

Course: Economics of Industry



Lecture 6: Business Case for Corporate Governance

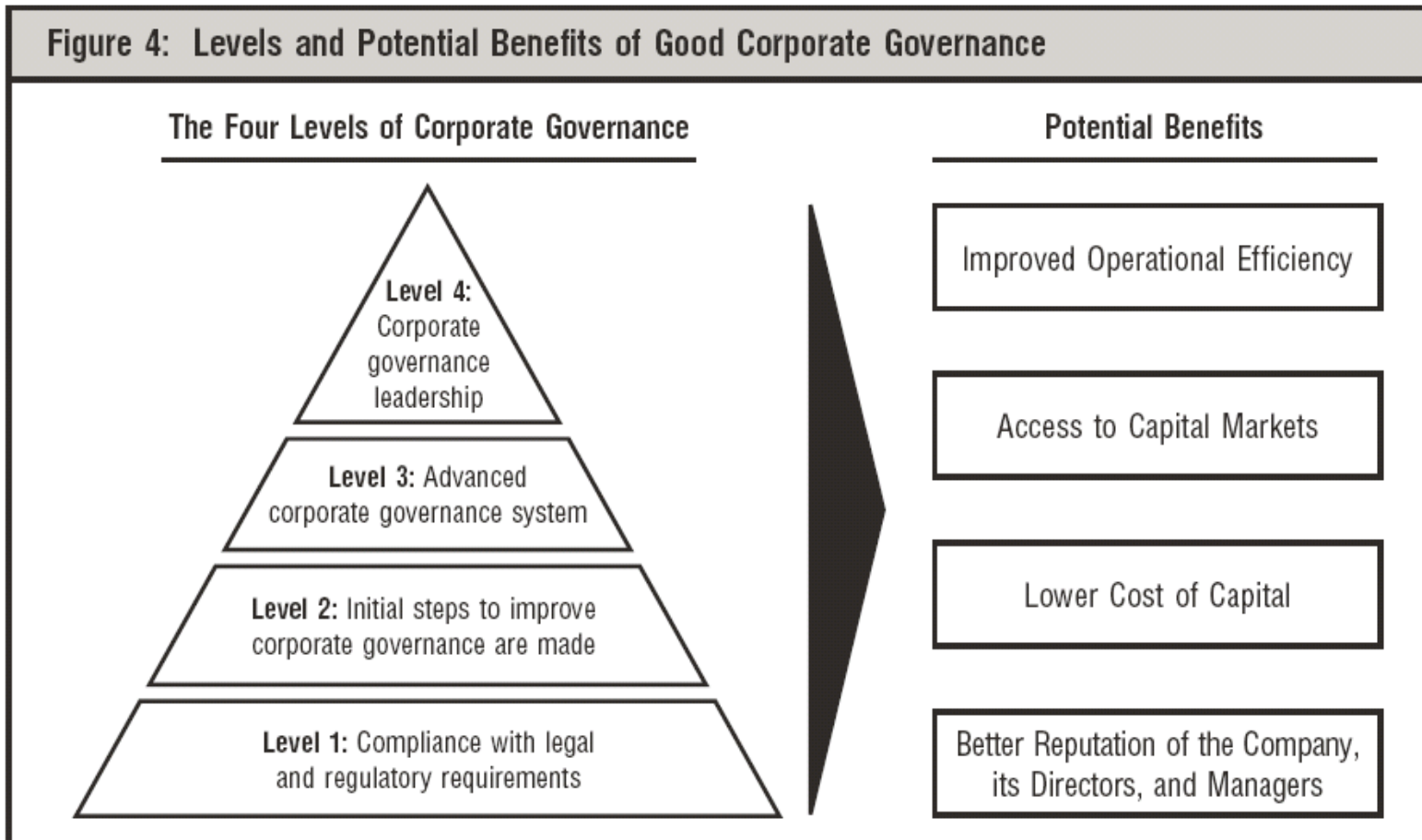
Presented by Rustam Gulyamov

Business Case for Corporate Governance

- Well governed companies have lower cost of capital
- Reduction of risks
- Higher valuation of human capital in companies that are well governed
- Higher share valuation

