The Ethical Corporation
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Lecture - 17
Conflicts and Key Elements in Corporate Governance

Hello, welcome back, we are on the lecture 17 of our 4th week and we have started a major topic namely Corporate Governance.

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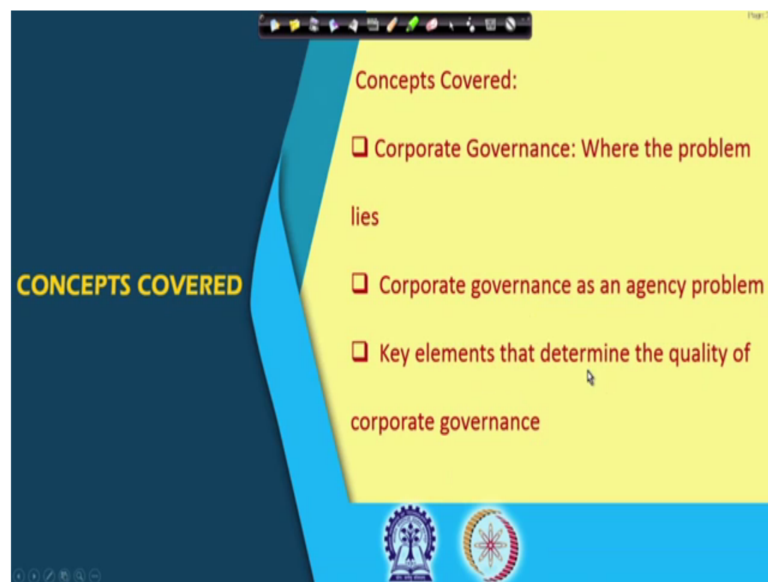

Last time when we talked I tried to detail you about what is not corporate governance and I said that we will elaborate this as we go along. So, today is our first lecture on what the problem is when corporate governance fails and what exactly is this corporate governance.

We will try to look up the corporate governance as an agency problem and we will try to understand that. And we also because we are all beginners, so we will try to understand the key elements that actually work to improve the quality of corporate governance. So, this is where we are starting out today.

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Corporate Governance

Main actors:

- Shareholders or investors (owners): Ordinary small investors, large shareholders, institutional investors, lending organizations, foreign investors, Government organizations.
- Management of a corporation: Corporate executives, led by the CEO. Some members from this team are also members of the Board of Directors of the company.
- Board of Directors: Members of the Board, Directors of the Company.

You see when we say about corporate governance; whether you understand it as a relationship or as a process; the main actors are like this you have the shareholders or the investors as a class. These are the actually owners, they own the company; now the investors class may have many different kinds of investors.

There may be very small shareholders, there can be very large shareholders you know the major chunk of the company shares are with them. There can be institutional investors I will explain that in subsequently and there might be even banks, foreign investors so on; either even might be some government participation in the shareholding. Then there is the management of the corporation ok, so this is where you see the corporate executives and then there is board of directors, the very top tier in a corporate structure; we will talk about that.

So, these are the major players in our corporate governance and we have to understand how they; what their duties are, what role they play, where actually the problem is and so on.

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Agency Problem and Corporate Governance

- Agency problem: A conflict of interest inherent in the relationship between two parties, where one party is supposed to act in the best interest of the other.
- Corporate Governance: An Agency problem in the relationship between shareholder / Investor and management. (Berle and Means, 1932)
- Earlier: Small family-owned, family-run companies. Owner/s used to be the managers. Now: That is rare. Many Corporations are large, international conglomerates. They trade publicly. Public ownership. In dispersed ownership: 'Many' shareholders / owners, but they do not manage the company.
- Professionalization of management: A separation between ownership and management functions. Nature of Corporate management has changed.
- Result: Changes in control over the Corporation. Top Corporate executives have better and direct control over the company.

I said that we will try to understand corporate governance as; as an agency problem. Following the literature on corporate governance it has been understood as a agency problem. So, what is this agency problem? The agency problem is actually a conflict of interest in the relationship between two parties conflict of interest; two parties such that one of the party is supposed to act in the best interest of the other all right.

