PART 3

STRATEGIC ACTIONS: STRATEGY IMPLEMENTATION

CHAPTER 10

Corporate Governance

Management of Strategy
Concepts and Cases

Michael A. Hitt • R. Duane Ireland • Robert E. Hoskisson

PowerPoint Presentation by Charlie Cook
The University of West Alabama

Knowledge Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define corporate governance and explain why it is used to monitor and control managers' strategic decisions.
2. Explain why ownership has been largely separated from managerial control in the modern corporation.
3. Define an agency relationship and managerial opportunism and describe their strategic implications.
4. Explain how three internal governance mechanisms—ownership concentration, the board of directors, and executive compensation—are used to monitor and control managerial decisions.

KNOWLEDGE OBJECTIVES *(cont'd)*

Studying this chapter should provide you with the strategic management knowledge needed to:

5. Discuss the types of compensation executives receive and their effects on strategic decisions.
6. Describe how the external corporate governance mechanism—the market for corporate control—acts as a restraint on top-level managers' strategic decisions.
7. Discuss the use of corporate governance in international settings, in particular in Germany and Japan.
8. Describe how corporate governance fosters ethical strategic decisions and the importance of such behaviors on the part of top-level executives.

Corporate Governance

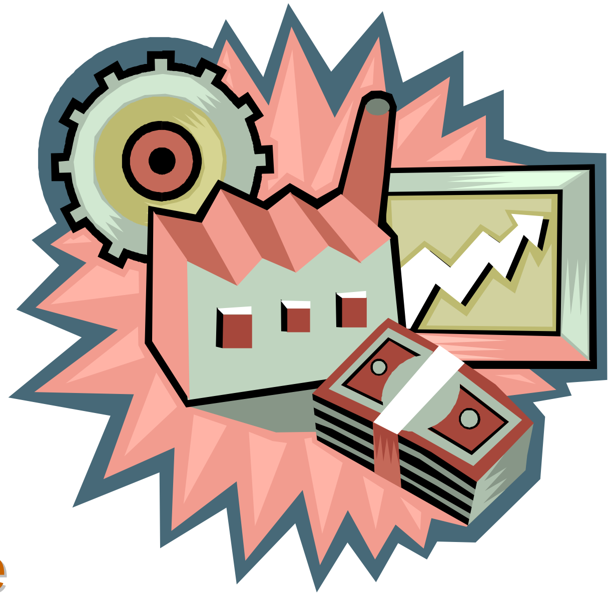
- Corporate governance is:
  - A relationship among stakeholders that is used to determine and control the strategic direction and performance of organizations.
  - Concerned with identifying ways to ensure that strategic decisions are made more effectively.
  - Used in corporations to establish order between the firm's owners and its top-level managers whose interests may be in conflict.

Internal Governance Mechanisms

- Ownership Concentration
  - Relative amounts of stock owned by individual shareholders and institutional investors
- Board of Directors
  - Individuals responsible for representing the firm's owners by monitoring top-level managers' strategic decisions

Internal Governance Mechanisms (cont'd)

- Executive Compensation
  - The use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests.
- Market for Corporate Control
  - The purchase of a firm that is underperforming relative to industry rivals in order to improve its strategic competitiveness.

