Korean Business & Management: Characteristics of Korean companies' corporate governance system

Week 10

Objective:

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.

Objective (cont.):

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.

The Unique Role of Stockholders

Stockholders are a company's legal owners and the provider of risk capital, a major source of capital to operate a business.

Risk capital –

No guarantee to the stockholders that:

- They will recoup their investment
- Or earn a decent return

ESOPs – Employee Stock Option Plans

Employees may also be shareholders

Maximizing long-run profitability & profit growth is the route to maximizing returns to shareholders, as well as satisfying the claims of most other stakeholder groups.

Stakeholders and Corporate Performance

Stakeholders are individuals or groups with an interest, claim, or stake in the company, what it does, and how well it performs.

Stakeholders are in an exchange relationship with the company

- Contributions: they supply the organization with important resources
- Inducements: in exchange they expect their interests to by satisfied

Companies should pursue strategies that maximize long-run shareholder value and *must also behave in an ethical and socially responsible manner.*

Stakeholder Impact Analysis

- Identify stakeholders most critical to survival:
  - Identify which stakeholders
  - The stakeholders' interests and concerns
  - Claims stakeholders are likely to make the organization
  - Stakeholders who are most important the organization's perspective
  - Identify the resulting strategic challenges

- Usually the most important:
  - Customers
  - Employees
  - Stockholders

Companies must identify the most important stakeholders and give highest priority to pursuing strategies that satisfy their needs.

Profitability, Profit Growth and Stakeholder Claims

To grow profits, companies must be doing one or more of the following:

1. **Participating in a market that is growing**
2. **Taking market share away from competitors**
3. **Consolidating the industry via horizontal integration**
4. **Developing new markets through:**
   - **Diversification**
   - **Vertical Integration**
   - **International Expansion**

Stockholders receive their returns as:

- **Dividend payments**
- **Capital appreciation in market value of shares**

ROIC is an excellent measure of profitability.
A company generating positive ROIC is adding to shareholders' equity and increasing shareholder value.

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

Governance mechanisms serve to limit the agency problem by aligning incentives between agents and principals and by monitoring and controlling agents.

- The Board of Directors
  - Elected by stockholders
  - Legally accountable
  - Monitors corporate strategy decisions
  - Authority to hire, fire, and compensate
  - Ensures accuracy of audited financial statements
  - Inside directors
  - Outside directors

- **Stock-Based Compensation**
  - **Pay-for-performance**
  - **Stock options:**

    The right to buy company shares at a predetermined price at some point in the future
- **Financial Statements**
  - **Auditors**
  - **SEC**
  - **GAAP**
- **The Takeover Constraint**
  - **Limits strategies that ignore shareholder interests**
  - **Corporate raiders**

