Ch.2 Theories of Corporate Governance

Thomsen, S., Conyon, M., 2012, Corporate Governance; Mechanisms and Systems, McGraw Hill.
Introduction

- Chapter reviews corporate governance theories
- Market model of standard microeconomics
- Agency theory
- Related non-governance disciplines with applications in corporate governance
The market model

- The firm is a black box characterized by a technology and profit maximization
- The economy works by itself under the price mechanism
  - Based on pre-industrial society
  - Buyers and sellers compete prices down
  - Centralized exchange
  - Full information
  - Complete markets
  - No transaction costs
Agency theory

- Different parties have different interests
  - potential risk of people acting in their own interest on the other party’s expense

- Agents and principals
  - Principals = owners, or anyone who hire someone else to do a certain job at their expense
  - Agents = managers, a person hired to do a certain job in exchanged for an agreed compensation

- Whenever in a contract, one party therefore needs to
  - 1) monitor the other party
  - 2) find ways to ensure that interests are aligned
Agency theory (cont’d)

- Rule of Man
  - Interest Divergence
    - Agency Problems
      - Agency Costs
        - Control Mechanisms
The owner-manager problem

- Separation of ownership and control give rise to the need for professional managers.
- Owners employ managers to run the firm in the best interest of the investors – and most managers do.
- However, some managers act criminal and embezzle shareholder funds.
- Another classical agency problem is excess expenditure: what expenses are business motivated and what is the manager’s private consumption (consider a private company jet)?
Assumptions in agency theory

- Homo Economicus is rational, individualistic and opportunistic

- Always seeks to maximize own benefits and personal utility

- Moral responsibilities to act in someone else's interest are second priority
Assumptions in agency theory (cont’d)

- Arise when two Homo Economicus meet, for example owners and managers

- In firms the conflict of interest becomes especially important since only one party bears the cost for running the firm
Types of agency problems

- **Agency conflicts type I** most common in firms/nations with dispersed ownership
  - Collective action problems and free rider problems (no one has incentive to monitor)
- **Agency conflicts type II** most common in firms/nations with concentrated ownership
  - Private benefits
- **Agency conflicts type III** in both dispersed and concentrated ownerships
Information problems

- Information problems concern primarily two types of asymmetric information between owners and managers.
- Adverse selection occurs before the manager makes a decision, while moral hazard occurs after a decision has been taken.

![Figure 2.1 Adverse selection and moral hazard](http://example.com/image.png)
Moral hazard

- “Hidden action”
- Occurs when the activity of the agent (manager) cannot be observed by the principal (owner)
- Moral hazard illustrates the trade-off between risk and incentives: if you don’t carry any risk you loose your incentives to protect yourself against it
- Managers can be given incentives to share some of the shareholders’ risk, for example by being remunerated with stock options or bonuses for excellent firm performance
Adverse selection

- “Hidden knowledge”
- Owners know less about the state of the firm than managers, and they know less about a the capabilities of a new manager than the manager herself
- Consider the example with Monday cars – “lemons”
- Adverse selection can partly be solved through monitoring
Extensions to agency theory

- We can imagine three types of extensions

1. With additional layers of agency relationships, as ownership shifts to institutional. Portfolio managers are not the ultimate owners of the invested capital. Thus, also the portfolio manager requires monitoring in the same way as the firm manager.

2. Most firms have several owners; principals might not share the same objectives and aims.

3. Agency problems have a time dimension. Bad decisions lead to bad reputation for the manager which provides incentive to improve.
Incomplete contracts

- Incomplete contracts theory provide that whoever has asset ownership possesses the residual right of control.

- Residual right of control means the right to control in all situations not already covered by contracts.

- Explains why large corporations cannot replicate the incentives of small entrepreneurial firms. As employees do not have the residual right of control they lack incentives to make an effort as the employer can act in his own interest whenever he’s not covered by a complete contract.
Transaction costs

- Transaction costs lead to many deviations from the market model.

- The existence (and size) of transaction costs affect firm decisions to trade or produce.

- Thus, transaction costs can explain vertical integration and why firms grow large, thus causing the need for external finance which makes ownership separate from control.
Psychology

- Behavioral economics rise with the recognition that underlying assumptions of agency theory might be incorrect
- Human beings are not completely rational or selfish
- Several streams of research can be applied to corporate governance settings:
  - Deviations from rationality
  - Managers looking for information that coincides with their personal ideas and preferences
  - People consider their own mistakes as a result of bad luck
  - Etc
The relevance of sociology concerns mainly:

- Social networks theory that describes connections between companies, boards and investors
- The study of social norms, values, and cultures
- Social networks can be considered as a set of agents connected through various ties (boards, ownership etc) which can be clustered to measure the size of a network
- Norms and values have obvious bearing on corporate governance as attitudes of honesty and fairness reduce agency problems
Politics is highly important because it shapes the law.

Parallels can also be drawn between models of democracy and corporate governance:
- One share, one vote principle: shareholders vote by the size of their holdings and dual-class shares significantly affect voting outcomes.
- Free rider problems make it disadvantageous for smaller investors to engage in voting procedures.
Law

Five core characteristics across jurisdictions:
1. Legal personality: company is independent from its owners, and thus, shielded from personal creditors of the owners
2. Limited liability: risk can be shared with creditors who have no recourse to the shareholders
3. Transferable shares: allows the firm to continue business independently of changes in ownership structure
4. Centralized management: company is run by the board that is formally separate from both management and shareholders
5. Investor ownership: right to control and right to profits
Philosophy

- Relevant primarily when discussing business ethics
- Stakeholder theory emphasizes that the purpose of a corporation is to create value for its stakeholders (customers, employees, creditors etc)
- Based on the argument that this is “the right thing to do”, and thus highly philosophical
- Others argue that profit is significantly dependent on close relationships with your stakeholders
Enlightened agency theory

- Starts with the basic agency problem and expands by taking the psychology of individuals into account
- Egoistic objectives might lead controlling investors and managers to actions
  - Extraction of private benefits by blockholding families
  - Imperial construction by CEOs
- This cannot be calculated for in mathematical agency theory
Summary

- Agency theory is the most influential theory in corporate governance
- It has been challenged with perspectives from a wide variety of academic fields
- Basic assumptions of agency theory, particularly concerning the human nature, can be questioned on the basis of psychology, sociology and other alternative perspectives
- Different approaches to corporate governance should be considered complementary