Corporate Governance: Theory and Practice

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ABSTRACT

Various theories and philosophies have provided the foundation for the development of alternative forms of corporate governance systems around the world. Furthermore, as economies have evolved through time it appears that corporate executives have deviated from the sole objective of maximizing shareholders' wealth. Owners of the capital have responded to these forces for the purpose of preserving their wealth and earning a reasonable return on their invested capital. Whereas internal corporate control, external financial market forces, and institutional investors' responses have been effective in securing shareholders' wealth, legal protection needs to be provided for them.

INTRODUCTION

As a legal entity, a corporation enters into contracts to produce goods and services and it has the right to own property. Furthermore, the firm can borrow from various lenders and raise cash by issuing shares of its ownership. Shareholders would not only benefit from the earnings generated by the corporation, but by electing members of the board of directors they could indirectly oversee actions undertaken by the managers. These managers, as agents of the shareholders, are expected to perform for the best interest of the owners of the corporation.

Corporate managers can add value to common stockholders without decreasing the welfare of the other corporate stakeholders. For example, borrowing a portion of the capital that is needed for financing activities of the firm, would lead to a higher return to common stockholders. This is because borrowing is generally inexpensive for the firm in the face of taxation benefits available to business enterprises. Executive decisions may result in a transfer of wealth from one group of shareholders to the other. For example, by undertaking risky investment projects, greater rewards may be available to common stockholders without any such benefits to bondholders, except for suffering from excessive risk. Corporate managers can also destroy wealth. History tells us numerous examples in which actions undertaken by corporate executives have resulted in bankruptcy of the firm. The managers of a business enterprise, however, could add value for all corporate stakeholders including owners of the capital, labor, and the society at large. This would be a case of Pareto optimality in which the welfare of some group is increased without any decrease in benefits to the others.

THE THEORY OF CORPORATE INTERNAL CONTROL

Corporate governance is concerned with managing the relationship among various corporate stakeholders. Roe (1994), states that the American corporate governance system emerged as a result of both economic evolution and its democratic philosophy. In effect, the government by deliberately weakening commercial banks gave corporate managers excessive power. U.S. Banks were prevented from becoming corporate shareholders, let alone a large shareholder. U.S. laws further restrained activities of large shareholders.

In this manner, the profile of the American corporate shareholding became as widely dispersed as possible. The idea, as expressed by the Coase Theorem, was that in this manner management would need to get the agreement of numerous dispersed shareholders, and thereby act in the best interests of them all. The political view on corporate governance was based on the belief that banks, as lenders to the corporation, should not be able to affect the payoffs to common stockholders. The modern view on corporate governance, as expressed by North (1994), depicts formal and informal contractual agreements among corporate stakeholders. These may include the payoff structure for suppliers of capital such as stockholders and lenders, the incentive structure for corporate managers, and the organizational structure for maintaining an effective balance in bargaining power of employees of the corporation. This humanly designed organizational structure would involve transaction costs for maintaining and enforcing agreements.

The neoclassical view assumes that institutions do not matter. Modigliani and Miller (1958), for example, hypothesize that assuming that the investment policy of the firm is known to the market, its total market value would

be independent of the mix of debt and equity that is used in financing the firm's assets. In particular, the firm's structure of capital claims would not affect its overall cost of capital. As a consequence, investment and financing decisions of the firm would remain independent of each other. In this manner, corporate governance structure of the firm would not contribute to creation of value for shareholders.

In contrast to the neoclassical view, Williamson (1988) states that the debt and equity are not mainly alternative financing instruments, but rather an alternative governance structure. Furthermore, whether a project should be financed by debt or equity depends principally on the characteristics of the assets. Re-deployable assets could be financed by debt, while projects that are not re-deployable should be financed by equity.

