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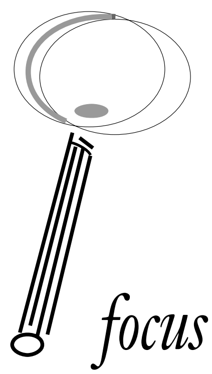
What Is Corporate Governance and Who Cares about It?



Learning Objectives

By the end of this chapter, you should be able to:

- Distinguish between a broad and a narrow definition of corporate governance.
- Explain why the separation of management and ownership in the modern corporation is an important issue for corporate governance.
- Explain the role of shareholders in a public corporation from a financial agency theory perspective.
- Identify the stakeholders in a public corporation and the conflicts of interest that can arise among them.

Introduction, Definitions, and a Historical Perspective

Corporate governance is an intractable term with many definitions. For some people, corporate governance is about "the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated" (Blair, 1995). Others narrow the focus of governance to "the relationship among various participants [chief executive officer, management, shareholders, employees] in determining the direction and performance of corporations" (Monks and Minow, 1995). Still others narrow the focus even more and say corporate governance deals with "the way suppliers of finance assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997). For them, corporate governance is about how suppliers of capital get managers to return profits, make sure managers do not misuse the capital by investing in bad projects, and how shareholders and creditors monitor managers.

These different definitions of corporate governance reflect different perspectives on what corporate governance is, what it should do, and the problems it should address. The broad definitions explicitly incorporate corporate governance questions into a larger question of how to organize economic activity so as to achieve societal objectives usually grouped under the umbrella of corporate social responsibility. The more narrow definitions focus on purely economic efficiency objectives such as maximizing owner wealth that may or may not be tied back into societal objectives.

Economic efficiency objectives need to be understood within the context of societal objectives. For the United States, the societal objectives have been to maintain a culture that promoted both freedom and equality while developing the citizen's moral character. The debate about corporate governance broke out over these concerns in the early twentieth century and culminated in the Adolf Berle and Gardiner Means' 1933 work, *The Modern Corporation and Private Property*. At the time, economic efficiency became important relative to how corporate management could be held accountable for advancing economic growth and not wasting resources.

In this book we focus on the economic efficiency objective and examine how managers fulfill and are held accountable, monitored, and rewarded for achieving the economic efficiency goals. However, we hasten to point out that our "narrow" focus is part of a broader construction of governance.

Plan of Book

In this chapter, we describe the fundamental problems Berle and Means identified with regard to the ownership and governance structures and of the modern corporation. We then explain how these problems can be solved by having public shareholders act as monitors of the corporate managers who, in turn, should maximize shareholder wealth.

The valuation models (asset pricing models) managers use to guide them in maximizing shareholder value are described in Chapter 2. Also explained in Chapter 2 is the important concept of financial market efficiency and why efficient financial markets are essential if market prices are to be used to evaluate managers and provide them with feedback about the quality of their investment and financing decisions.

Chapter 3 develops the connection between governance issues and investment decisions. We show how investment decisions have historically affected stock prices and address questions about how conflicts of interests among the various corporate stakeholders affect investment decisions. We continue with an examination of the rules managers use (or are asked to use) with regard to allocating capital within the firm and describe how the rules can help managers achieve broad economic efficiency goals.

Chapter 4 takes up the financing decision in the context of governance and shareholder value. The chapter introduces financial agency theory and free cash flow theory and connects them to the conflicts of interest we describe here in Chapter 1. The chapter ends with a list of agency problems that need to be mitigated through governance and organizational structures.

Chapter 5 considers the connection between governance and dividend policy which is an extension of the financing decision.

Chapter 6 addresses what could be considered the most controversial issue in corporate governance: managerial pay. Here we look at ways whereby managerial pay can be tied to performance and review the evidence about whether any connection between pay and performance actually exists.

Chapter 7 addresses major organizational restructuring issues such as mergers, acquisitions, spin-offs, divestitures, and management buyouts. The discussion is tied back to the asset pricing models in Chapter 2 and developed in the context of what is called the market for corporate control.

Chapter 8 looks at the corporate governance role of the board of directors. Here we focus on board composition, board responsibilities, and shareholder rights. The role of institutional investors is also explored in Chapter 8.