So, the duty of one party is to look after the best interest of the other and when they do not; we see an agency problem forming. Now corporate governance has been understood as a kind of agency problem where the two parties; where the relationship sort of stumbles or the relationship that that does not sometimes work out is at these two parties; one the shareholder or the investor as a class and the management as a class; we will follow this idea slowly.

Now there have been some changes as corporations have come to be what they are today, there have been some changes in the way businesses used to run. Earlier what was it? There were the small businesses; mostly family run and family managed. So, the owners were the managers and now that is kind a rare; why? Because corporations have grown very large and they have become international conglomerates and not only that they are not private, but they are publicly traded companies; so there are other people involved. The concept of public ownership is when the ownership is dispersed; distributed over

many small owners. Many people own the shares of this company but note that they are owners, but they do not manage the company.

So, who manages the company? Now this is where we saw the rise of a different class the professionals, the business professionals who professionally manage the companies. So, what we saw in our modern time is a separation between the ownership function and the management function. Those who own the company do not necessarily manage the company; there is a special class corporate management and corporate managers.

And also the necessity is such that now corporate activities have become so complex; It requires different kind of expertise. So, the nature of corporate management also has changed. What is the upshot? The upshot is that the change there has been a change in the control over the corporation. The corporate executives actually know the company better, they also have better control over the company. You see now the inkling of the agency problem here.

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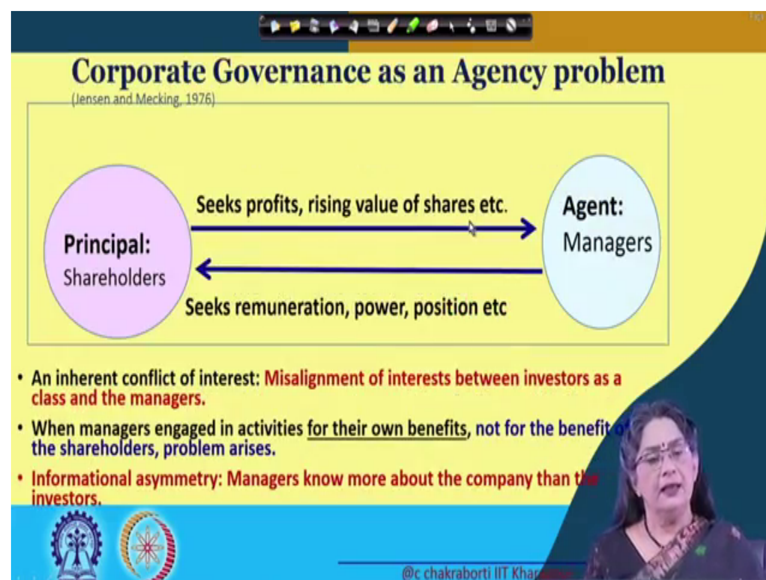

This is would be a schematic graphic representation of what we say is the agency problem. I said shareholders as a class, we call them principal they are the important central ones. And here are the agents; that is the managers, so the corporate executives. Now between these two there is an inherent conflict of interest; as you can see the shareholders want these things profits, you know return for the money invested.

Managers on the other hand look for you know compensation, power, position, private gates and so on. Now where the problem starts; is when there is misalignment of interests between these two groups. This group is supposed to look after the best interest of this group when that does not happen, namely when managers become engaged in private gains. They are working for their own benefits, not for the benefits of the shareholders; that is when we find there is corporate governance related problems.

There is also as I pointed out there is a informational asymmetry meaning the managers have more information about the company than the owners; it is not symmetrical, it does not whatever they know they do not pass necessarily to the owners. So, if this is the contour of the agency problem.

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Corporate Governance: Agency Problem

- Power is given to the corporate executives, with checks and balances in place to control that power. The duty of the executives is to run the Corporation for creating joint value for the company and for the investors. With power, comes the responsibility to exercise the power within the guidelines or constraints.
- When that is not done, due to greed, ambition, personal gain, indiscretion or bad judgment, failures of corporate governance occur.
- Rights of shareholders / investors are not always protected by the management. E.g. Right to correct information about the company.
- Duties are not always observed by management. E.g. Duty to run the company in the interest of shareholders. Duty of due diligence: Taking due care to check all possible facts before making a sale / contract/ or a deal.
- Conflict may also rise between: (a) Majority shareholders Vs Minority shareholders. (b) Controllers (Managers or the Majority shareholders) and the non-shareholder stakeholders, e.g. Creditors. These too are types of Agency problem.