IFC Business Case

Figure 4: Levels and Potential Benefits of Good Corporate Governance



Advantages of Good Corporate Governance

- Stimulating Performance and Improving Operational Efficiency
 - Better oversight and accountability
 - Improved decision making
 - Better compliance and less conflict
 - Less self-dealing
 - Better informed
 - Avoidance of costly litigation through adherence to laws and regulations

Advantages of Good Corporate Governance

- Improving Access to Capital Markets
 - Transparency, accessibility, efficiency, timeliness, completeness, and accuracy of information critical
 - Listing requirements
 - Inclusion of Corporate Governance in investment decision process

Anglo-Saxon Model

- US, UK, Canada, Australia, New Zealand
- Shareholder value maximization
- “outsider” model – arms length investor
- Internal governance mechanisms
 - board of directors
 - employee compensation
- External mechanisms
 - market for corporate control
 - monitoring by financial institutions
 - competition in product and input market
- Reliance on legal mechanisms to protect shareholder rights
- Short term financial performance key

German (Continental) Model

- Co-determination - partnership between capital and labor
- Social cooperation
- The two-tier board structure that consists of a supervisory board and executive board – greater efficiency in separation of supervision and management
- Cross-shareholding in financial – industrial groups
- Role of banks as major shareholders
- Primary sources of capital – retained earnings and loans

Japanese Model

- Formal role of large and almost entirely executive boards – single tier board
- Historical roots of the Keiretsu network interlocking business relationships
- Existence of significant cross holdings and interlocking-directorships,
- Lifetime employment system plays in corporate policy
- Role of banks
- Market share maximization over shareholder value maximization
- Long term perspective

Corporate Governance Framework in Russia

- Concentrated Ownership
- The observation that there is little separation between ownership and control
- Holding structures and reorganizations used to deny free exercise of ownership rights
- Inexperienced Directors
- Government Intervention

Market for Corporate Control

- “Friendly Takeover”
 - When a bidder makes an offer for another, it will usually inform the board of the target beforehand. If the board feels that the value that the shareholders will get will be greatest by accepting the offer, it will recommend the offer be accepted by the shareholders.
- A takeover would be considered "hostile" if
 - 1) the board rejects the offer, but the bidder continues to pursue it, or
 - 2) if the bidder makes the offer without informing the board beforehand.

Theory

- Berle and Means (1932) – separation of ownership and control through modern corporation structures
- Agency Problem

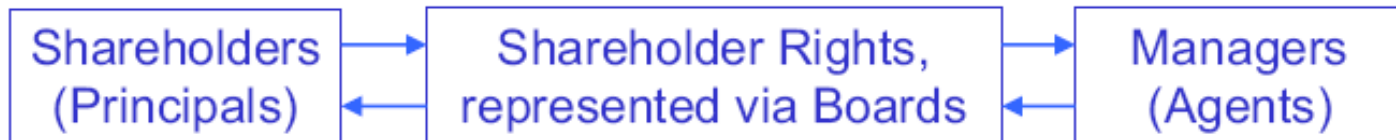
Agency Problem

- Separation of Ownership and Control
- Contract between financiers and management
- Managerial discretion - Business judgement
- Managerial opportunism – self dealing

Agency Problem

- Duty of loyalty of management to firm
- Incentive contracts that align management interests with investors
- Agency costs – monitoring and compliance
- Shareholder actions- shareholder democracy, proxy fights, access to the proxy ballot, derivative lawsuits

Control Mechanisms



Raises another principal-agent situation:
Shareholders & Directors



Raises another principal-agent situation:
Small owners & Large owners

More Theory

- Conventional Wisdom (Manne 1971) :
- The business literature describing the classical functions of boards of directors typically includes three important roles: (1) establishing basic objectives, corporate strategies, and board policies; (2) asking discerning questions; and (3) selecting the president.