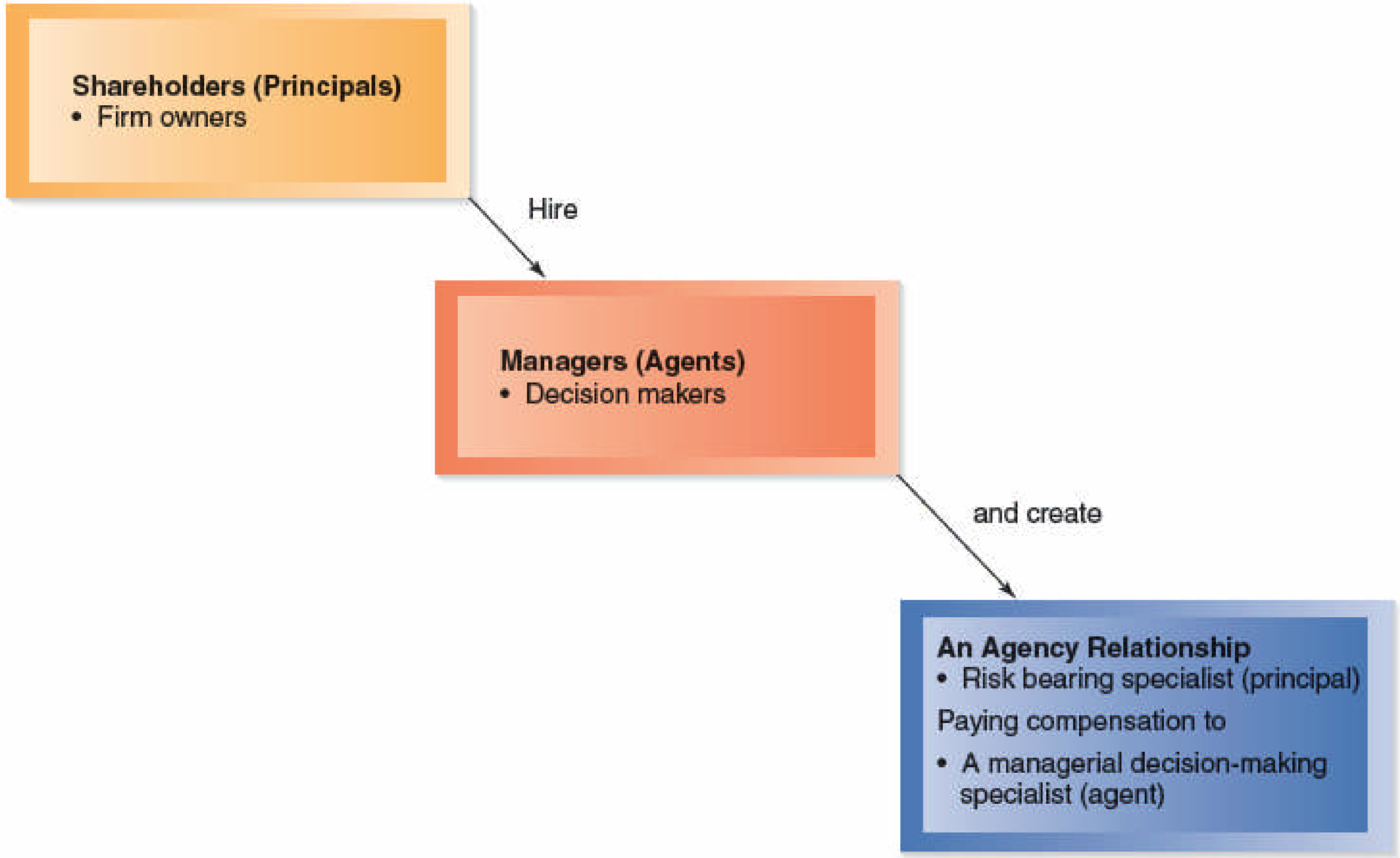


Separation of Ownership and Managerial Control

- Basis of the modern corporation
  - Shareholders purchase stock, becoming residual claimants.
  - Shareholders reduce risk by holding diversified portfolios.
  - Professional managers are contracted to provide decision making.
- Modern public corporation form leads to efficient specialization of tasks:
  - Risk bearing by shareholders
  - Strategy development and decision making by managers

FIGURE 10.1

An Agency Relationship



Agency Relationship Problems

- Principal and agent have divergent interests and goals.
- Shareholders lack direct control of large, publicly traded corporations.
- Agent makes decisions that result in the pursuit of goals that conflict with those of the principal.
- It is difficult or expensive for the principal to verify that the agent has behaved appropriately.
- Agent falls prey to managerial opportunism.

Managerial Opportunism

- The seeking of self-interest with guile (cunning or deceit)
- Managerial opportunism is:
  - An attitude (inclination)
  - A set of behaviors (specific acts of self-interest)
- Managerial opportunism prevents the maximization of shareholder wealth (the primary goal of owner/principals).