So, then the agency problem in a nutshell would be like this that there are certain duties of the managers, they are actually put there so that they can run the corporation for the joint value for the company So, the all the stakeholders particularly the shareholders are given that returned with some value on their return.

Now with power they; they; they are given certain power and privileges, but their duty is to run the corporation accordingly. When that is not done failure of corporate governance should occurs; this is what we understood. In terms of rights and duties we can say like this that there are certain rights; morale rights that the shareholders have; those are not always protected by the agents namely the management.

For example, passing on the correct information, correct financial status about the company. In my last lecture I have talked about certain cases where you saw that the investors were completely kept in the dark about what is happening inside the company; that is a violation of the basic right of a shareholder. Similarly the duties of the management is to do for example, due diligence you have to check before you venture out on some new path new direction.

So, you and you need to do all the reasonable checking that is needed; so the; if that is not done properly then you are failing in your duty. So, this is how we will understand corporate governance as an agency problem, but I said that is one kind of agency problem. In corporate governance agency problem can also show up between these two groups; the majority shareholders and the minority shareholders.

Those who hold the large; larger chunk of the company shares and those who hold small number of shares of the company. And one group is supposed to look after the best interest of the other and that usually does not happen; so, there lies the agency problem between majority and minority shareholders. The other situation where agency problem can also show up is between the controllers of the company; who controls the company? Well it might be the managers or the majority shareholders; they are running the show versus the non shareholders, stakeholders of the company.

A company I have told you have has many a business has many stakeholders; not all of them are shareholders; so non shareholders stakeholders. For example, the creditors of the company those who have lent out to the company; the company owes them money they are not shareholders, but they are still stakeholders. Employees are also an important non shareholder stakeholder; so these two are types of agency problem.

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Key elements in determining quality of Corporate Governance

1. Pattern of shareholding: Varies from country to country. Ownership structure determines to some extent how the company is managed.

Dispersed ownership: Widely distributed shares. Many small shareholders. No dominant shareholder, or group of shareholders. Ownership changes frequently. Some institutional shareholders. Anglo-American Model: Common in US, UK. Weakens owners' control, gives management and Board more discretionary power, allows possible restructuring of management, e.g. via takeovers. Also, executives earn bonuses for short-term performance. Incentives for direct monitoring are weak.

Concentrated ownership: Large number of shares in an individual's, or family's, or a group's hand. Controlling shareholder. E.g Walmart, Ford, Google. Many are successful. But, controlling shareholder is likely to abuse power and control at the cost of minority shareholders. E.g Pursuing own projects, misuse of corporate resources. Prevalent: Continental Europe, Japan: Highly concentrated.

Let us now understand the key elements which actually help to improve the quality of corporate governance and you can understand also what is involved in this a very complex concept of corporate governance.

First is the pattern of shareholding; we have been talking about shareholders so many times, but its time has come to look into this concept of shareholding with a little bit more closer view. Now the pattern of shareholding varies from country to country; the ownership structure determines how and where the company is managing its ownership function. The ownership structure; generally though it varies from country to country generally we can classified it into two kinds; one is the dispersed ownership widely distributed shares.

So, we are talking about many small shareholders you know there is no one controlling shareholder, but many small owners here and often up for very large corporations; this is the case. And these small owners are not permanent owners because they have some disposable money, they have invested in company A and when company A is not doing well or company B is doing better than company A; they will move with their share, they will sell the shares of company A and invest in company B.

So, the ownership also changes frequently; this is very common in United States and United Kingdom;. If we have to talk about the ownership structure of this kind; this first kind then please note that the owners do not really have the control of the company. Who

does? The management and the board and they exercise their discretionary power about where the company is going to go.