Some Early Research (Manne 1971)

- First classical role
 - Found that boards of directors of most large and medium-sized companies do not establish objectives, strategies, and policies however defined
 - These roles are performed by company management
 - Presidents and outside directors generally agreed that only management can and should have these responsibilities.

Some Early Research (Manne 1971)

- A second classical role assigned to boards of directors is that of asking discerning questions - inside and outside the board meetings. Again it was found that directors do not, in fact, do this. Board meetings are not regarded as proper forums for discussions arising out of questions asked by board members.
- A third classical role usually regarded as a responsibility of the board of directors is the selection of the president. Yet it was found that in most companies directors do not in fact select the president, except in the two crisis situations cited earlier.

Research that confirms Stewardship Theory

- Muth and Donaldson (1997) challenged agency theory, which underpin conventional assumptions about the benefits of checks and balances –
 - Boards with well connected, executive directors perform better than those that meet the paradigms of conventional governance thinking
- Also research has shown that increasing governance conformance and compliance may not add to corporate performance - it can actually detract - Donaldson and Davies (1994)

Theoretical Challenges to Agency Theory

- Stewardship theory, the alternative perspective, takes an altogether broader frame of reference, being based on the original and legal view of the corporation in which directors have a fiduciary duty to their shareholders to be stewards for their interests.

Performance Governance Relationship

$$Y_{it} = \alpha + \beta_1 Gov_{it} + \gamma X_{it} + e_{it}$$

- Y_{it} is one of the firm performance measures, Gov_{it} is a governance rating, X_{it} is a vector of control variables and e_{it} is the error term.