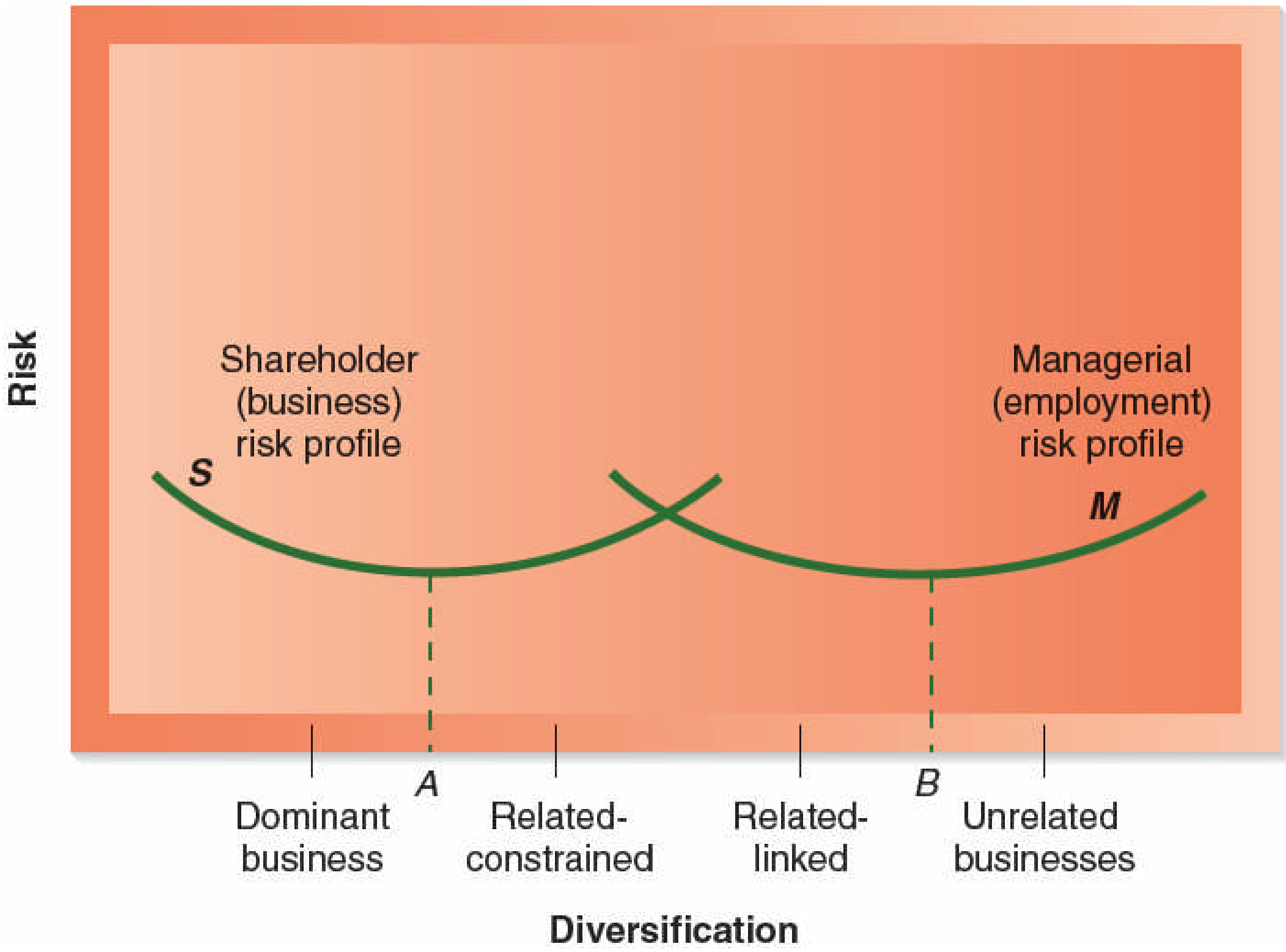
Response to Managerial Opportunism

- Principals do not know beforehand which agents will or will not act opportunistically.
- Thus, principals establish governance and control mechanisms to prevent managerial opportunism.

Examples of the Agency Problem

- The Problem of Product Diversification
  - Increased size, and the relationship of size to managerial compensation
  - Reduction of managerial employment risk
- Use of Free Cash Flows
  - Managers prefer to invest these funds in additional product diversification (see above).
  - Shareholders prefer the funds as dividends so they control how the funds are invested.

