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Reading 31: Corporate Governance and ESG: An Introduction

LOS 31a: describe corporate governance

Corporate governance may be defined as the system of internal controls, processes, and procedures by which a company is managed, directed or controlled. Weak corporate governance practices have resulted in the failures of many companies.

The corporate governance practices of countries tend to be different, and it is also not strange for different corporate governance systems to coexist within a single country.

Corporate governance systems generally reflect the influences of either shareholder theory, stakeholder theory or a convergence of the two. Current trends, however, point to an increase in convergence.

Shareholder theory posits that the most important responsibility of a company’s managers is to maximize shareholder returns. Stakeholder theory, on the other hand, emphasizes the need for a company to consider the needs of all its stakeholders and not just its shareholders. This includes the company’s customers, suppliers, creditors, employees and essentially anyone who has an interest in the company.

Question

At a recent conference, the following statements were made about corporate governance.

I. Countries tend to have similar corporate governance practices.
II. According to Shareholder theory, the most important responsibility of a company's management is its customers.
III. There is a current trend towards convergence of shareholder and stakeholder theories.
IV. Corporate governance is the system of internal controls and procedures by which individual companies are managed.

Which of the statements regarding corporate governance is/are most accurate?

A. I and II only

B. II only

C. III and IV only

Solution

The correct answer is C.

Statements III & IV are correct.

Statement I is incorrect. Corporate governance practices can be different from country to country.

Statement II is incorrect. According to Shareholder theory, the most important responsibility of a company's management is its shareholders.

Reading 31 LOS 31a:

Describe corporate governance

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LOS 31b: describe a company's stakeholder groups and compare interests of stakeholder groups

Corporate governance systems can be influenced by several stakeholder groups which may or may not have conflicting interests. A company's primary stakeholder groups include its shareholders, creditors, managers, other employees, customers, suppliers, governments/regulators, and its board of directors.

Shareholders

By providing a company with equity capital, the shareholders of a company are considered its owners. Their interests lie primarily in the profitability of the company and anything which leads to an increase in the company's equity. In the event of bankruptcy, shareholders receive proceeds only after all creditors' claims have been paid. Controlling shareholders hold sufficient shares in a company to control the election of its board of directors and to influence company resolutions. Minority shareholders, on the other hand, have far fewer shares and limited ability to exercise control in voting activities.

Creditors

The creditors of a company are the stakeholders who provide the company with debt financing. Included in this category are bondholders and banks who expect to receive periodic interest payments and principal repayments arising from money that they lent to the company.

Creditors generally prefer stability in a company's operations and performance as this tends to increase the likelihood that a company will generate sufficient cash flow to pay back its debt obligations. In contrast, shareholders tend to accept higher risks in return for a higher return potential from strong company performance.

Managers

Managers and other employees tend to benefit when a company performs well and are adversely affected when the company's financial position weakens. They seek to maximize the value of their total remuneration while securing their jobs. Their interests are therefore not surprisingly different from those of shareholders, creditors, and other stakeholders. Something of potential benefit to other stakeholders may be disadvantageous to them.

The Board of Directors

The board of directors is elected by the shareholders of the company and is charged with the responsibility of protecting shareholders' interests, providing strategic direction and monitoring company and management performance.

Customers

A company's customers expect to receive value when they purchase its goods or services. They tend to be more concerned with company stability and less with financial performance.

Suppliers

Suppliers, just like creditors, are concerned with a company's ability to generate cash flows sufficient to meet its financial obligations.

Governments and Regulators

Governments and regulators seek to ensure that companies comply with the law and act in a manner which safeguards the interests and well-being of the public.

Question

Corporate governance is a system that provides a framework that defines the rights, roles, and responsibilities of various groups. Which one is *least likely* one of these group?

A. Directors

B. Shareholders

C. Employees

Solution

The correct answer is C.

Corporate governance is a system that provides a framework that defines the rights, roles, and responsibilities of board members, shareholders and managers, but it does not include employees as major stakeholders.

Reading 31 LOS 31b:

Describe a company's stakeholder groups and compare interests of stakeholder groups

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LOS 31c: describe principal–agent and other relationships in corporate governance and the conflicts that may arise in these relationships

The term ‘Principal-agent relationship’ or just simply ‘Agency relationship’ is used to describe an arrangement where one entity, the principal, legally appoints another entity, the agent, to act on its behalf by providing a service or performing a particular task.

The agent is expected to act in the best interests of the principal. It is however not unusual for principal-agent relationships to lead to conflicts. The most common example of this occurs when managers, acting as agents, do not act in the best interests of the shareholders of the company (the principals).