Russian Corporate Governance Structures

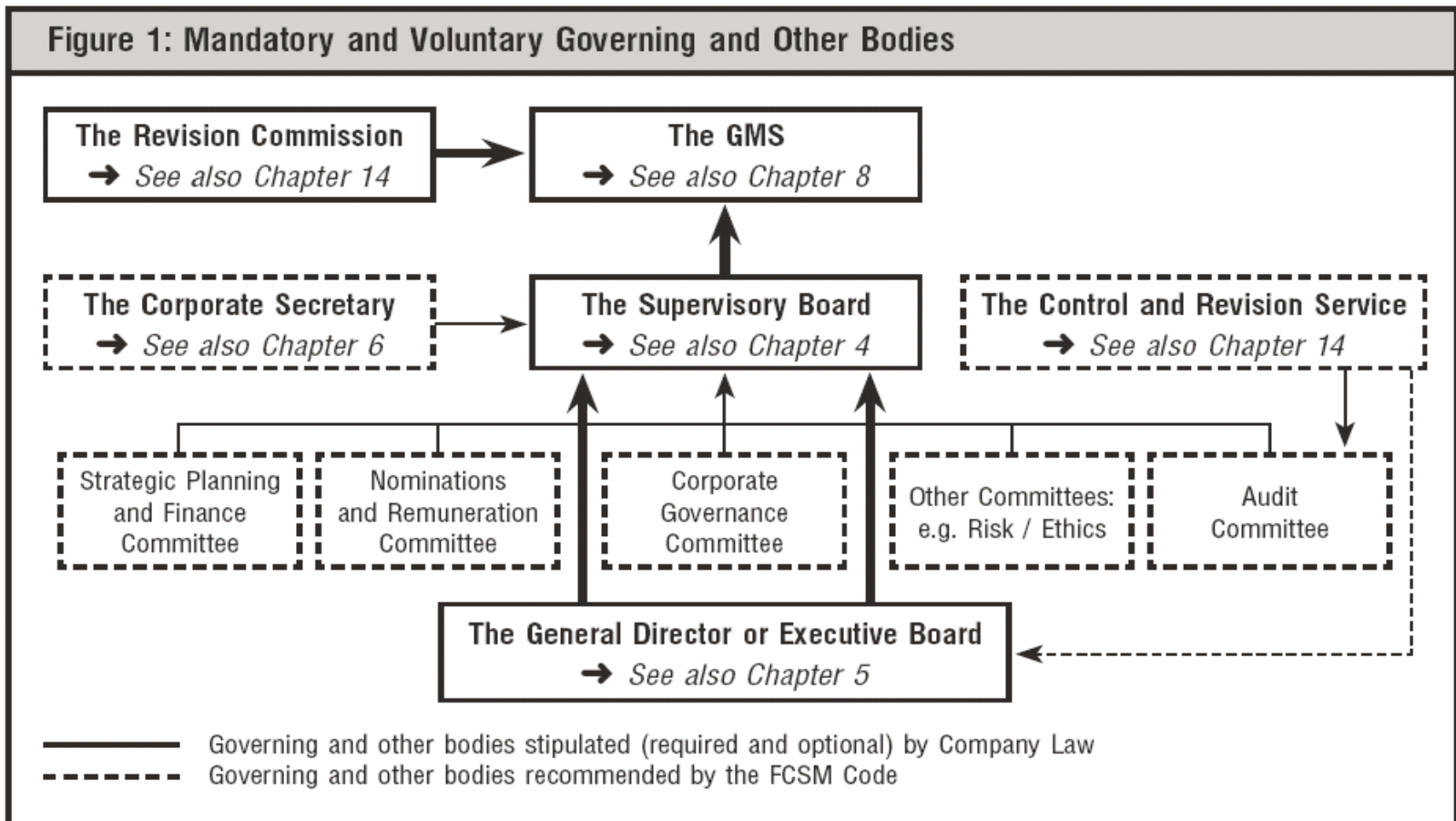


Figure 3: Functions Performed