So, direct monitoring of the inner working of the company is not possible by the owners and this is where lies some of the major problems of corporate governance with dispersed ownership. Whereas, look at this other kind concentrated ownership; what is this? This is large number of shares of a company is in the hand of one individual or in the hand of a family or with a group. They own the large amount say eighty seven percent of the company shares is with this group that is concentrated ownership. So, naturally the situation is that there is a controlling shareholder a dominant shareholder.

Many companies actually follow this kind of ownership; very big companies many of them are successful quite successful, but the corporate governance issue that comes with this kind of a ownership structure is the majority or majority shareholder trying to override the interest of the minority shareholder.

For example, the large chunk holder the controller shareholder (Refer Time: 14:52) wanted to go ahead with this project and the minority shareholder may not always agree to that. This is prevalent in continental Europe a lot even in Japan, but these are the general ownership structures that are seen.

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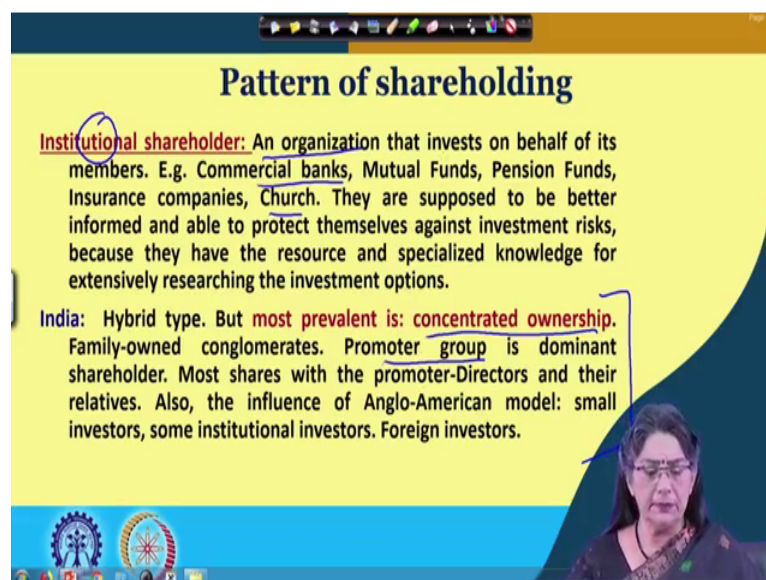

There is another kind that might interest you some shareholders are institutional shareholder. What it means is that instead of an individual; it is an organization which invests on behalf of its members. So, what we are talking about is for example, mutual funds you know they collect from other people, but they are the one who are investing on your behalf.

Pension fund managers, insurance companies or even churches and commercial banks are known to be also such investors. And they are supposed to be much better informed and they because people's money; you know they have their accountable very closely to the members. So, they have the results and they do a lot of research now in India; we see a hybridization of ownership part.

If you ask what is the predominant characteristic of a ownership; then I have to say it is the concentrated to ownership. Family owned conglomerates are there, promoter groups is dominant and so they the promoter directors own majority of the shares and then their relatives own few more; so the concentrated one is more common .

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Next is after ownership structure, we need to talk about the corporate structure. The idea is corporate structure is in the organizational structure in a corporation. So, the idea is to protect the investors and their interest; many companies follow this kind of a structure that we are going to talk about.

Most commonly it is seen in the United States, but as you know the majority of the corporations follow the similar structure. So, there was two tier of this structure; one is the very first the topmost is the board of governors or the board of directors. The second one is formed by the top management, the top executives of the corporation these are the professionals who are hired by the board.

Now, board of directors the members are elected by the shareholders. In; in our in our country Ministry of Corporate Affairs; you know MCA says that at least one of the director has to be a resident of India. So, that in case of any problem there was no question the problem with availability of the director. Looking at the composition of the board who are going to be the members, what kind of people will be there that is there, but first take a look into the types of memberships; one is what we would call the inside of the executive directors.

Here inside means those who are inside the company, those who work for the company on a daily basis. And these are typically the very senior and the top most corporate executives; we are talking about a chief executive officer, the chief financial officer and so on. Then there is this important group called the outside directors or the non executive directors. Outside as if those who come from outside the company; they are not the ones who work for the company, but nonetheless they and the members of the board.