Furthermore, Jensen and Meckling (1976), and Meyers (1977), state that capital structure affect the nature of income to be distributed between the suppliers of the capital. Since bondholders and stockholders are jointly sharing the risk of the firm, maximizing shareholder wealth may not be in line with maximizing the total value of the firm.

In addition, the incentive structure of the corporate decision makers can play a significant role on the mix of debt and equity used in financing the firm's assets, and on its capital investments. History shows that managers can create and add value to the firm by proper investment and financing decisions, or they may transfer and redistribute corporate wealth among the stakeholders, as well as destroying shareholders' wealth. In effect, investment, financing, and the distribution of business profits are all integrated with each other rather than being independent.

CORPORATE GOVERNANCE IN PRACTICE

Common stockholders have the right to elect their representatives on the board of directors of a corporation. Members of the board of directors assume the responsibility of monitoring, directing and appointing the firm's managers. In this manner disperse shareholders are potentially empowered in setting direction, monitoring performance, and controlling distribution of profits of the corporation. In particular, this internal control mechanism is purported to integrate the interests of common stockholders and the executive managers of a corporation by rewarding good corporate performance. The board of directors has the right and responsibility to remove poorly performing managers. Historically, dissatisfied shareholders have "walked away" from the corporation by selling their shares at depressed prices and thereby incurring losses. Alternatively, major shareholders either through hostile actions, "investor activism," or a friendly approach, "relationship investing," have pursued their objectives of monitoring corporate managers. Furthermore to the extent U.S. corporate laws permit, competing managers would remove incompetent ones and take over poorly performing firms. These aforementioned actions collectively are purported to add value for the existing shareholders. The business judgment rule followed by the U.S. courts, has kept the courts out of corporate decisions. The U.S. Business Law rests on the belief that actions of corporate managers are evaluated and approved by members of the board of directors of the corporation. In particular, corporate actions that have direct effects on shareholders' wealth are assumed to be communicated to them in a timely manner. Therefore, the U.S. courts would not interfere in corporate matters except for fraudulent activities. If members of the board of directors are not able or motivated to control managers, relationship investing is purported to achieve that. Relationship investing is an example of involved ownership of a business enterprise. Large investors tend to act as mentors to the managers of the firm and behave in a supportive and friendly manner. Investors pursue different approaches for maintaining corporate internal control for the purpose of creating a well functioning business enterprise. The underlying reason for the corporate governance system is the stakeholders' pursuit for preserving their respective share of profit earned by business enterprises.

CORPORATE CONTROL DESIGNS AROUND THE WORLD

Corporate governance system varies significantly among different countries. In a highly dispersed shareholding system, such as is the case in the U.S., members of the board of directors are granted the responsibility of monitoring executives. Internal corporate governance systems in Germany and Japan, on the other hand, rest with large shareholders. This is because their business and legal systems allow concentrated and cross shareholdings. The actions of these large shareholders appear to be a combination of aggressively controlling the management as well as a friendly one. Corporate financial managers are expected to act on behalf of shareholders, with the goal of obtaining a reasonable return on their investments. Once the board fails in its duty, share prices would fall and

institutional shareholders with a large stake would assume the responsibility of the board of directors. These actions could either be supportive or unfriendly towards the incumbent management team.

Shareholder Activism

Shareholder activism involves the task of aggressive monitoring and controlling the firm's management for the purpose of enforcing changes in the firm's structure of internal control and increasing shareholders wealth. It is generally found that shareholder activism tend to be beneficial to all investors in terms of appreciation of their wealth. Carleton et al. (1998), studied the influence of TIAA-CREF corporate governance practices for firms in its investment portfolios during 1992-1996. It was found that at least 87 percent of the target firms took actions in line with the terms negotiated by TIAA-CREF. Carleton et al. (1998), further concluded that the benefits of activism tended to depend upon the type of issues involved. The magnitude of benefits though appears to be small or insignificant. Board diversity issue had resulted in negative abnormal return, whereas confidential voting resulted in positive abnormal return.

