1.1.1 The Agency Problem and Good Corporate Governance

Unit: Unit 1 – Treasury strategy

Module: Module 1 – Corporate strategy

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Summary: The separation of ownership and management of a firm creates an agency problem, where interests of owners and managers might differ. Corporate governance is seen as the answer to this issue and this has implications for treasury.

Keywords: corporation, agency problem, corporate governance, shareholder, stakeholder, code of practice, accountability, probity, equity, transparency, comply or explain, SOX, financial risk

Contents

Learning outcomes:

1. Large corporations are typified by the separation of ownership from management.
2. Owners and managers may have different motivations, the Agency problem.
3. Corporate Governance is seen as the solution to the problem.
4. To understand to whom the more formal rules apply.
5. To understand where these conflicts might arise.
6. To understand the principles of good corporate governance and how they are provided for in law and guidance.
7. To understand the changing and international nature of corporate governance.
8. To understand the Treasury role in corporate governance.

1 Introduction

1.1 What is the agency problem, and why does it exist in large corporations?

Consider how large corporations[1] are run. Most large corporations, particularly publicly quoted ones, are run by professional managers who are distinct from the owners of (usually the shareholders in) the corporation. Additionally, most large corporations are not funded entirely by their owners, but also by lenders such as bondholders and banks.

This separation gives rise to a number of 'Agency Problems' (so-called because managers are running the organisation as agents for the owners), some of which are considered below. The first of these is the one most commonly cited, yet all are important in the way in which large modern corporations are run; and the solutions (more accurately perhaps 'techniques') used to address Agency Problems – good Corporate Governance – are concerned with a wider stakeholder group than the owners alone.

Agency problems:

1. How do owners ensure that their managers act in the owners' best interests? As salaried employees, what incentives do managers have to act in the best interests of the owners rather than pursuing their own aims? Clearly, it helps if management incentives are aligned with the owners' interests.

2. There is a risk that the managers of corporations with excess free cash flow will use this cash in a sub-optimal manner – i.e. in a way that fails to add value for owners. Whilst alignment of management and owner interests mitigates this, it has also been argued in the past that such corporations should gear up, i.e. return more free cash to shareholders thus reducing net cash or increasing net debt. Indeed, some corporations pay significant dividends and this reduces the risk. In the mid 2010s, this is particularly relevant because many corporations have significant cash piles. While there are several arguments in favour of this, mainly around the uncertainty of the ability of lenders to provide liquidity when needed, this cash does give management an easy ride and is likely to lower returns to shareholders.

3. Shareholder and stakeholder conflicts. Corporations run solely for the benefit of shareholders may be run to the detriment of stakeholders such as lenders, employees, customers, suppliers and the Defined Benefit pension schemes. Generally, gains (and losses) from taking on increased business risk accrue to the owners; owners focussing up the upside have an incentive to take on risks which can adversely affect the lenders' position, and indeed the position of other stakeholders. See Jamie Whyte's article in the Times, *The Corporate Virtue of Bankers*, dated December 30, 2010. This is about non-financial corporations as much as it is about banking and bankers.

1.2 How are these agency risks addressed?

[1] Throughout the MCT course we will use terms such as 'corporation', 'firm', 'business' to refer to *any* organisation. The concept of a 'business' can also refer to the type of trade carried on.

Eugene Fama argued in his 1980 paper 'Agency Problems and the Theory of the Firm' that the separation of management and ownership is not an issue because the market for management capital will address any performance issues. Essentially, an underperforming manager will earn less in future. There is an after-the-event reckoning for failure. You could even argue that a manager will act *properly* to maximise his future earning capacity.

The trouble with this theory is that a) it is a theory, and b) the owners of individual corporations may suffer as the benefits of the after-the-event reckoning will not accrue to them.