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Key elements in determining quality of Corporate Governance

Board members in three categories:

1. Chairperson: Leader of the Corporation. Responsible for running the Board meetings efficiently and smoothly. Duties include staying in regular contact with the top management, formulating company strategy, representing the Board to the general shareholders and to the public. Chairperson is elected from the members of the Board. Chairperson may be executive or non-executive director. In UK, Ireland, non-executive chairman has become the rule.
2. Executive Directors: Approving budget, implementing and monitoring business strategy and policies, presenting the perspective from inside the company etc.
3. Non-executive Directors (NEDs): In addition to the duties of executive directors, the NEDs are supposed to bring the unbiased, impartial perspective to the forum. Should represent those shareholders who are not present in the Boardroom.

Companies Act (2013): At least one woman director (gender representation)

And then we can look into the composition of the board in this way. That first there is the chairperson and this is the somebody; who actually runs the board, the meeting the when the board members meet. This is the person who set of conducts the meeting and sees that it is run efficiently. And they if; this is the person who actually stays in regular contact with the CEO and the top management and this is the one who presents proposals to the board.

And also it is unsuitable on behalf of the board the person should communicate to the shareholders, as well as to the public. The out of the members of the board the chairperson is selected. Now, the executive directors as I said out from the company and their job is to approve the budget; you know they, they to bring to the board the insiders perspective from within the company.

The Non Executive Directors or NEDs for abbreviation are the ones; they are supposed to bring impartial and unbiased perspective to the board. Their job is to represent those shareholders; who are not present in the boardroom you know. So, this the this is a very important group who are supposed to bring in the desired impartiality in the board; when these are all people who are who may have vested interest.

But this is the group who are supposed to put in a balanced approach; I am I should not pass up the opportunity to also mention that in Companies Act, 2013; there is also a requirement that there has to be at least one woman director. So, that there is gender representation correct; gender representation in the board as well, this is a practice in Europe also.

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Key elements in determining quality of Corporate Governance

Structure of company boards: Board of Directors decide the company objectives, corporate policies, the general company rules. It recruits the top executives to carry out these policies and achieve the goals.

Since the top executives report to the Board, it is the duty of the Board to assess and monitor the company and top management performance, and to watch out for any lapses. The Board must have access to all the key information that it requires.

Anglo-American Model: One single board, Board controlled by the Executives, other Directors and the shareholders. India also follows this.

Now, having said that so as you see now that the chairperson is of course there and the board together; they recruit the top executives, but the board decides the policies and the future direction and so on, the company objectives. The job of the executives is to report back to the board, as it tries to execute those policies and strategies in order to reach the objectives.

They are answerable to the board and they must report all the important information. Now in UK and US; the board is one, there is only one board and it is controlled by this executive and non executive directors, India also follows that, but let me show you.

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Structure of company boards

Continental model: Two-tier boards.

- Lower board with the executive directors: Oversees the running of the company
- Upper board with the non-executive directors (Supervisory board): Oversees the function of the lower board.

Germany: Worker's representation in the Board.

But workers can sit only in the Supervisory Board, not in the Board of Directors.

Many other countries in Europe also have some form or other of workers' representation in the board.

In continental Europe; that is not the practice they follow a two tier board system. The lower board is the one that has the executive directors and it oversees the running of the company, the upper board on the other hand is what is called the supervisory board and that is where you will see all the non executive directors; their job is to supervise the function of the lower board. So, this is the board of directors, this is the board of non executive directors this is what they call.

Not only that in; in continental Europe also the boards have employee representation, workers representation; it is the demand of the union, Germany, we always cite this example that Germany actually allows in their board workers representation but only in the supervisory board; not in the board of directors. Similarly, many other countries in Europe tries to have some workers representation in some way in the board. This is not done in India.

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Key elements in determining quality of Corporate Governance

The other tier: Management Team. Key members are:

Chief Executive Officer (CEO): Top manager, responsible for the Corporate's actions, also for implementing the Board's suggestions and initiatives, maintain and run the company smoothly. Reports directly to Chairperson, Board of Directors.

Chief Operations Officer (COO) / Senior Vice President: Responsible for overseeing the day-to-day operations, marketing, sales, production, human resource. Gives feedback to CEO.

