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CHAPTER 2

CORPORATE GOVERNANCE

1. A sole proprietorship is a business owned by one person, a partnership is a business with shareholder-managers called partners. Most partners will have unlimited liability although some partners will have limited liability. A corporation is a business withlimited liability shareholders who do not normally manage the firm. The weaknessesand strengths of each business form are as follows:

	Corporation	**Partnership**
Liquidity and marketability	Shares can be exchanged without termination of the corporation. Shares can be listed on a stock exchange.	Shares are subject to substantial restrictions on transferability. There is usually no established trading market for partnership shares.
Voting rights	In single-tier board structures, usually each share of equity entitles the holder to one vote per share on matters requiring a vote and on the election of the directors. Directors determine top management.	Some voting rights by limited partners. However, general partners have exclusive control and management of operations.
Taxation	Corporations may have double taxation: Corporate income is taxable, and dividends to shareholders are also taxable. Each country has its own approach to how it deals with double taxation and may give a full or partial rebate on the corporate tax payment.	Partnerships are not taxable. Partners pay personal taxes on partnership profits.
Reinvestment and dividend payout	Corporations have broad latitude on dividend payout decisions.	Partnerships are generally prohibited from reinvesting partnership profits. All profits are distributed to partners.
Liability	Shareholders are not personally liable for obligations of the corporation.	Limited partners are not liable for obligations of partnerships. General partners may have unlimited liability.
Continuity of existence	Corporations may have a perpetual life.	Partnerships have limited life.

Sole proprietorships have roughly the same weaknesses and strengths as partnerships primarily because shareholders are normally managers and have unlimited liability.

2. Clearly the bidder thinks that the £35 is money well spent and that your firm has untapped value that the market does not appreciate. Managers have many agendas, including job

safety. However, it is also possible that they do not believe that thebidding company will be good for the company over the longer term.

3. As firms become more complex, the agreements between shareholders and operational considerations necessarily become more complex and problematic. Clearly, since a sole proprietorship has only one owner, there is no need for an agreement between shareholders. The big difference between partnerships and corporations is the separation of ownership and control. Since partners also tend to manage a partnership, there are less governance problems to deal with. This is not the case in corporations.

4. The ability of corporate executives to trade the shares of their own company impinges upon several principles. Principle 1 is affected because it deals with regulation and the fairness of the governance system. Principle 2 is clearly involved because the trading of shares involves shareholders and their rights. Principle 3 is important because corporate executives who are also shareholders will have more information about the firm than other outside shareholders. Corporate insider trading affects principle 5 because the insider transactions should be promptly disclosed to outside stakeholders. Corporate executives are on the board of directors and this is covered under principle 6.

5. The Corporate Governance document will change every year, so the instructor should go through the document and show what, if any principle, is not covered.

6. A limited company can either be public or private.
   The main similarities are:
   - investor liability is limited to the amount of money he or she has invested.
   - a company is a separate legal person/entity
   - shares can be transferred without affecting the existence of the company
   - main goal is to create value to the equity owners

   The differences between private and public companies are;
   - Public corporations are permitted to offer shares for sale or advertise to the public.
   - Public corporations require minimum share capital to be issued and allotted in order to carry out business
   - Public corporations are subject to rigorous regulatory requirements
   - In private companies directors are more likely to be major shareholders. A good example of a private corporation is a family firm. In public firms, directors are less likely to be major shareholders.
   - In public corporations, the shareholders and managers are likely to be two distinct groups. That is, there will be some separation of ownership of the firm and control of the firm. In private corporations, this is significantly less likely to be the case.

   Public listing is not necessarily an optimal situation for a firm to be in. The costs of listing on an exchange are potentially higher than other forms of financing. In addition, many emerging market countries do not have enough public investment capital to fund lots of publicly listed firms. This is borne out by the small number of public companies that are listed in emerging markets.

7. Corporate behaviour in bank-based financial systems would be different from market-based financial systems because of the nature of financing between the two financial systems. In a bank based financial system, companies will strive to meet the requirements set out by their chief financiers, which are banks. Banks, as a major sourceof funding, will influence corporate risk taking behaviour and encourage longer investment horizons. On the other hand, corporations in market based environment must satisfy the needs of the investing public, who naturally focus on share price performance.

8. Corporate governance is important to the shareholders of a firm because of different interests between shareholders and management in principal-agent relationship. Corporate governance aligns the interest of these parties, and other groups/ stakeholders. Corporate governance is not a one-shoe-fits-all concept. Firms have different corporate governance requirements based on their sizes, forms, cultures, and complexities. Imposing the same governance structures on all firms would hinder growth and the risk-taking opportunities that determine the return to the shareholders.