Smith (1996), reviewed the operating performance for 51 firms targeted by CalPERS during 1987-93. He found that shareholder wealth tend to increase for firms that adopt or settle, and decreases for firms that resist. However, there were no statistically significant changes in performance as measured by operating income, and cash flows.

Bethel et al. (1998), reviewed the nature of investor activists' block share purchases in the 1980s and found that the target firms were highly diversified and with poor performance. It was found that activists' efforts had resulted in abnormal share price appreciation, operating profitability, asset divestitures, and a decrease in acquisitions. Their sample included 425 firms during 1980-89. Activist investors were found to be able to influence firm policies during the 1980s even though takeovers typically did not take place in the targeted firms. Thus, suggesting that the market for partial control can play an important role in reducing the agency costs. This is the result of the separation of ownership and control in U.S. corporations. The greatest profitability improvements were observed two and three years after block purchases, and in firms that invested assets after such actions.

Studies by Wahal (1996), Karpoff et al. (1996), and Gillan and Starks (2000), on the other hand, suggest that activism on the part of public pension funds does not appear to increase the market value of their holdings. The U.S. capital markets possess a high degree of operational efficiency. This flexible system facilitates and allows activist shareholders to pursue trading in large quantity of shares without incurring a market impact or undue transactions costs. It also resolves the "free rider" problem. The “free rider” problem may arise due to the fact that all shareholders would tend to benefit from the actions taken by a select group of activist shareholders, even though the cost is borne solely by the activists.

Maug (1996), found that a liquid stock market is beneficial because it makes investor activism a more effective tool for corporate internal governance and control. This is because a liquid stock market makes it less costly to hold larger amounts of the outstanding shares of a target firm. In particular, in most cases other large shareholders cooperate in order to influence the management of a company.

Relationship Investing

Relationship investing is defined as involved ownership in a helping and positively influencing the management for improving corporate performance. It includes an active, two-way communication between large shareholders and the management. Kensinger and Martin (1996), state that relationship investing is often referred to as the approach followed by Warren Buffett. Buffett's approach is perceived as taking an active but friendly role with directors and senior management in a patient, value-added, negotiated involvement. In effect, it is believed that Buffett brings more than money to these corporations, since he brings valuable experience and a helping hand to their management.

Concentrated and Cross Shareholding Systems

In Germany and Japan large percentages of shares of companies are held by banks, individuals, and other companies. Such a system is perceived as an effective way for monitoring and influencing the management, thus leading to better performance. This cross shareholding system is also believed to be a low cost and efficient financing alternative than the capital markets. Banks in Germany are allowed to own stocks in the companies they lend to. Their large voting rights would allow these banks to remain informed and maintain control over the management. In the Japanese system, the cross shareholding, known as the Keiretsu, provides a mechanism for stockholders to control management's actions. The Presidents' Council meets on a regular basis in which the lending

banks, large shareholders, and other investing firms interact with the management. The German and Japanese systems of corporate governance resemble the relationship investing.

Kaplan (1997) explains that in Germany, the management board is comprised of the top managers. They include the chairman, who is the equivalent of the CEO. The supervisory board, which is the equivalent of an outside board, includes both shareholders and labor representatives. In Japan the board consists of all insiders. The president is also the CEO. A few top directors, including the president, are given special rights to represent the company. These are known as representative directors. Large shareholders have the means and the incentives to collect pertinent information regarding investment and financing activities of the firm. Shleifer and Vishney (1997), state that it is feasible for large shareholders to collect information about the firm and to monitor the management. However, while large shareholdings are not common in the U.S., majority ownerships are prevalent in Germany and Japan. Management and director turnovers are common in Germany and Japan in response to poor corporate performance. The Japanese large investors appear to be soft with the management and in Germany large investors have few incentives to discipline managers. Shleifer and Vishney (1997), conclude that firms in the U.S. rely on legal protection of investors, whereas in much of Europe and in Japan there is more reliance on large investors to exert effective internal corporate control.