Internal Governance Mechanisms

- Ownership Concentration
  - Relative amounts of stock owned by individual shareholders and institutional investors
- Board of Directors
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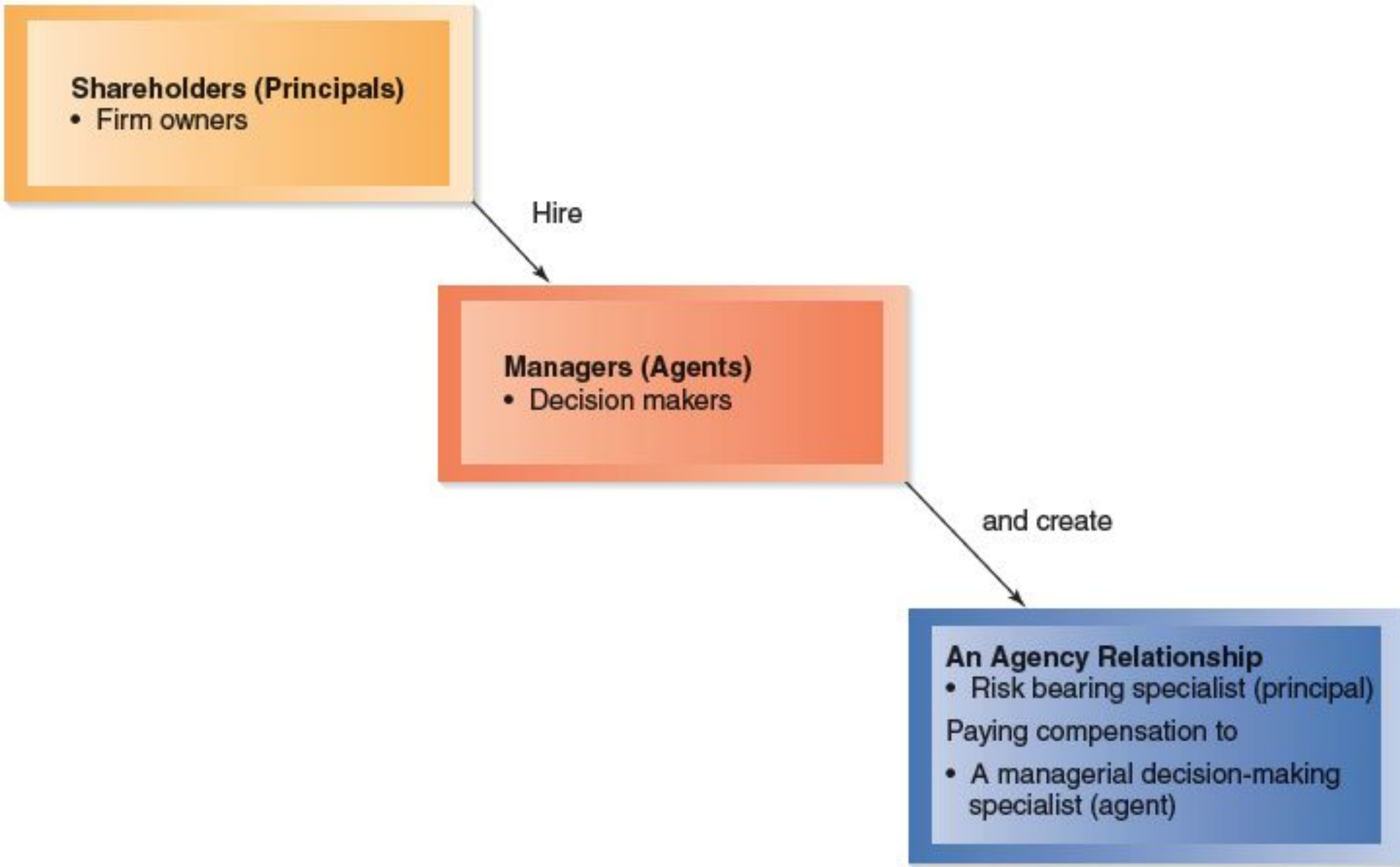
Internal Governance Mechanisms (cont'd)

- 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

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).

The Challenge for Principals

Confronted with agency problems, the challenge for principals is to:

1. Shape the behavior of agents so that they act in accordance with goals set by principals
2. Reduce information asymmetry between agents and principals
3. Develop mechanisms for removing agents who do not act in accordance with goals and principals

Principals try to deal with these challenges through a series of governance mechanisms.

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.

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.

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.

INCENTIVE COMPENSATION

Annual bonus plans

Oldest form of incentive pay. Board can evaluate executives' performance along multiple dimensions and allocate a year-end cash award

Stock options

An employee receives the right to buy a set number of shares of company stock at a later date for a predetermined price

Other long-term incentives

More recent forms of incentive compensation.
Long-term bonuses linked to performance over several years. May help executives avoid short-term myopia and focus on long-term

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**

- 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
- **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.

THE MARKET FOR CORPORATE CONTROL

Corporate

The right to choose the members of the board of directors of a company and to control all major decisions made by a company

Share holders

Elect

Board

Hires/fires

Top management

Directs

Corporation

Example:

- Corporate raiders such as T. Boone Pickens, Carl Icahn, Ted Turner and Michael Milken
- Oracle engaged in 18-month battle to gain control of PeopleSoft

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.

