Corporate Governance and Financial Strategy

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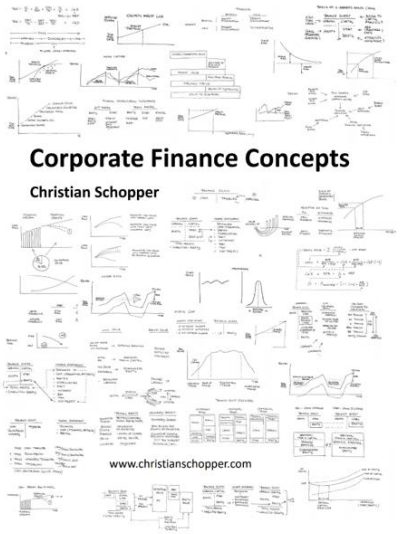

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Governance over the Life Cycle of a Company

A theme in governance - followed by regulators and academics - is **agency theory**, …
… which considers the differences in motivation between principals (shareholders) and their agents (executives)

- The development of the agency relationship as **ownership changes over the life cycle**

- In each stage the company will **also** have **funding from lenders** with the protection of these lenders ' positions also an aspect of governance to consider

- Given that the cost of funding reflects the investor's or lender's perceived risk, one important function of corporate governance is to reduce this …
- … with mechanisms of **risk reduction** can broadly be categorized as ' **monitoring**' or ' **control**'
  - Monitoring involves the disclosure of information by the company to the stakeholder, which allows that stakeholder to evaluate management's activities
  - Control gives the stakeholder the ability to prevent management from undertaking certain activities, or oblige them to take others

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Governance over the Life Cycle of a Company (cont´d)

	Sole trader	Partnership	Limited company, owned by management	Limited company, owned by management and close associates (e.g. family and friends)	Limited company, owned by the public (inc institutions)
Agency problems	None	None, until the business becomes so big that the management function is delegated.		Some, but close contact between management and shareholder(s) can reduce this.	Growing agency problems, as management is separate from the dispersed ownership.
Internal control and internal reporting	Make sure everything gets invoiced and nothing gets lost As the business grows, need to ensure employees are acting properly. Regular reporting of profits, cash and balance sheet position.		Division of duties and clarity of delegated activities. Formalized internal control and risk management systems. As the business grows, the internal control system becomes more critical. Outside shareholders may also demand that the organization has an internal audit function. Regular reporting of profits, cash and balance sheet position, including more sophisticated systems to be able to answer investors' and analysts' legitimate queries.		
External reporting (excluding tax requirements)	Not required	Not required	May be a legal need to file financial statements.	Need to report the company's performance and financial position to investors.	May be a requirement for extensive reporting on a regular basis. To include financial and non-financial information.

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External audit	No need	Optional	Compulsory in many regimes, depending on size of company	Compulsory in many regimes, depending on size of company. May be demanded by the shareholders.	Compulsory
Management and direction of the business	Self	Partners	Directors	Management, and investors if they choose	Bring in outsiders for advice and resources, and also for independent action. Board committees needed in line with regulation.
Management compensation (discussed in Chapter 6)	To suit self and business needs	To suit partners and business needs	To suit owners and business needs	Agree with external investors. Probably a large capital-related element, to encourage growth and exit	Agree with external investors and governance regulation. Format of compensation will vary as to salary, bonus and long-term incentive dependent on the corporate objectives and life cycle stage.

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Control & Financial Reporting over the Life Cycle

- 1. Sole trader
- 2. Partnership
- 3. Company with equity funding from the management
- 4. Company with equity funding from close associates (e.g. family)
- 5. Company with funding from the public (including institutional investors)

- For the **sole trader** with no employees, the main function of internal control is to **keep track of the money**
  - Accounting records are needed, at a minimum, to manage the cash and tax returns
- Once the trader **takes on employees**, **internal control systems** are also **needed** to monitor and co-ordinate activities
- If the sole trader **takes a partner**, formal internal controls becomes more important, also as partners have a **responsibility to each other**
- The **move to the corporate form** is significant, as the company is a **legal entity distinct from its owners**
  - **Business transactions are kept separate** from those of the managers and owners, and properly accounted for
  - Obligation for better record-keeping and systems, maybe a requirement for the company's **records to be independently audited**; in others, this obligation applies only to companies