Prowse (1995), observes that the difference between countries corporate governance system is as a result of differences in their legal and regulatory environments. Regulatory restrictions and limits placed on investors' holdings in the U.S. have led to dispersed holdings of stocks. Conversely, the absence of such restrictions in Japan and Germany has resulted in concentrated shareholdings.

In both Germany and Japan, unlike the U.S., banks have substantial influence in the companies they lend to. It is therefore, hypothesized that lack of a liquid financial market in Germany and Japan and the availability of low cost, long-term borrowing have contributed to the development of their respective corporate governance systems.

On the other hand, it is believed that the ample liquidity and marketability in the U.S. financial system has created dispersed shareholdings, block trading, and facilitated relationship investing as feasible forms of corporate internal control in the U.S.

Denis (1995) finds that the forced resignations of top managers are preceded by large and sufficient declines in operating performance and followed by large improvements in performance. However, forced resignations are rare and are due more often to external factors than to normal board monitoring. Following the management change, these firms significantly down size their operations and are subject to a high rate of corporate control activity.

CORPORATE GOVERNANCE AND PAYOFF TO COMMON STOCK

Cremers and Nair (2003), find that the market for corporate control (external governance) and shareholder monitoring (internal governance) are strong complements although external governance appears to be having the lead. Their study covers 1990-2001, in which a portfolio that is long in firms with high external governance and short in firms with low external governance, when internal governance is high in both cases, would generate 10-15 percent excess return. During the same time horizon, a portfolio that is long in firms with high internal governance and short in firms with low internal governance, when external governance is strong in both cases, generates an excess return of 8 percent. External governance is defined as the degree to which the firm would be subject to takeovers.

Performance Linked Compensation

Compensation for corporate managers is often based on accounting earnings, or performance of its common stock during a short period of time. Since the firm’s earnings and its common stock tend to follow the general path of the economy and the market, managers are excessively rewarded for the trend rather that their efforts or expertise. Corporate managers however, should be compensated for the incremental reward that they have generated for the shareholders that is over and above the general level of the market.

One alternative would be to compare corporate earnings growth to its respective industry growth and reward the incremental value generated by the manager. Alternatively, market-based compensation would reward any excess growth beyond the general level of the growth rate of stock for its industry. Economic value added

(EVA) would also appear to be a suitable device for performance-linked compensation. The difference between return on total capital and the associated cost of capital is a true measure of the value added by corporate executives. By forming an index of real, inflation-adjusted, economic value added for both the company and its respective industry, one can easily judge the contribution of the company's managers. Corporate officers who provide a real, inflation-adjusted, economic value added for their firm over and above their respective industry level could be rewarded. A possible benchmark is shown in Exhibit 1, which depicts real, inflation-adjusted, economic value added for the Standard and Poor's Industrial Companies.

Jensen (1993) considers managers' compensation as an incentive for efficient use of resources. Compensation that is contingent upon performance may induce managers to undertake profitable investment projects. Shleifer and Vishny (1997) explain that in the long run the competition in the product market would force firms to reduce their cost including executive compensation. However, in the short run executive compensation should be managed through concentrated shareholdings and through the legal system.

Exhibit 1: Real, Inflation Adjusted, Economic Value Added Standard and Poor's Industrial Composite

Year	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Real Return on Capital	7.5	7.6	9.7	6.7	4.8	2.9	4.4	5.5	7.1	9.0	9.5	10.2	10.0	10.1	8.1	4.8	7.1
Real Cost of Capital	7.5	6.5	6.0	4.9	4.2	5.1	5.6	4.7	6.3	5.6	5.6	5.7	6.0	6.5	5.0	5.6	5.6
Real Economic Value Added	0.0%	1.1%	3.7%	1.8%	0.5%	(2.1%)	(1.1%)	0.7%	0.9%	3.4%	3.9%	4.5%	4.1%	3.6%	3.1%	(0.8%)	1.5%
Consumer Price Index	1.9%	3.7%	4.1%	4.8%	5.4%	4.2%	3.1%	3.0%	2.6%	2.8%	2.9%	2.3%	1.6%	2.2%	3.4%	2.8%	1.4%

Source: Goldman Sachs Research, Inc. August, 2002.