In general, the owners of corporations attempt to align their managers' interests with their own using a range of incentives, both short term (e.g. cash performance bonuses) and long term (e.g. share options). However, it is managers who propose these arrangements (at least in quoted companies) and we have seen high growth in remuneration for managers, despite some shareholder activism. Sometimes it is not clear who carries the power. Actually, in quoted companies, it is probably management that carries the power.

This alignment has been developed with incentives designed to ensure that managements' and owners' interests continue to be aligned. Using the United Kingdom as an example, the Greenbury Report (1995) set out to identify good practice in determining directors' remuneration and to prepare a code of practice for UK quoted companies. In particular, Greenbury favoured the use of Long Term Incentive Plans (LTIPs). See 'A Guide to Long Term Incentive Plans – *ifs Proshare* fact sheet' for additional information on LTIPs[2].

The codes of practice adopted in the US and UK jurisdictions and which are described in section 2 of this reading apply only to some publicly quoted companies. They do not address the similar issues that arise in other jurisdictions or in smaller companies with owner managers or private owners. Naturally the same issues arise in almost every structure and jurisdiction.

Larger non-quoted companies do tend to make some efforts in the direction of the code although the shareholders are usually professional (e.g. in private equity or infrastructure). In those situations, however, the balance of power tilts more towards the owners than the managers.

The European position is outside this syllabus but the approach is described in the following link:

http://eur-lex.europa.eu/legal-content/EN/ALL/;ELX_SESSIONID=62yZTsfPV15ZMksJPrsvZV5s53lj0QPd7LSGpmvVXXB7wHb4Gv52!1812492189?uri=CELEX:52012DC0740

[2] There are other forms of share based incentive schemes and the LTIP described is used in the UK.

2 Good corporate governance

We can start by stating that corporate governance is the direction and control of an organisation for the benefit of its stakeholders. So, corporate governance has always been around, although it has been much more prominent since 1990 after a serious of corporate failures.

Arguably the United Kingdom's Cadbury Report (1992) which set out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures was the beginning of the codification of good corporate governance. Its recommendations have been the basis for similar processes in the European Union, United States and elsewhere, and it is worth examining in some more detail.

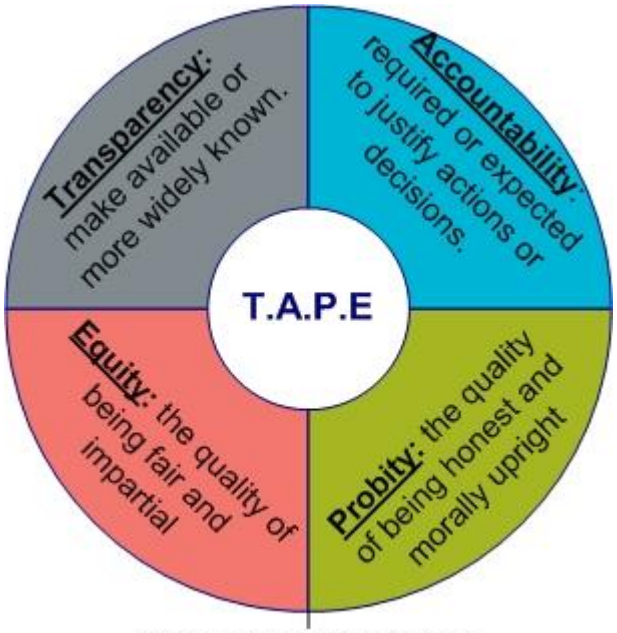
Corporate governance is constantly developing as, inevitably, major disruption to the business and economic environment escalates the pace of change. Indeed, the Cadbury Report on good corporate governance was born out of such events in the early 1990s in the United Kingdom which undermined public confidence in the leadership of corporations, especially those in the privileged position of being quoted on the stock market, where public ownership is a key feature:

1. Maxwell Communications. After Robert Maxwell's disappearance in 1991 it emerged that £440 million was missing from the Mirror Group's pension funds.
2. The Bank of Credit and Commerce International (BCCI) collapsed. Depositors, shareholders and employees all lost money.
3. The demise of Polly Peck, a FTSE100 company, with debts of £1.3 billion.