by Supervisory Boards in Russia

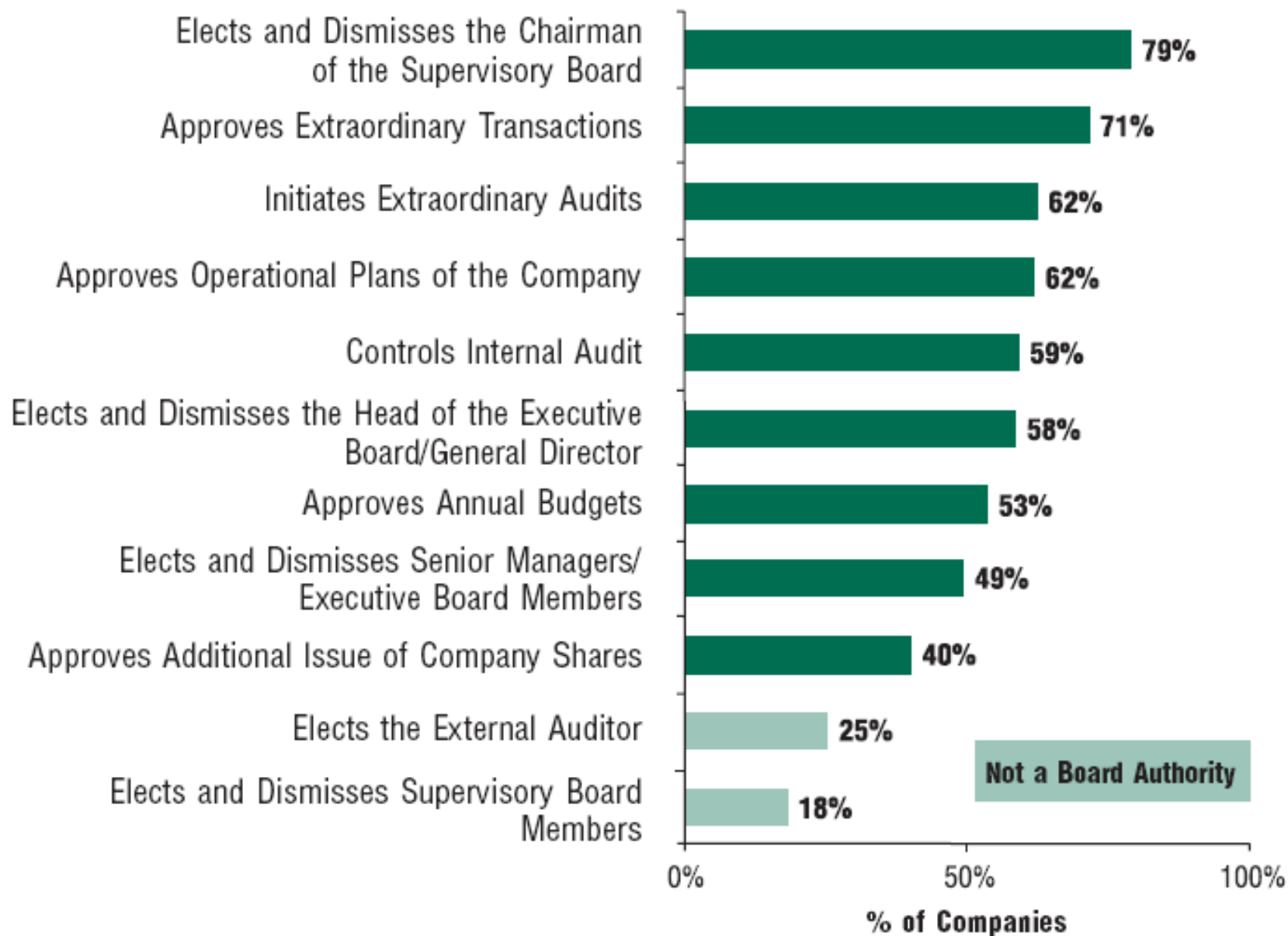
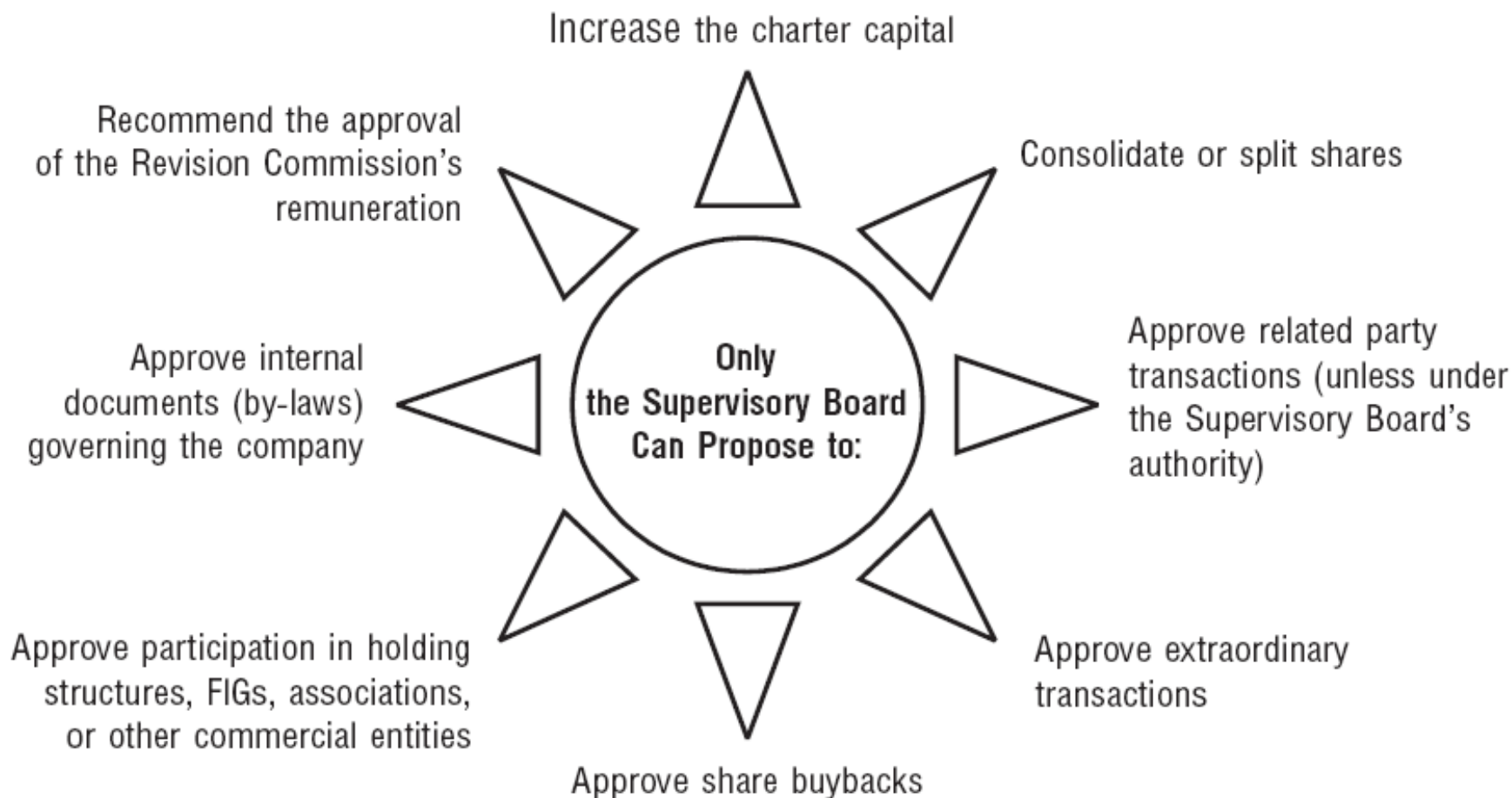


