Part 2:
Corporate Governance comprises of several interrelated institutions

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Corporate governance and its key players

- Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer &Vishny, 1997)
- Owners: Provide risky capital
- Board of directors: Represent owners and control executives
- Executives: Run daily business operations
- BUT there could be other players, like employees, banks and other creditors, customers, suppliers…

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Why aren’t owners running the business?

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What does an institution of corporate governance mean?

- Corporate governance institution (Roe, 2004):

Institutions are those **repeated mechanisms** that **allocate authority** within corporate governance and that **affect, modulate and control** the decisions made at the top of the corporation.

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Why do we need institutions?

- Two kinds of intended roles from the perspective of normal shareholder
  - Cost reducing
    - Preventing majority owner's opportunistic behavior
    - Preventing managerial opportunistic behavior
- Costs: reduce the wealth from the perspective of normal shareholder due to majority owner's or managerial opportunistic behavior or due to attempts to avoid the costs of opportunism.
- But also for value increasing (actions increase the value of company)

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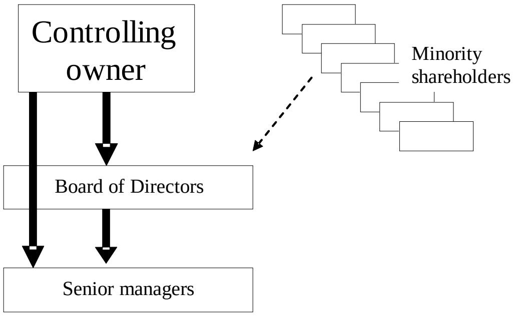
The influence of controlling owner is strong



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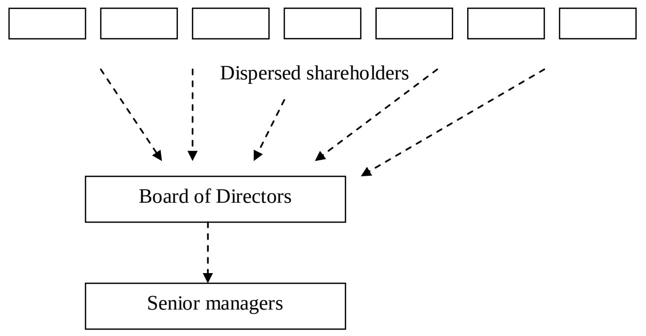
The influence of dispersed shareholders to senior managers is weak



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Types of owners and opportunistic behavior

- Wealthy family based
- Financial institution based
- Government based
- Investor based

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Tunneling: transfer of resources out of a company to its controlling shareholder

- Cash flow tunneling: Removes a portion of current year's cash flow
- Asset tunneling: The transfer of major long-term assets from (to) the firm for less (more) than market value
- Equity tunneling: Increases the controller's share of the firm's value at the expense of minority shareholders

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What can minority shareholders do to avoid tunneling?

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Problems that occur in agency relationship:

- Agency problem arises when
  - Moral hazard: The goals of the principal and agent differ
  - Adverse selection: The agent knows more than the principal.
  - It is expensive for the principal to verify what the agent is actually doing
- Risk sharing problem:
  - Principal and agent do not face same risks
  - Principal and agent have different attitudes toward risk

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Agency costs:

- The monitoring costs by the principal (our main focus)
- The bonding costs by the agent
- The residual loss

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Managerial opportunistic behavior and agency costs

- Stealing
- Shirking

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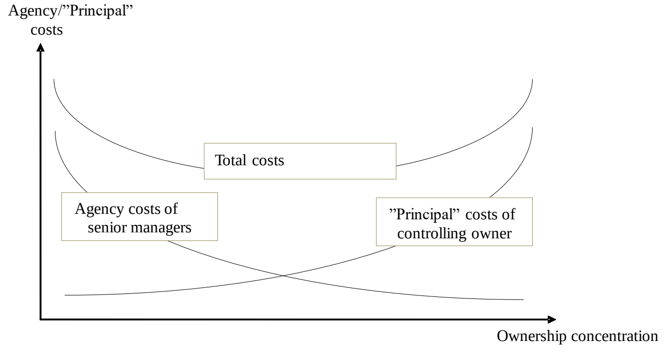
Costs of opportunistic behavior



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CG institutions act against tunneling, stealing and/or shirking

- Institutions are interrelated to each other either directly or indirectly

- The better the markets work, the easier is for the other institutions to act

Markets create the basis of institutions

- Product and service markets

- Capital markets

But it is only a basis

- Managerial labor markets

- Poorly working markets create problems for other institutions

Board of directors

- Key element in vertical corporate governance
- Shareholders elect
- Key tasks:
  - Control executives
  - Hires and fires CEO
  - Decide executive compensation
  - Advice executives

Information distribution and gate-keeping

- Reduces information asymmetry between distant shareholder and executives
- Periodic and continuous financial disclosures
- Legal-based but offers room for financial disclosure management.
- Market value vs. fair value

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Coalescing shareholders

- For diversified investors it is difficult to influence companies
- Shareholder voice
- Stewardship role of shareholders
- Proxy fights, LBOs and takeovers

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Executive compensation

- Fixed and variable element of compensation
- Variable elements attempt to align shareholders' and executive's interest
- Time horizon challenges
- Risk-taking challenges
- Instead of solving the agency problems, may create agency problems

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Professionalism and norms

- Satisfaction of doing a good job
- If internalized, very effective
- Corporate governance codes
  - Guide listed companies and also other companies towards good corporate governance
  - Window dressing?

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Control

- Audit
  - ”Guarantee” the quality of published financial information
  - Independence and quality are important
- Risk management
  - Strategic, operative, reporting and compliance
- Internal audit
  - Assures the processes
  - Management control, risk management and governance

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Corporate lawsuits

- When other institutions do not work properly
- Most common cases:
  - Unequal treatment of shareholders
  - Manipulation of financial information
  - Insider trading

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Increased role of legitimacy

- Good for the society and sustainability
- Controlling for externalities
  - Social and environmental
  - Long-term perspective

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Internal corporate governance plays a primary role in the governance game

- Institution from the inside to the external ones
  - Board of directors, the core of internal corporate governance
  - Executive compensation
  - Investor relation
  - Auditing and internal control
- When internal mechanisms fail!
  - Managerial markets
  - Threat of corporate takeover
  - Legal system and norms

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Institutions are not independent, rather they are complements and substitutes.

- Institutions are interrelated

- They complement and substitute each other

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