2.1 What are the principles of good corporate governance?

The 1992 Cadbury Report included a Code of Best Practice for companies, which is built around the principles of accountability, probity and transparency. These principles, along with the concept of equity, became the benchmark for good corporate governance.

Exhibit 1: Principles of corporate governance



Definitions: Oxford English Dictionary

From these foundations other organisations have developed their own ideas of what good corporate governance looks like. The Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance have gained worldwide recognition as an international benchmark for good corporate governance. The OECD revised their principles in 2004 to take into account the lessons learnt from a number of governance failures, notably Enron, MCI/WorldCom & Parmalat. In 2006 the OECD published a methodology for assessing the implementation of the OECD principles on corporate governance, and in 2009 it launched a plan to address weaknesses in corporate governance that are related to the financial crisis. The latest incarnation was approved in 2015.

For more information on governance principles the European Corporate Governance Institute (ECGI) provides an index and links to corporate governance codes throughout the world. See www.ecgi.org/codes.

2.2 Corporate governance in the UK

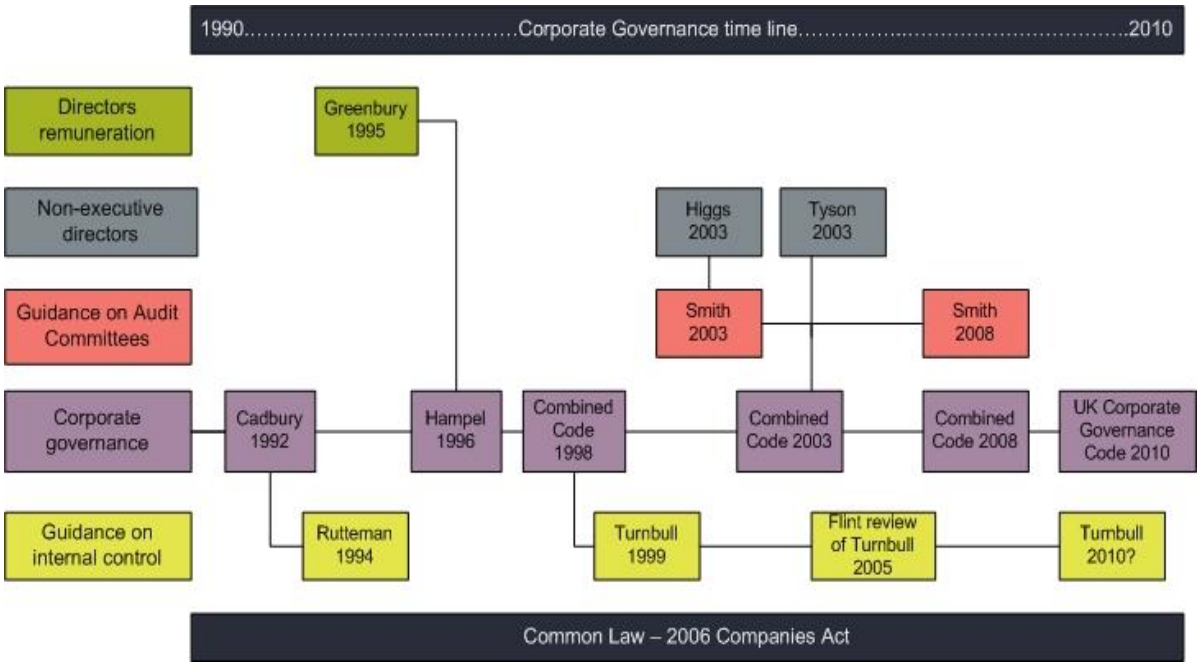
Modern and rapid development of governance in the UK began in the early 1990s with the publication of the Cadbury Report 1992, which stressed the needs for better reporting, non-executive directors and audit committees.