Figure 4: Items That Only the Supervisory Board Can Include on the Agenda of the GMS



Source: IFC, March 2004

Figure 5: Sources of Assurance



Source: The Institute of Chartered Accountants in England and Wales, Implementing Turnbull, a Boardroom Briefing, 1999.

Required number of Directors

- At least five directors for companies with 1,000 and fewer shareholders with voting rights;
- At least seven directors for companies with more than 1,000 shareholders with voting rights;
- At least nine directors for companies with more than 10,000 shareholders with voting rights.

Who can be a director?

- Only individuals with “full dispositive capacity” can be directors. Directors should have the capacity to acquire and exercise civil law rights by their actions, be able to create civil law obligations, and fulfill these rights and obligations;
- A legal entity cannot be a director, although an individual who happens to be a representative of a legal entity can be elected to the Supervisory Board. In this case, the individual elected to the Supervisory Board may only serve in his capacity as a director and not as a representative of the legal entity, i.e. he must act in the interest of the company on whose Supervisory Board he is sitting and not of the company he is representing

Who can not be a director?

- Revision Commission members cannot be directors
- Counting Commission members cannot be directors
- An Executive Board member or the General Director of Company A can only be a director of Company B after the Supervisory Board of Company A has given its consent.

Types of Directors

a) Executive Directors

Executive directors can be defined as those that also hold an executive position in the company, namely that of:

The General Director;

An Executive Board member; or

A manager of the company who is not an Executive Board member.

Types of Directors

b) Non-Executive Directors

Non-executive directors are Supervisory Board members that do not hold an executive position in the company.

c) Independent Directors

Russian law does not define the concept of independent directors. The Company Law does, however, refer to independent directors under specific circumstances to determine the position of individuals engaged in related party transactions and to prevent possible conflicts of interests.