FIGURE 10.2 Manager and Shareholder Risk and Diversification



Agency Costs and Governance Mechanisms

- Agency Costs
  - The sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals, because governance mechanisms cannot guarantee total compliance by the agent.
- Principals may engage in monitoring behavior to assess the activities and decisions of managers.
  - However, dispersed shareholding makes it difficult and inefficient to monitor management's behavior.

Agency Costs and Governance Mechanisms (cont'd)

- Boards of Directors have a fiduciary duty to shareholders to monitor management.
  - However, Boards of Directors are often accused of being lax in performing this function.

TABLE 10.1 Corporate Governance Mechanisms

Internal Governance Mechanisms

Ownership Concentration

- Relative amounts of stock owned by individual shareholders and institutional investors

Board of Directors

- Individuals responsible for representing the firm's owners by monitoring top-level managers' strategic decisions

Executive Compensation

- Use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests

External Governance Mechanism

Market for Corporate Control

- The purchase of a company that is underperforming relative to industry rivals in order to improve the firm's strategic competitiveness

Governance Mechanisms

Ownership Concentration (a)

- Large block shareholders have a strong incentive to monitor management closely:
  - Their large stakes make it worth their while to spend time, effort and expense to monitor closely.
  - They may also obtain Board seats which enhances their ability to monitor effectively.
- Financial institutions are legally forbidden from directly holding board seats.

Governance Mechanisms (cont'd)

Ownership Concentration (b)

- The increasing influence of institutional owners (stock mutual funds and pension funds)
  - Have the size (proxy voting power) and incentive (demand for returns to funds) to discipline ineffective top-level managers.
  - Can affect the firm's choice of strategies.

Governance Mechanisms (cont'd)

Ownership Concentration (c)

- Shareholder activism:
  - Shareholders can convene to discuss corporation's direction.
  - If a consensus exists, shareholders can vote as a block to elect their candidates to the board.
  - Proxy fights.
  - There are limits on shareholder activism available to institutional owners in responding to activists' tactics

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (a)

- Board of directors
  - Group of elected individuals that acts in the owners' interests to formally monitor and control the firm's top-level executives
- Board has the power to:
  - Direct the affairs of the organization
  - Punish and reward managers
  - Protect owners from managerial opportunism

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (b)

- Composition of Boards:
  - Insiders: the firm's CEO and other top-level managers
  - Related Outsiders: individuals uninvolved with day-to-day operations, but who have a relationship with the firm
  - Outsiders: individuals who are independent of the firm's day-to-day operations and other relationships

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (c)

- Criticisms of Boards of Directors include:
  - Too readily approve managers' self-serving initiatives
  - Are exploited by managers with personal ties to board members
  - Are not vigilant enough in hiring and monitoring CEO behavior
  - Lack of agreement about the number of and most appropriate role of outside directors.

Governance Mechanisms (cont'd)

Ownership Concentration

Board of Directors (d)

- Enhancing the effectiveness of boards and directors:
  - More diversity in the backgrounds of board members
  - Stronger internal management and accounting control systems
  - More formal processes to evaluate the board's performance
  - Adopting a "lead director" role.
  - Changes in compensation of directors.

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- **Executive Compensation (a)**

- Forms of compensation:
  - Salaries, bonuses, long-term performance incentives, stock awards, stock options
- Factors complicating executive compensation:
  - Strategic decisions by top-level managers are complex, non-routine and affect the firm over an extended period.
  - Other variables affecting the firm's performance over time.

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- **Executive Compensation (b)**

- Limits on the effectiveness of executive compensation:
  - Unintended consequences of stock options
  - Firm performance not as important than firm size
  - Balance sheet not showing executive wealth
  - Options not expensed at the time they are awarded

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- Executive Compensation
- **Market for Corporate Control (a)**

- Individuals and firms buy or take over undervalued corporations.
  - Ineffective managers are usually replaced in such takeovers.
- Threat of takeover may lead firm to operate more efficiently.
- Changes in regulations have made hostile takeovers difficult.

