 **Agency Relationships** Who owns a corporation? Describe the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization? In this context, what kinds of problems can arise?

21 **Agency Problems and Corporate Ownership** Corporate ownership varies around the world. Historically individuals have owned the majority of shares in public corporations in the United States. In Germany and Japan, however, banks and other large financial institutions own most of the equity in public corporations. Do you think agency problems are likely to be more or less severe in Germany and Japan than in the United States? Why? In recent years, large financial institutions such as mutual funds and pension funds have been becoming the dominant owners of shares in the UK, and these institutions are becoming more active in corporate affairs. What are the implications of this trend for agency problems and corporate control?

22 **Government Ownership** In recent years, governments have taken control of banks through buying their shares. What impact does this have on the lending culture of these banks? Is this consistent with shareholder maximization? Use an example to illustrate your answer.

23 **Stakeholders** Discuss what is meant by a stakeholder. In what ways are stakeholders represented in two-tier board structures? How does this differ from companies with a unitary board structure? Use real examples to illustrate your answer.

24 **Institutional Shareholders** Regulators have developed a number of new policies with respect to institutional shareholder involvement in the running of firms. Review the reasons why regulators would prefer more or less involvement of institutions in the running of corporations. In addition, discuss the proposals that have been put forward by regulators in your own country and whether these are likely to be effective.

25 **Managerial Objectives** Why would we expect managers of a corporation to pursue the objectives of shareholders? What about bondholders?

CHALLENGE 26–30

26 **Codes of Corporate Governance** Download a set of country codes from the European Corporate Governance Institute website (www.ecgi.org) and identify any differences and similarities between your chosen country and the US codes. What are the main differences between your chosen country and the US's governance codes?

27 **Board of Directors** You have been hired as a consultant to evaluate the performance of a board of directors. What things would you look for? Why would shareholders want to hire a consultant to do such a job, when the share price is supposed to give an accurate reflection of corporate performance?

28 **Managerial Ownership** How do agency costs in a firm change as managers build up their shareholdings? What does it mean when we say that managers are entrenched? Provide some examples of real life cases where managers have acted in a selfish fashion even when they are shareholders in the firm.

29 **Executive Compensation** Critics have charged that compensation to top managers in the banking sector is simply too high and should be cut back. Look at the financial accounts of some banks in your region and determine the total pay of their chief executive officers. Are such amounts excessive? In answering, it might be helpful to recognize that superstar athletes such as Cristiano Ronaldo and Lionel Messi, top entertainers such as Robert de Niro and Will Smith, and many others at the top of their respective fields earn at least as much, if not a great deal more.

30 **Managerial Objectives** In 2012, the Argentinian government nationalized YPF, which is a subsidiary of Repsol, the Spanish oil giant. YPF was integral to the operations of Repsol. The firm was set up 10 years earlier, and had received more than €20 billion of capital investment from Repsol. The benefits to Repsol's shareholders from YPF were large and every year, $600 million of dividends were paid to the parent company. How do you think the presence of a major state shareholder (the Argentinian government) will change the agency relationships within YPF? Explain.

Exam Question (45 minutes)

As the financial manager of an unlisted manufacturing company based in Amsterdam, you have been tasked with preparing your firm for potential listing on Euronext. The company is closely held with only five shareholders, each holding 20 per cent of the company's shares. The shareholders are all directors of the firm and they make up the board of directors. Because of the company's ownership structure, there has been no real consideration of corporate governance issues before.

The share listing will result in the total directors' cash ownership falling to 20 per cent of the total firm. This means that 80 per cent will be owned by external shareholders (mainly banks and financial institutions). However, the five directors have informed you that they do not wish to relinquish control of the firm. They have asked you to answer the following with respect to corporate governance issues:

1. How can the board maintain control of the firm while only having 20 per cent of the shares? (20 marks)
2. Should the company's board structure change? If so, what should be done and why? (20 marks)
3. What processes should be put in place to ensure that all shareholders have some say in the company's strategy? How should the company deal with foreign shareholders? (20 marks)
4. How should the company decide upon director remuneration? Are there any structures that should be put in place to ensure that the directors are fairly compensated for the work that they have done? (20 marks)
5. There is a proposal that the company should instead possibly list in London or Shanghai and move headquarters to the listing location. Are there any institutional differences that the directors should be aware of before making their decision? Explain. (20 marks)

Mini Case

Since the financial crisis, investors have become increasingly vocal about the size of executive pay and many companies have seen remuneration packages refused by shareholders at annual general meetings. Assume that you are on the remuneration committee of a 150-year-old family firm that has been proud of its family heritage for six generations of ownership. The company recently appointed its first ever non-family chief executive and the family shareholders are uncertain how they should structure her remuneration package. You have been tasked with putting together a sensible package that recognizes the specific objectives of the family but also the incentives required for an external non-family manager. Write a brief report to the board of directors on your proposed pay package, emphasizing its strengths and weaknesses.