Chief Financial Officer (CFO)/ Senior Vice President: Responsible for financial health of the company and for integrity. Duty is to analyze and review financial data, preparation of budgets, monitoring revenues, and expenses. Reports directy to CEO, but is also required to present all necessary information to the Board, and to the shareholders, and regulatory bodies, e.g SEBI in India.

Now, next team; if I have talked to you about the board of directors; but let us take a look into the management team; who are there? The top executives, first is the Chief Executive Officer or the CEO. This is the person whose responsible for the entire corporates actions and chiefly for implementing; what the board has suggested or the board is wants to implement and reports directly to the chairperson of the board.

This is Chief Operations Officer a COO also called senior vice president, this is the person who is responsible for looking overlooking the day to day operations such as marketing, such as HR and so on; answers to CEO. Then there is this Chief Financial Officer or CFO; again senior vice president; this is the person whose responsible for all the financial oversight. This is the person who overlooks the financial data, the preparation of the budget you know monitoring the revenues and cost and expenses and so on reports directly to CEO.

But also reports to the board as well as to the shareholders and also to regulatory bodies. For example, in our case in the regulatory bodies SEBI; Securities Exchange Board of India; SEBI; must have heard the name. So, these are some of the top corporate executives.

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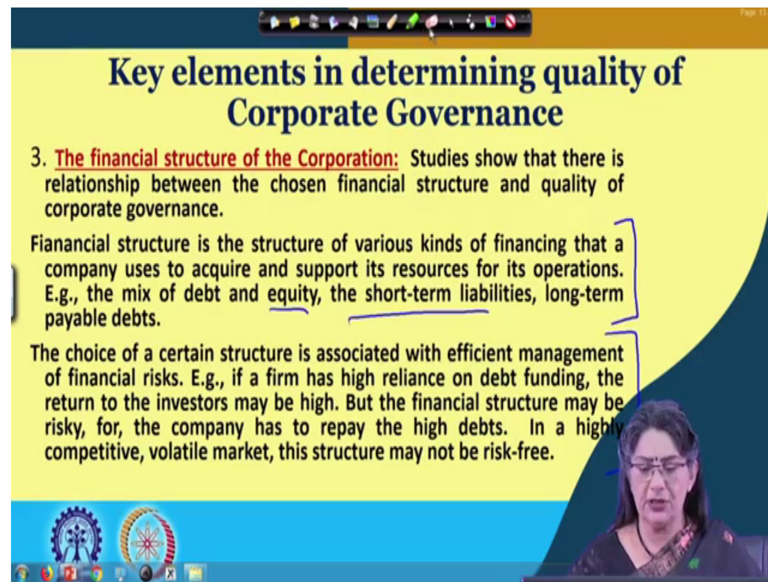

Next is the financial structure; if that was the corporate work structure, this is the financial structure. Financial structure means that this is how the company acquires resources, financial resources for its operations, there are several choices here. For example, you want to loan you want to borrow money or you want to try out and sell out your shares as an equity; do you want to get into short term liabilities or long term payable dates and so on; so financial structure.

The choice of stock financial structure is associated with effective management of financial risks. In a wrong choice of financial structure is going to land the company in the financial trouble. So, lot of corporate; corporate governance fiasco starts with the wrong choice of financial structure.

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Key elements in determining quality of Corporate Governance

- Financial structure has serious implications for corporate governance.
- In each company, it is a manager who chooses the company's financing, restructuring and default policies. Managers who act in their own interest, may prefer a financial structure that puts the shareholders' interest at risk. Companies with weaker corporate governance tend to have a higher debt level, and to become loan defaulter.

As said the; it is the management group; the CFO included it is the management group we chooses which what is going to be the company's financial structure. And those managers who are acting only on their own interest or for short term gain; may not always prefer the safest financial structure for the company or for the shareholders.

So, companies with weaker corporate governance; you will see that often there is an indiscretion shown in the choice of the financial structure.