Independent Director

- In this respect, an independent director is defined as an individual who has not been in any of the following positions at the time of the approval of a business transaction, or during one year immediately preceding the approval of such a transaction:
 - The General Director, the External Manager, an Executive Board member or a member of the governing bodies (Supervisory Board, General Director and Executive Board) of the External Manager; or
 - A person whose spouse, parents, children, brothers, and sisters by one or both parents are the External Manager or hold a position in the governing bodies of the External Manager; or
 - A person whose adoptive parents or adopted children are the External Manager or hold a position in the governing bodies or the External Manager; or
 - An affiliated person other than a director of the company.

What is Independence?

- **Independence of a Director:** a Director must always act in a manner independent of management and never be conflicted by any relationship to management (i.e., financial, familial, or social). Independence measurements include:

Relatedness of the Director:

- Employee (in last three years);
- Professional advisor (in last three years);
- Executive of any affiliated company;
- Other income from company;
- Kinship or social ties;
- Interlocks with other Directors;
- Number of Boards on which Director serves.

Independent Director

- In conflict situations, an Independent Director shall be guided by the principles of increasing shareholder value and an equitable approach to the interests of all shareholder groups, and encourage the parties involved in the decision to adhere to the same principles.
- An Independent Director shall not abuse his/her position to the detriment of the company or its shareholders or for the purpose of gaining direct or indirect personal advantage or advantage for any other associated person, except for the remuneration for Board membership.

Independent Director

- Observance of the independence requirement is the most important aspect of the activity of an Independent Director.
- (1) An Independent Director shall refrain from any actions that could lead to a loss of his/her independence. Where circumstances arise which make an Independent Director lose his/her independence, the Independent Director must immediately notify the shareholders, the management and the Association accordingly.
 - (2) An Independent Director shall be prepared to provide arguments in support of his/her position if he/she disagrees with the majority of members of the Board of Directors, its chairman, the president of the company, or its managing director.

Independent Director

- Transparency and openness to dialog are the distinguishing characteristics of an Independent Director.
 - (1) An Independent Director shall strive to establish constructive dialog with the company's Board of Directors and executive management. An Independent Director's ethical standards, decision making principles and reasons for disagreeing with a proposed decision should be clear for the Board of Directors and executive management.
 - (2) An Independent Director is recommended to present the present Code to the company's Board and the management.

Independent Director

- An Independent Director acts as an agent of all the company shareholders and therefore shall, within the limits of his/her authority, protect the rights and legitimate interests of all of the company's shareholders and help establish constructive dialog between the company's shareholders and management.
- An Independent Director shall endeavor to ensure that shareholders are given access to corporation information.

Independent Director

- When dealing with third parties, an Independent Director shall be loyal to the company and its shareholders and protect their interests.
- When dealing with the investment community and stock market analysts, an Independent Director shall make every possible effort to enable all the parties concerned to have simultaneous access to the information disclosed.
- An Independent Director shall disclose only accurate information that may be disclosed according under applicable laws and does not damage the company's business.

Reference

- Entertainment Industry Economics: A Guide for Financial Analysis L. Vogel | Aug 27, 2020
- The New Economics for Industry, Government, Education (The MIT Press) by W. Edwards Deming | Oct 30, 2018
- Marketing Strategy for the Creative and Cultural Industries (Discovering the Creative Industries) Part of: Discovering the Creative Industries (12 Books) | by Bonita Kolb | Sep 17, 2020
- Entertainment Industry Economics: A Guide for Financial Analysis by Harold L. Vogel | Dec 31, 2014
- The New Economics for Industry, Government, Education - 2nd Edition by W. Edwards Deming | Jul 31, 2000
- The New Economics for Industry, Government, Education, Third Edition by W. Edwards Deming and Kevin Edwards Cahill | Jan 1, 2019