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- In a significant leap from Stage 3 to Stage 4 **owners** of the company are **not anymore involved in its day-to-day management**
  - Owners to receive regular communication about the business, in the form of financial statements
  - Probably request an independent audit
- As companies grow and have more resources put into them by a wider body of **investors**, the role of accounting communication expands
- Companies listed on **stock markets** are generally required to follow **very detailed rules** and codes, and make extensive **disclosures**
  - Accounting and control systems verified through the report of an independent auditor …
  - … to reduce the perceived and …
  - … to raise the profile of the particular stock exchange, positioning it as attractive to investors
- Overall conclusion is that **well-governed companies attract a pricing premium** in poorly governed regimes, as they stand out as lower risk for investors
  - However, the impact of good governance, although still there, is less obvious in regimes which have an institutional context that supports good governance

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Management and Direction of the Business

- As a **sole trader** you can make all your **own decisions** …
  - … this also applies to making your own mistakes
  - The wise sole trader takes counsel when needed, …
  - … but has the ultimate right to choose what he/she wants

- In a **partnership** decisions are taken **jointly**
  - As the number of partners grows, some sort of executive structure is essential for the day-to-day running of the business with the choice of structure entirely up to the partners themselves

- Once a **business incorporates**, **directors** are appointed to run it
  - Executive vs Non-Executive Directors …
  - Corporate governance regulations set out who can appoint these directors, who can remove them, and what powers they have
  - Control over board membership is a useful protection for the investors

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Determining the Independence of Directors

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The following criteria are used, in various jurisdictions, as indicators that a director is *not* independent:

- Has been an employee or executive of the company or a related company in the past *X* years.
- Is a close family member of a director of the company or a related company.
- Has had a significant business relationship with the company in the past *Y* years.
- Is a professional advisor to the company, or has some other business relationship.
- Represents a block shareholder or a major lender to the company, or has significant business transactions with same.
- Holds cross-directorships with other members of the company's board.
- Participates in the company's pension scheme or share option scheme.
- Has served on the board continuously for more than Z years.

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Corporate Governance, Shareholders and Shareholder Value

Thesis that a main objective of the company is to create value for its shareholders, …
… and such value takes the form of dividends and capital gain

- **Family companies** might have a different view of shareholder value
  - Desire for a comfortable **lifestyle**, pass a healthy business to **future generations**

- **Different shareholder groups** may have **different motivations**, resulting to issues in regards to governance and financing …
- … with the challenge to align a company's shareholders to the same objective
  - Eg a company owned and controlled by managers who seek a comfortable lifestyle will sit uneasily in the portfolio of a financially driven investor who seeks a profitable exit

- Such conflict of interest can also be seen in a **hostile takeover**
  - "Hostile" only to the management; shareholders may prefer the change in ownership …
  - Managers implementing poison pills may be doing so for their own entrenchment, while reducing value for shareholders in the process

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Corporate Governance and Minority Shareholders

Minority owners are considered as being **shareholders other than** the "**blockholders**"

- Many academic papers take a shareholding of around 5% as being 'controlling'…
- … better: A continuum between (a) shareholder(s) with sufficient votes to make management pay attention, …
- … through to a level of voting power to pass resolutions with minimal consideration for the desires of other shareholders

- Examples of block shareholders could include a founding family, a holding company, or the State

- In a **widely owned company** with no controlling shareholder and no blockholder, there is clearly the potential for an **agency problem**
  - Management has the ability to give themselves an easy life, should they so wish …
  - Shareholders would need to band together to prevent them from doing so …

- This differs from a company where there is a block-holder with both an interest in the business and the power to do something about it
  - Shareholders are in a better position to control the managers' actions
  - This can be very beneficial to the non-block-holder shareholders, as there is a powerful party with the desire to create value …
  - … … or the block-holder to act in its own interests to the detriment of other shareholders

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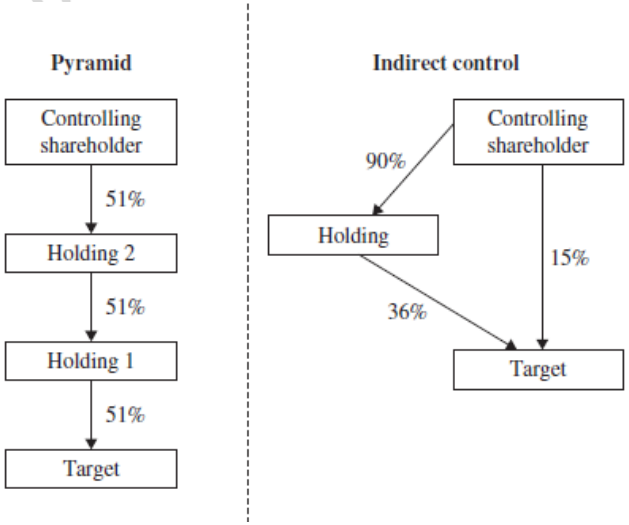
Structures of Control