CONCLUSIONS

Corporate governance structure of a business enterprise relates to formal and informal contractual agreements among corporate stakeholders. These may include the pay-off structure for the suppliers of capital including owners and creditors of the firm, the incentive structure of corporate decision makers, and the organizational structure for maintaining an effective balance in bargaining power of the participants. This humanly designed organizational structure would involve transaction costs for maintaining and enforcing agreements. Due to the dispersed ownership of U.S. corporate securities, members of the board of directors elected by a vote of common shareholders approve and monitor overall actions of corporate executives. The "business judgment rule," followed by U.S. Courts, keeps the courts out of corporate decisions. If the board members appear to be uninterested to control managers, major shareholders may take a friendly approach of relationship investing. Relationship investing works well when long-term investors are equipped with knowledge and experience to act as a mentor to corporate decision makers. Activist investors, on the other hand, demand changes in corporate policies for the purpose of increasing shareholders' wealth, or ultimately seek removal of the incumbent management team.

Neoclassical theories advocated by Modigliani and Miller pay no or limited attention to corporate governance issues since it is believed that the value of the firm is independent of its mix of debt and equity employed in financing the assets of the corporation. Therefore, corporate governance does not matter. The post neoclassical views, however, show that stakeholders' incentives can play a significant role on the mix of debt and equity used in financing the firm's assets, and on its capital investment decisions. Thereby corporate executives can add value to the firm and affect distribution of wealth between common stockholders and bondholders.

In addition to market forces, however, it appears that investors need and should require legal protection through government entities that would regulate corporate executive actions. In this regard, LaPorta et al. (2002), show that the common element to the well being of creditors and common stockholders has been the degree to which they have been protected by the law from expropriation by the managers and controlling shareholders. The payoff structure available to owners of the corporate capital differs in the presence of executive managers. This is because, at best, executive managers would aim at providing a satisfactory return to the owners. But more importantly, the executive managers would tend to maximize their respective payoffs. Corporate internal control mechanisms are established by shareholders with the hope of reaching a near convergence between their payoffs and the benefits to managers. This is sought for by "relationship investing," "investor activism," and "legal protection," by U.S. investors. Dispersed shareholders in the U.S. elect the members of the board of directors of the corporation to direct and monitor corporate executive actions. These executive agents are expected to act with care to shareholders and loyalty to all corporate stakeholders. In numerous cases, members of the board of directors have omitted their fiduciary duties that had resulted in total ruin of the corporation to the detriment of all stakeholders. For many years investors took a "Walk" out of the corporation by selling their shares at a loss. However, developments in the legal and regulatory sphere purporting shareholders protection, and improvements in trading mechanisms as well as deregulation of the financial markets have helped bringing about new systems for corporate governance.

The operationally efficient structure of the U.S. capital markets appears to facilitate this task in two ways. First, it allows the existing shareholders to pursue their goals, since they can motivate, pressure, and threaten their executive agents. Secondly, corporate managers have access to capital outside of the existing shareholders. Overall, the system relies and rests on the effectiveness of the board of directors. Concentrated and cross shareholdings by investors in operationally diverse fields appear to have achieved the task of monitoring executives in Germany and Japan. When a group of companies form an informal but long term business alliance, such interrelationships would tend to help them all. In cross shareholdings it appears that a "center bank" may provide the capital at a reasonable cost, and shareholders of equal would act with care and loyalty to all stakeholders. In particular, they would exert checks and balances on executive managers in the group.

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BIOGRAPHY

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