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Key elements in determining quality of Corporate Governance

- The institutional environment: The institutions: Legal system, regulatory framework, political scene; these also determine the quality of corporate governance.
- E.g. How much the shareholders can control the company depends on the kind of legal and regulatory support they have .
- Sarbanes-Oxley Act (2002), USA, Companies Act (2013), India: Examples of legal support for better corporate governance,

Then there is last element is the institutional environment; every business works in an environment; the social environment where there are social institutions. What we are talking about specifically in this case is the legal system for example, what kind of laws are there? What kind of regulatory framework you have? What kind of political scene you have? These are also factors which determine the quality of corporate governance you know.

So, for example, if the law is lacks; you do not expect companies always to stay in line or if the if there is a; the regulatory framework is weak you know companies might not always stay on the right track and so on. So, in our case Companies Act, 2013; tried to reform the entire corporate governance through this. Similarly, in fact this was earlier the Sarbanes Oxley Act; I have mentioned this earlier after Enron was United State's Government's effort to completely revamp corporate governance.

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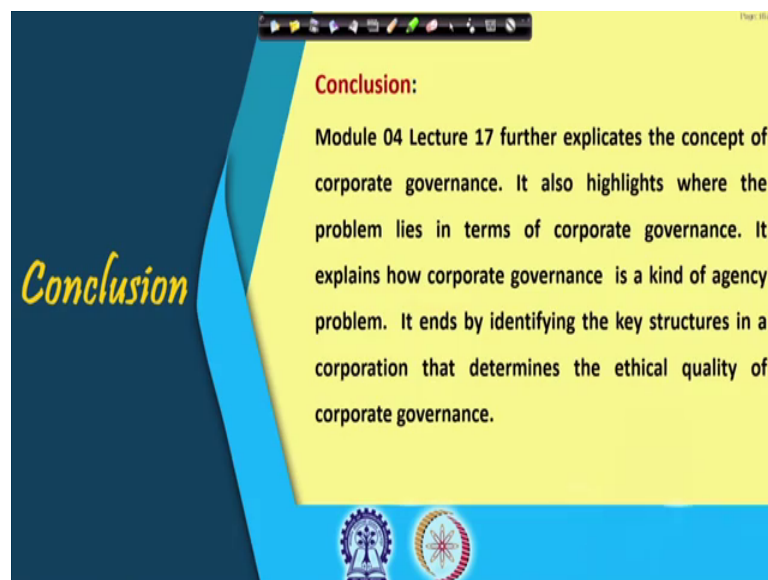

So, there is better answerability, better accountability and so on. So, this is where I am going to stop this lecture; I hope I have given you some outline here and what I have tried to do is to show you corporate governance as a agency problem.

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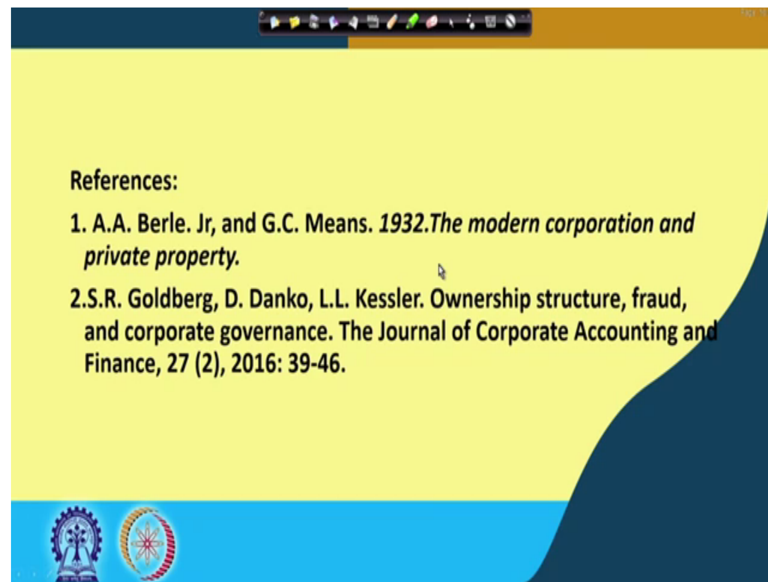

In our next lecture, I will be talking about where specifically the problem starts, but that is all for now. So, see you again bye.