9. In a sole proprietorship there is no real need for formal governance structures since all business activities are concentrated on one individual. That is, the stakeholders, the shareholders, and the managers are all one individual. In a partnership semi-formal corporate governance structures are present, such as a Partnership Agreement or Partnership Deed. These are designed to ensure that each partner carries out his or her duties as expected. A limited corporation is a separate legal entity that is different from a sole proprietorship and partnership. Corporate governance structures are required.

10. While a corporation's goal remains the same (maximization of share value), different institutional, economic, legal, financial, and cultural characteristics means that the corporate governance environment will vary across countries. Similarly, corporate governance codes for emerging market firms should consider the real issues in each country such as poor quality of law enforcement and limited ability to obtain independent directors. Thus, corporate governance structures that are borrowed from developed markets such as the US, UK, Japan, Germany and others must be adjusted ina manner that suits the environment in emerging markets.

11. Supervisory boards, like the Sharia board, can be of use when the objectives of a firm are tied to social, environmental or ethical issues. The purpose of such a board is to guide executives in making the correct decisions with respect to the company's remit.An example of a supervisory board that may work in a separate area is that of football teams. In this situation, the supervisory board would consist of fan representatives and they would guide the executive board on football decisions. Other areas include firms where public oversight is required, such as the banking sector.

12. In a general partnership all partners agree to provide some fraction of the work and cash and to share the profits and losses. Each partner is liable for all of the debts of the partnership. A partnership agreement specifies the nature of the arrangement.
    Limited partnerships permit some of the partners to have limited liability and who are legally liable only to the amount of cash each has contributed to the partnership. Limited partnerships usually require that (1) at least one partner be a general partner and (2) the limited partners do not participate in managing the business.
    Firms choose to be partnerships instead of limited liability corporations because it is inexpensive and easy to set up a partnership rather setting up a limited liability corporation.

13. Although a sole proprietorship is the cheapest to set up, it has disadvantages such as a limited ability to raise funds, a limited life, and unlimited liability. The sole proprietor may reduce these problems by forming a partnership. Other partners are expected to bring in extra cash to finance business activities, and the scope of the firm can be

widened. However, a partnership does not resolve all the problems such as transferability of ownership, unlimited liability and the ability to raise money from the public. In order to remove these hurdles a partnership may convert to a limited corporation.

14. All the governance principles are important. However, clearly your role in a company would make you feel one principle is more important than any other. For example, if you are a minority shareholder, Principle 3 (2004 OECD Principles of Corporate Governance) would be important. If you are an international investor, then Principle I (2004 OECD Principles of Corporate Governance) would be more important.

15. Yes, it is possible to improve one governance principle and weaken another. For example, Principle II (2004 OECD Principles of Corporate Governance) encourages firms to ensure that the rights of shareholders are maintained and promoted. However, that may weaken the rights of other stakeholders (Principle IV-2004 OECD Principles of Corporate Governance) such as employees and communities. Many examples can be given here and lecturers should encourage students to come up with their own solutions.

16. Corporate governance is the trust entrusted into those running the corporation whether directly or indirectly that they will treat all stakeholders fairly. This is an extremely important function in business as if not properly followed the corporate goal to maximize shareholders' wealth cannot be achieved. Yes, corporate governance reduces conflicting interests that are costly to shareholders and other stakeholders. It also encourages improvement in corporate performance and enterprise within firms. Although Starbucks appears to be serious with corporate governance within the organisation, it does not place the same emphasise on one of its key stakeholders, the farmers from poor countries. The farmers are indeed not receiving a fair return for their contribution to the success of the company. Therefore, a 'good' corporate governance system should address other stakeholders' interests.

17. Students should take most of their answer from section 2.4, which goes into the OECD principles in a lot of detail. They should also be encouraged to develop their own ideas as to the most important principle and come up with their own examples.

18. Students should consider the different principles of corporate governance that are discussed in Section 2.4 and reflect on the main issues pertaining to a poor country. In these environments, governance at the government level is just as (and even more) important as governance in corporations. As such, Principle I is likely to be of most importance in the first instance.

19. The Audit committee is one of the sub-committees of the Board of Directors and will normally report to it. It is responsible for oversight of financial reporting disclosure, regulatory compliance, and risk management. Members of the committee are drawn from members of the company's board of directors. The chairperson of the committeeis also elected from among the members.
    a. The duties of an audit committee include:
    b. Oversee and promote risk management

c. Ensure appropriate audit work is undertaken and of high quality
d. Review internal and external audit reports
e. Review corporate governance statements
f. Report to the governing body.

Students are expected to come up with their own examples of flawed audit processes. Recent years have provided many good examples!