In 1998 The Hampel Committee proposed that the report on directors' remuneration (Greenbury 1995) be combined with Cadbury giving birth to a Combined Code. The Code sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. Listed (publicly quoted) companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or - where they have not - to provide an explanation – so called 'comply or explain'. The UK's Financial Reporting Council (FRC) has responsibility for the Combined Code and issued updates in 2003 and 2008.

During 2009 the FRC conducted a thorough review of the Code in the light of the lessons from the 2007/08 financial crisis. The new code, now known as the UK Corporate Governance Code was published on 1 June 2010 and places greater emphasis on the need for effective risk management. A 'Stewardship Code' was also published in July 2010.

The chart below shows a timeline and key documents relating to company corporate governance in the UK up to 2010 – note the core areas of concern, and the number of iterations over time. Corporate governance is hard to pin down and is continually evolving.

Exhibit 2: Development of corporate governance in the UK to 2010



Changes to the UK Corporate Governance Code and Stewardship Code were made in 2012, 2014 and again in 2016. In addition, the FRC also publishes other guidance and standards, notably around audit, accounting and reporting. See 'The UK Corporate Governance Code, April 2016'.

2.3 Corporate governance in the US

The bankruptcies of Enron and WorldCom, as well as lesser corporate scandals, such as Adelphia Communications, AOL, Arthur Andersen, Global Crossing and Tyco, led to increased political interest in corporate governance. This resulted in the Sarbanes-Oxley Act of 2002 ("SOX") which was developed from the UK framework.

The main provisions of SOX are:

- The establishment of a Public Company Accounting Oversight Board (PCAOB), to police the auditing profession.
- Guidelines to ensure outside director and auditor independence.
- Definition of corporate responsibility and accountability.
- Requirements for accurate financial disclosures.
- Enhanced penalties for corporate fraud and white-collar crime.

Two of the main effects of SOX have been to provide shareholders with more opportunity to monitor and participate in the governance of companies, and to establish a new control and enforcement mechanism. In the case of the latter, CEOs must take personal responsibility for the company's compliance with corporate governance standards, and for the company's procedures to verify the accuracy and completeness of the information.

SOX also mandates the composition of boards. Independent directors (who have no material relationship with the company) must make up the majority of the board. There must be a nominating committee, a compensation committee and an audit committee each made up entirely of independent directors.

SOX also includes provisions to ensure that auditors are as far as possible independent, by preventing them offering other services (e.g. bookkeeping, valuation, actuarial, internal audit, HR or management functions and other advisory services) to audit clients.

The chief criticism of any regulation or legislation is that it tends to deal with the last crisis, not the next one. Neither the Combined Code, SOX, or any of the other governance regulation prevented the crisis of 2007/08, which was arguably caused by governance failings.

2.4 What is Treasury's role in corporate governance?

Taking the UK Corporate Governance Code as an example, there are two broad hints that we can see. Firstly in the Preface, paragraph 9, we have:

> "… companies are encouraged to recognise the contribution made by other providers of capital and to confirm the board's interest in listening to the views of such providers …"

This recognises the importance of lenders to the role of governance. Bond holders tend also to be shareholders, admittedly often through different asset managers, so the emphasis here is around bank lenders, so management is encouraged to listen to its bankers, the channel of communication of which is predominantly through the treasurer.

Secondly, we see that in C.2 Risk Management and Internal Control on page 17 of the code:

> "The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."

Whilst many of these risks are commercial and outside treasury's scope, treasury will be responsible for many of the financial risks.

Therefore, to tackle the "nature and extent" clause, treasury needs to be able to identify and measure the risks in order to manage them, understanding also how they might interact with other risks that the firm faces.

Treasury also needs to be aware of the internal dimension to corporate governance. How does the group align the interests of headquarters or the holding company with those of divisional or subsidiary managers? Governance is something that has to be integrated right through the organisation, not seen as something specific to investor relations.