- A **series of partly owned holding companies** can be structured for the benefit of the controlling shareholder,…
- … even though that shareholder should only be entitled to a minority of the company's cash flows
  - Their voting interest is greater than their shareholding would suggest
- Examples can be found where such structures were used to expropriate assets from the Target business
  - **Tunnelling** at an extreme, the controlling shareholder can just order the transfer of assets at an under-value from the controlled company to the holding companies, or to another business that it owns …
  - Excessive **management charges** …



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Attitudes to Investors and Creditors

- Rules and regulations in force in **different countries** can themselves be favourable towards the rights of the **funder / financier**, thus reducing their risk, …
- … or could be tilted towards protecting the interests of **management**, which can be seen to make the investment riskier
- Likewise, regimes where all **investors** are treated **equally** are seen to be less risky for minority shareholders …
- … than are those where **block-holders** are favoured
- In addition, factors affecting the perception of risk include the overall **corruption rating** of the country, the **standards of accounting** and auditing, and the rigour, or otherwise, with which laws are enforced
- For listed companies, relevant are the regulations of the stock exchange
  - Insider trading will also be relevant, as strong regulation means that investors should
- Reducing vulnerability due to losses amid information asymmetry have led to a strengthening of protection of minority shareholders
- This has implications for companies in such regimes which wish to raise equity and extend their share ownership

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Attitudes to Investors and Creditors (cont´d)

Corporate governance mechanisms and the minority shareholder

Reducing risk for minority shareholders

- Ability to vote on all resolutions, including voting directors onto or off the board
- Ease of voting
- Legal mechanisms for minority shareholders to take action against oppression by the majority or against expropriations by management
- Laws or codes protecting the minority during a takeover
- Laws protecting against insider trading
- Requirement for independent non-NEDs on the board
- Requirement for high levels of relevant financial and non-financial disclosures, for example details of transactions with related parties

Increasing risk for minority shareholders

- Control enhancement mechanisms (CEMs) such as certain shares carrying multiple votes, or no votes, or cellings on votings rights, or vetoes in certain situations[4]

Corporate governance mechanisms and the lender

Reducing risk for lenders

- Ease of ability of a lender to enforce their security to repossess assets if loan terms are breached
- Strong legal protection over property rights, including intellectual property rights (so that the company's assets cannot be expropriated)

Increasing risk for lenders

- Bankruptcy laws that leave the existing executives in control of the company rather than letting creditors put in their own management
- Bankruptcy laws that enable management to protect the company against creditor claims
- Priority of social or government claims over the rights of secured lenders

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The Role of the Investor

The Role of the Institutional Investor

- Wide free float embedds a *free rider* problem…
- … with the majority of investors not spending time dealing with company issues in performance and governance

- Nonetheless, a growing number of investing institutions have devoted time and resources to improving corporate governance and social responsibility in the companies in which they invest
  - … also out of own interest: pension funds, mutual funds, hedge funds, etc …

Investors with Short-Term Interests

- Problem exacerbated by practices that decouple the ownership of the shares from the voting rights …
- … such as selling short …
- … or entering derivative contracts

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Corporate Responsibility´s Aim to Create Shareholder Value

Driver of value	Some examples of driving performance through sustainability
• Grow sales faster	• Innovative products to meet sustainability needs. • Attract customers by corporate responsibility stance.
• Increase operating profit margin	• Better workforce efficiency by treating people better – attract better people, more training, less absenteeism, lower staff turnover. • Efficiencies due to energy and waste management.
• Reduce cash tax rate	• Possibly take advantage of incentives.
• Fewer fixed assets	• Improved efficiencies.
• Less working capital	• Reduced waste leading to reduced inventory. Better supply chain practices as companies work in co-ordination.
• Increase the period for which the organization has a competitive advantage	• Increased brand equity in the sustainable company. • Compliance leads to legitimacy which extends the 'licence to operate'.
• Lower cost of capital	• Investors perceive lower risk in companies that are compliant with 'best practice' governance regulations.

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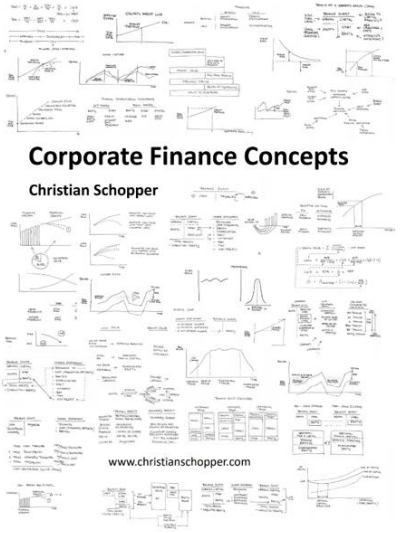

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