20. In the corporate form of ownership, the shareholders are the owners of the firm. The shareholders elect the directors of the corporation, who in turn appoint the firm's management. This separation of ownership from control in the corporate form of organization is what causes agency problems to exist. Management may act in its own or someone else's best interests, rather than those of the shareholders. If such events occur, they may contradict the goal of maximizing the share price of the equity of the firm.

21. We would expect agency problems to be less severe in countries with a relatively small percentage of individual ownership. Fewer individual owners should reduce the number of diverse opinions concerning corporate goals. The high percentage of institutional ownership might lead to a higher degree of agreement between owners and managers on decisions concerning risky projects. In addition, institutions may be better able to implement effective monitoring mechanisms on managers than can individual owners, based on the institutions' deeper resources and experiences with their own management. The increase in institutional ownership of equity in the United Kingdom and the growing activism of these large shareholder groups may lead to a reduction in agency problems for U.K. corporations and a more efficient market for corporate control.

22. Governments have different objectives to shareholders. Whereas shareholders wish to maximise the value of their own investment, governments are more concerned with maximising social welfare. This can sometimes contradict that of shareholders. For example, several governments purchased the shares of financially stricken banks in 2008. Shortly afterwards, they put pressure on the banks to lend to smaller companies and give mortgages, even though the banks themselves felt that the lending decisions were not value maximising.

23. A stakeholder is any party which has an interest in the operations of the company, either directly or indirectly. Examples include shareholders, employees, creditors, customers, suppliers, normal citizens, etc.
    In a two tier board system, the board structure is divided into two parts consisting of the supervisory and executive board. The supervisory board is composed of outside shareholders and other stakeholders, such as employee groups (trade unions) and banks (capital providers). A good example of a supervisory board is DaimlerChrysler AG, which was comprised of 20 members - half of which were elected by shareholders at the Annual Meeting. The other half comprises members elected by the company's employees who work in Germany (Annual report, 2008). The supervisory board can hire or fire any member of the executive board. The latter is composed of executive directors who direct the day to day operations of the firm. In a unitary board, the

executive and non-executive directors sit on the same board and it is very rare for stakeholders such as employees to be represented.

24. Institutional shareholders are increasingly becoming instrumental in demanding good corporate governance in companies in which they invest, (e.g. NAPF in UK and CalPERS in US). The main reason why institutions are important in corporate governance is because they are normally the largest shareholders in the firm. As representatives of their investee base, they should take the role of owners in monitoring firms. With respect to country specific regulations, the student should review their own countries corporate governance code and take a view on the effectiveness of the code.

25. In agency theory, the underlying contract between the principal (shareholders) and agent (management) is based in maximising the principal's wealth. One aspect of corporate governance is to align the interests of managers and shareholders. Given that bondholders' interests may not be fully convergent with shareholder interests, bondholders protect their interests through bond indentures that restrict the activities of management.
We would expect managers to pursue the objectives of shareholders only if their interests are the same as that of the shareholders. This can be done through appropriate executive compensation contracts. In most situations, the shareholder and bondholder objectives will be the same. However, when a firm is in financial distress, these may differ and then shareholder objectives will naturally take precedence. This is why we have bond indentures.

26. The student would be expected to carry out this research themselves.

27. The board is a supreme body that represents shareholders' interest within the company. It sets strategies and the direction of the company. An effective board is more likely to influence major decisions which enhance shareholders value. In evaluating board performance, the following issues should be taken into account; board attendance, independence of board members, contribution of each member, ability of members to work as a team etc.
Boards provide long term strategic direction of the company which can influence its long term well being. Hiring an independent and objective consultant can give confidence to the shareholders that the board is performing efficiently and making the right decisions.

28. As managers build up their shareholdings, they become more like equity holders. This effect will grow in strength as managers' shareholdings get larger. At moderate levels of shareholdings, managers will have a significant stake in the company but can also make more money or power out of extracting wealth from the company through the purchase of executive jets, company cars, excessive administrative support and other wealth destroying behaviour. When this happens, we say that managers are entrenched. Examples are in abundance for managerial entrenchment in corporations and it is up to the student to find these in their own research activities.

29. How much is too much? Who is worth more, Cristiano Ronaldo or Lionel Messi? The simplest answer is that there is a market for executives just as there is for all types of

labour. Executive compensation is the price that clears the market. The same is true for athletes and performers.

30. State shareholders have different objectives to private companies. Whereas privatefirms have an overriding objective to earn profits for their shareholders, the governmenttends to have political objectives such as maximizing social welfare. These can conflict when the government wishes to develop infrastructure that is not necessarily consistent with maximizing shareholder value. In the YPF case, the Argentinian government surprised the shareholders by nationalizing the firm suddenly. Only time will tell how this affects the shareholders of the firm.