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 (Management Board) — Responsible for the functions of direction and management

Aufsichtsrat (Supervisory Board) — Responsible for appointing members to the Vorstand

Union members, Employees, 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

CORPORATE GOVERNANCE: U.S VS. JAPAN

	U.S		Japan
Owner-manager relationship	Adversarial	⟷	Co-operative
Manager and shareholder relationship	Through one company	⟷	Through a Keiretsu (group of interlocking companies)
Ownership concentration	Control function	⟷	Monitoring function

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)

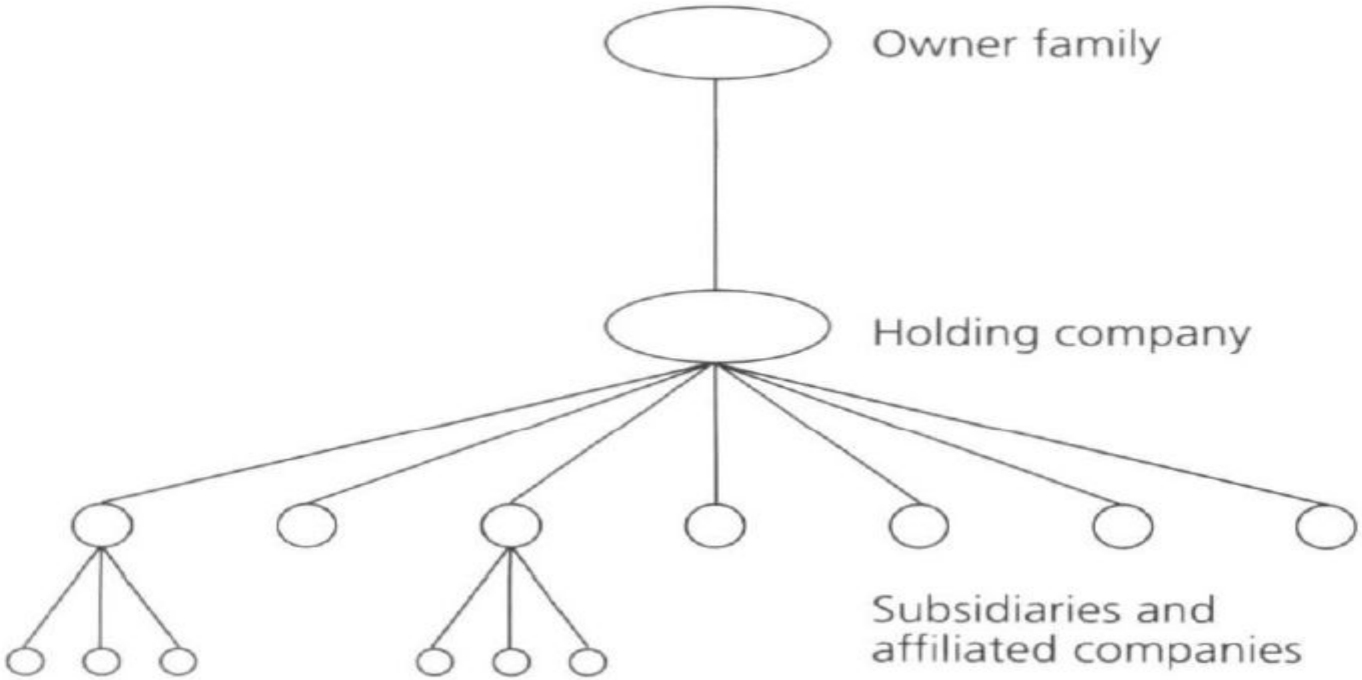
It is important to serve the interests of the firm's multiple stakeholder groups!

- 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.