Governance Mechanisms (cont'd)

- Ownership Concentration
- Board of Directors
- Executive Compensation
- Market for Corporate Control (b)

- Managerial defense tactics increase the costs of mounting a takeover
- Defense tactics may require:
  - Asset restructuring
  - Changes in the financial structure of the firm
  - Shareholder approval
- Market for corporate control lacks the precision of internal governance mechanisms.

TABLE 10.2 The General Environment: Segments and Elements

Defense strategy	Category	Popularity among firms	Effectiveness as a defense	Stockholder wealth effects
Poison pill	Preventive	High	High	Positive
Corporate charter amendment	Preventive	Medium	Very low	Negative
Golden parachute	Preventive	Medium	Low	Negligible
Litigation	Reactive	Medium	Low	Positive
Greenmail	Reactive	Very low	Medium	Negative
Standstill agreement	Reactive	Low	Low	Negative
Capital structure change	Reactive	Medium	Medium	Inconclusive

Source: J. A. Pearce II & R. B. Robinson, Jr., 2004, Hostile takeover defenses that maximize shareholder wealth, *Business Horizons,* 47(5): 15–24.

International Corporate Governance

- Germany
  - Owner and manager are often the same in private firms.
  - Public firms often have a dominant shareholder, frequently a bank.
  - Frequently there is less emphasis on shareholder value than in U.S. firms, although this may be changing.

International Corporate Governance (cont'd)

Germany: Two-tiered Board

Vorstand — Responsible for the functions of direction and management

↑

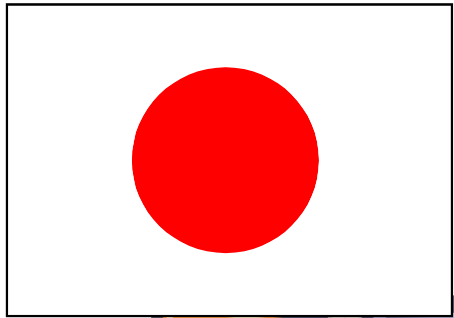
Aufsichtsrat — Responsible for appointing members to the Vorstand

↑

Union members Shareholders — Responsible for appointing members to the Aufsichtsrat

International Corporate Governance (cont'd)

- Japan
  - Important governance factors:
    - Obligation
    - "Family"
    - Consensus
  - Keiretsus: strongly interrelated groups of firms tied together by cross-shareholdings.
  - Banks (especially "main bank") are highly influential with firm's managers



International Corporate Governance (cont'd)

- Japan (cont'd)
  - Other governance characteristics:
    - Powerful government intervention
    - Close relationships between firms and government sectors
    - Passive and stable shareholders who exert little control
    - Virtual absence of external market for corporate control

International Corporate Governance (cont'd)

- Global Corporate Governance
  - Organizations worldwide are adopting a relatively uniform governance structure.
    - Boards of directors are becoming smaller, with more independent and outside members.
    - Investors are becoming more active.
    - In rapidly developing market economies, minority shareholder rights are not protected by adequate governance controls.

Governance Mechanisms and Ethical Behavior

It is important to serve the interests of the firm's multiple stakeholder groups!

Capital Market Stakeholders
Product Market Stakeholders
Organizational Stakeholders

- Shareholders (in the capital market stakeholder group) are viewed as the most important stakeholder group.
- The focus of governance mechanisms is on the control of managerial decisions to assure shareholder interests.
- Interests of shareholders is served by the Board of Directors.

Governance Mechanisms and Ethical Behavior (cont'd)

It is important to serve the interests of the firm's multiple stakeholder groups!

Capital Market Stakeholders

Product Market Stakeholders

Organizational Stakeholders

- Product market stakeholders (customers, suppliers and host communities) and organizational stakeholders may withdraw their support of the firm if their needs are not met, at least minimally.

Governance Mechanisms and Ethical Behavior (cont'd)

It is important to serve the interests of the firm's multiple stakeholder groups!

- Capital Market Stakeholders
- Product Market Stakeholders
- Organizational Stakeholders

- Some observers believe that ethically responsible companies design and use governance mechanisms that serve all stakeholders' interests.
- Importance of maintaining ethical behavior is seen in the examples of Enron, WorldCom, HealthSouth and Tyco.