Shareholder and Manager/Director Relationships

Directors and managers (agents) are expected to act in the best interests of the shareholders (principal) by maximizing the company’s equity value. These two groups, however, tend to diverge on issues related to the risks that a company should undertake. Managers and directors tend to act in a more risk-averse manner in order to better protect their employment status, whereas shareholders would want for directors and managers to accept more risk in order to maximize equity value.

Additionally, managers usually have greater access to information and are more knowledgeable about the company’s affairs than the shareholders. This information asymmetry makes it easier for managers to make strategic decisions that are not necessarily in the best interests of shareholders.

Controlling and Minority Shareholder Relationships

Minority shareholders usually have limited or no control over management and limited or no voice in director appointments or in major transactions that could directly impact shareholder value. As a result, conflicts between minority and controlling shareholders usually occur wherein the opinions or desires of the minority shareholders are overshadowed by the influence of the controlling shareholders.

Manager and Board Relationships

Whereas managers are involved in the day-to-day operations of a company, the board of directors, especially the non-executive board members, are not. This leads to information asymmetry and makes it difficult for the board to effectively carry out its functions.

Creditor Versus Shareholder Interests

Creditors desire a company to undertake activities that promote stable financial performance and maintain default risk at an acceptable level to essentially guarantee a safe return of their principal and payment of interest. Shareholders, on the other hand, prefer for the company to undertake riskier activities that have strong earnings potential and are more likely to enhance equity value. There is, therefore, a divergence in risk tolerance between these two groups.

Other Stakeholder Conflicts

Examples of other conflicts between stakeholders include: conflicts between customers and shareholders, conflicts between customers and suppliers, and conflicts between shareholders and governments or regulators.

Question

Which of the following statements about principal-agency relationships is *most likely* accurate?

A. Shareholders and creditors tend to have similar risk tolerance with respect to the investments that a company should undertake.

B. In a principal-agent relationship one entity, the agent, appoints another entity, the principal, to act on its behalf.

C. Managers typically have greater access to information about the company’s affairs than the shareholders.

Solution

The correct answer is C.

Shareholders and creditors tend to have different risk tolerance with respect to the investments that a company should undertake.

Option A is incorrect. Creditors desire a company to undertake activities that promote stable financial performance while shareholders prefer for the company to undertake riskier activities that have strong earnings potential.

Option B is incorrect. In a principal-agent relationship one entity, the principal, appoints another entity, the agent, to act on its behalf.

Reading 31 LOS 31c:

Describe principal-agent and other relationships in corporate governance and the conflicts that may arise in these relationships

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LOS 31d: describe stakeholder management

Proper stakeholder management is critical to the success of any organization. It involves taking appropriate steps to identify, prioritize and understand each stakeholder group in order to properly manage the relationships with them. Effective communication and engagement are, therefore, necessary if an organization wants to get the most out of its stakeholder management.

The approaches to stakeholder management may vary across organizations. Typically, however, organizations try to balance stakeholder interests as best as possible. This has the effect of limiting any potential conflicts.

Stakeholder Management Components

To assist with balancing stakeholder interests, corporate governance and stakeholder management frameworks reflect legal, contractual, organizational, and governmental infrastructures. These four components define the rights, responsibilities, and powers of each stakeholder group.

Legal infrastructure

The legal infrastructure defines the framework for legally establishing rights as well as the remedial action to be taken for violations of these rights.

Contractual infrastructure

The contractual infrastructure refers to the contractual arrangements which are entered into by an organization and its stakeholders and which help to define and secure the rights of both parties. An organization has the most control over this component of stakeholder management as compared to other components.

Organizational infrastructure

The organizational infrastructure refers to the internal systems and governance practices that an organization uses to manage its stakeholder relationships.

Governmental infrastructure

The governmental infrastructure refers to the regulations which are imposed on an organization.

Question

The component of stakeholder management which refers to the internal systems, governance procedures, and practices which are adopted and controlled by an organization in managing its stakeholder relationships is called:

A. Organizational infrastructure

B. Contractual infrastructure

C. Legal infrastructure

Solution

The correct answer is A.

The organizational infrastructure refers to the internal systems, governance procedures, and practices that are adopted and controlled by an organization in managing its stakeholder relationships.

Option B is incorrect. The contractual infrastructure refers to the contractual relationship between an organization and its stakeholders.

Option C is incorrect. The legal infrastructure is established by law.

Reading 31 LOS 31d:

Describe stakeholder management

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