1. Corporate Governance System of Korean firms

Key feature of large Japanese business group(Zaibatsu)



Source: Hattori 1989: 85

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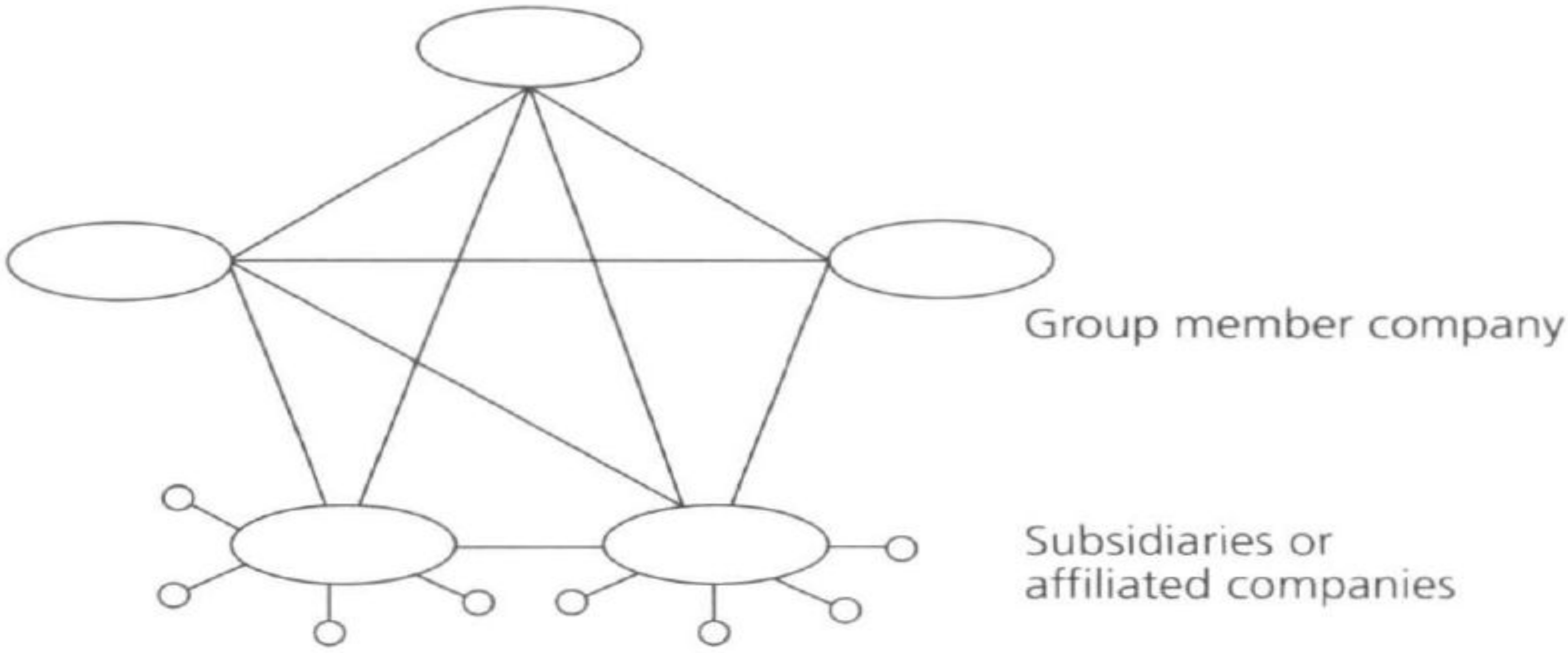