Practical Case Study

Finance executives need to know and understand the corporate governance environment in which they operate.

1. Visit the European Corporate Governance Institute website (www.ecgi.org) and download the appropriate corporate governance code for your country. If your country does not have a governance code, download the OECD Principles of Good Governance.
2. Read over the document, identify five aspects of corporate governance that have been highlighted in the document, and explain their importance for your country.

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Additional Reading

Corporate governance is one of the fastest growing research areas in finance and the number of top quality papers that have been published over the last few years is enormous. In 2012 alone, more than 1,000 papers were submitted to the online research database SSRN with corporate governance as the topic. The ownership structure and governance environment, as well as their impact on all aspects of financial decision-making, has rightly been recognized as crucial to understanding how corporations make decisions. Consequently, the number of papers listed below is necessarily large. (The country of study is highlighted in bold.) We have capped the list to 100 papers but interested readers are encouraged to visit the Corporate Finance website (www.mcgraw-hill.co.uk/textbooks/hillier) where a much fuller list is provided. A good starting point for readers is:

1. Bebchuk, L.A. and M.S. Weisbach (2010) 'The State of Corporate Governance Research', *Review of Financial Studies*, Vol. 23, No. 3, 939–961.
2. Fan, J.P.H., K.C.J. Wei and X. Xu (2011) 'Corporate Finance and Governance in Emerging Markets: A Selective Review and an Agenda for Future Research', *Journal of Corporate Finance*, Vol. 17, No. 2, 207–214. **International**.

Macro Governance

Macro governance papers consider the impact of regulatory structures, culture and law on corporations. They normally examine more than one country and compare different regulatory and governance environments. Important papers are as follows:

1. Aggarwal, R., I. Erel, R. Stulz and R. Williamson (2009) 'Differences in Governance Practices between US and Foreign Firms: Measurement, Causes, and Consequences', *Review of Financial Studies*, Vol. 22, No. 8, 3131–3169. **International**.
2. Aggarwal, R., I. Erel, M. Ferreira and P. Matos (2011) 'Does Governance Travel around the World? Evidence from Institutional Investors', *Journal of Financial Economics,* Vol. 100, No. 1, 154–181. **International**.
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12 Doidge, C., G.A. Karolyi, K.V. Lins, D.P. Miller and R. Sultz (2009) 'Private Benefits of Control Ownership and the Cross-Listing Decision', *Journal of Finance*, Vol. 64, No. 1, 425–466.

13 Donghui, L., F. Moshirian, P.K. Pham and J. Zein (2006) 'When Financial Institutions Are Large Shareholders: The Role of Macro Corporate Governance Environments', *Journal of Finance*, Vol. 61, No. 6, 2975–3007.

14 Dyck, A. and L. Zingales (2004) 'Private Benefits of Control: An International Comparison', *Journal of Finance*, Vol. 59, No. 2, 537–600.

15 Erkens, D.H., M. Hung and P. Matos (2012) 'Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide', *Journal of Corporate Finance,* Vol. 18, No. 2, 389–411. **International**.

16 Ge, W., J-B. Kim and B.Y. Song (2012) 'Internal Governance, Legal Institutions and Bank Loan Contracting around the World', *Journal of Corporate Finance,* Vol. 18, No. 3, 413–432. **International**.

17 Giannetti, M. and Y. Koskinen (2010) 'Investor Protection, Equity Returns, and Financial Globalization', *Journal of Financial and Quantitative Analysis,* Vol. 45, No. 1, 135–168. **International**.

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19 Guiso, L., P. Sapienza and L. Zingales (2008) 'Trusting the Stock Market', *Journal of Finance*, Vol. 63, No. 6, 2557–2600.

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