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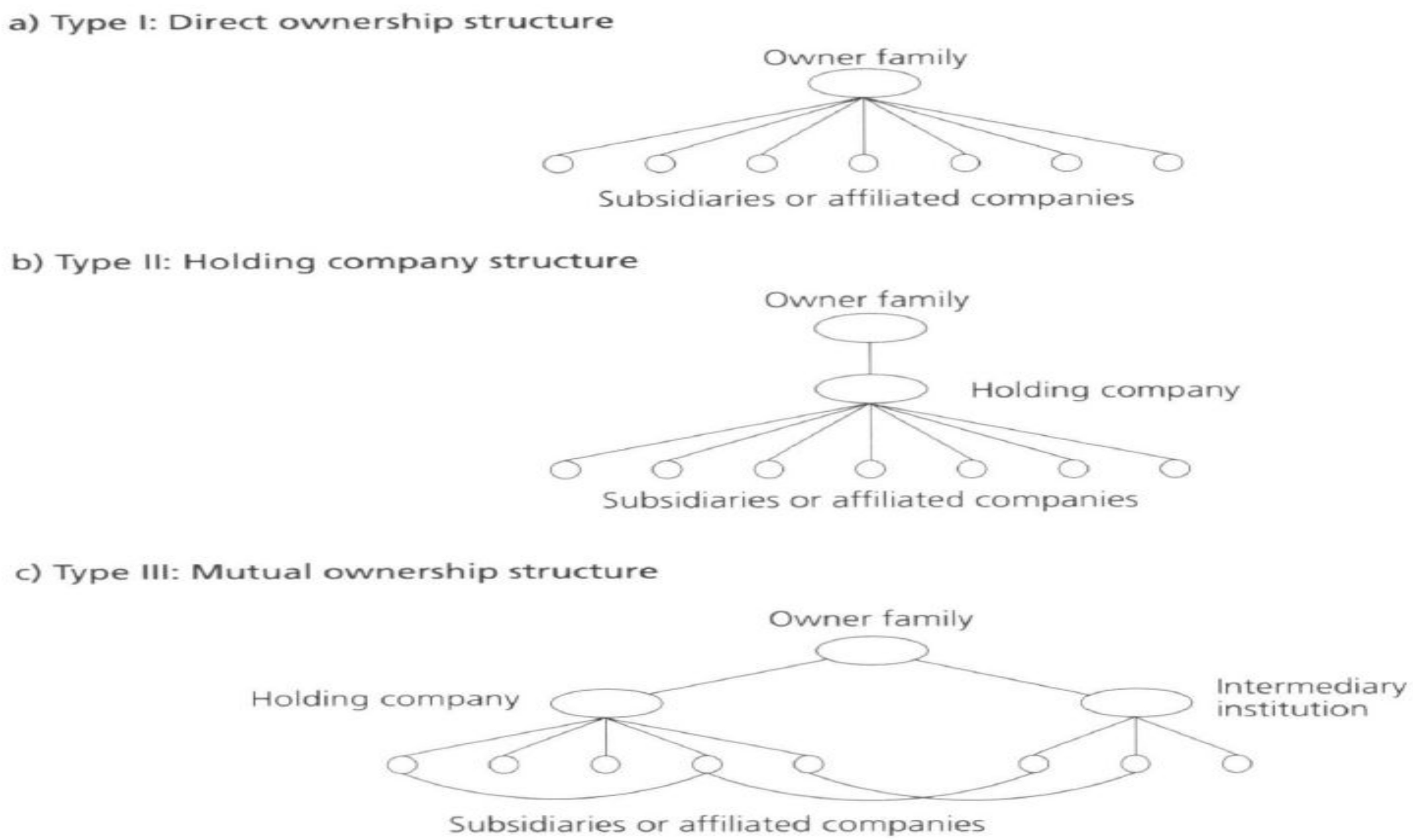
1. Corporate Governance System of Korean firms

Key feature of large Korean business group(Chaebols)



2. Corporate governance issues related to Korean Chaebols

- What has made Chaebol's ownership structure survive for long period of time?

- Is Chaebol's ownership structure truly inconsistent with goal of modern firm and shareholder profit maximization?

3. Controversies around Chaebol corporate governance

- Chaebol's family owns on average 3% of ownership of their conglomerates but still runs the whole companies like their own fiefdoms.

How this is possible?

→ cross funding!

3. Controversies around Chaebol corporate governance (cont.)

- Government attitude toward Chaebol recently dramatically changed after the financial crisis→pushing restructuring toward holding company structure
- However, still, lack of monitoring by financial institution and institutional investors is key characteristics of Korean Chaebol's governance system

3. Controversies around Chaebol corporate governance (cont.)

- Whether Chaebol's governance structure should be thrown away is subject to empirical evidence.
- Likewise, the question "should Chaebol firms be run by professional managers?" is also matter of empirical evidence
- More urgent need is to have proper and effective monitoring systems to Korean Chaebols