Chapter 9 concludes the book with a look at alternative governance systems. We compare the American market-based system to the banking-based and relational systems, such as those found in Germany, Japan, and South Korea. Recent evidence suggests that corporate governance systems in major industrial countries are converging toward the Anglo-American system. We offer some ideas as to why this convergence is occurring and what it means for managers competing in a global marketplace.

THE MODERN CORPORATION

The *modern corporation*, a term coined by Berle and Means, refers to a limited liability company where management is separated from ownership and corporate control falls into the hands of the managers. This separation of ownership from management, and the loss of direct owner control and involvement in the firm, posed a major political problem for the country as it moved from an economy dominated by agriculture, and small locally and family-owned businesses, to an industrially based economy with very large firms, and an increasing concentration of wealth in the hands of a few.

The problem was that managers and insider control groups could serve their own personal interests in the corporation without benefiting the public shareholders and society. Managers, instead of managing the firm in the best interests of society, might manage the firm in their own interests, or the interests of an oligarchy. Consequently, what Berle and others sought were ways to subordinate managerial private interests to the public good. Two approaches emerged, a trustee structure and a contracting structure.

Controlling Managers

The trustee solution defined managers as legal trustees for the shareholders' property. Under this structure, managers would be held legally accountable in the courts for the waste and misappropriation of the owners' property. However, who was to say that the courts had the technical competence to monitor managers or that judicial officials would be any less self-seeking than the managers themselves? And, why should the managers of the corporation be anointed the trustees? Why not the workers or at-large community members? The contracting solution, rather than relying on the courts as did the trustee solution, relied on market mechanisms and the counterbalancing self-interest of the firm's stakeholders. In this structure, corporate managers negotiated and administered contracts with the corporation's customers, suppliers, employees, creditors, and the shareholders. The shareholders would receive what remained after all the other stakeholders had received their due; hence, the characterization of the shareholders as residual risk bearers and residual claimants. The self-seeking and opportunistic behavior of all but the residual risk bearers would be held in check by managers, who were responsible for carrying out their contract written with the residual risk bearers (the owners) as well as with the other stakeholders. Managers would be motivated to write the best contracts they could with the workers, suppliers, customers, and other managers because it was in the managers' self-interest. If they didn't, they would be replaced by the owners who sought to maximize the present value of the residual cash flows coming to them. The present value of these residual cash flows is another (technical) name for the stock price of the company.

Financial Agency Theory

Ultimately, this contractual approach evolved into modern day *financial agency theory*, the framework we use for exploring the implications of corporate governance for managers. The key to understanding financial agency theory is to view the firm as a nexus of contracts among individuals where the explicit and implicit contracts control everyone's self-interest. In particular, financial agency theory is primarily concerned with the contracts that suppliers of capital write with each other and with managers; hence, the focus of financial agency theory is on managerial performance contracts, security indentures, financial reporting, and governance rules for electing and controlling boards of directors.

More generally, financial agency theory describes a governance system where the firm is prevented from growing beyond an economically efficient size by the shareholders. The role of the shareholders is to monitor the performance of management to ensure managers are acting in the shareholders' best interests, interests that are equated with economic efficiency at the societal level. Ultimately, the shareholders evaluate managerial performance by looking at the present value of the residual claims on the firm—otherwise known as the market value of the firm's common stock, or stock price for short.

Chapter 2 takes up the question of common stock valuation and the importance of efficient markets for using stock prices to measure managerial performance. First, though, we present a schematic governance structure of the public corporation. We use it to describe the conflicts of interest among and within owners, managers, and creditors that we address in this book and briefly explain the role of managers in exacerbating or mitigating these conflicts and the costs they impose on the shareholders.

Schematic Governance Structure

Exhibit 1–1 contains a schematic model of the corporation from the perspective of the suppliers of capital. The owners of the corporation, who are placed at the center of the diagram, supply equity capital to the company. The contractual essence of equity capital is that it confers property rights to the owners—rights that give the owners control over the acquisition and disposal of the assets of the company—and, therefore, a claim on whatever assets remain after all other contractual claims on the firm such as wages, salaries, debt service charges, and taxes have been paid. With respect to the company's day-to-day operations, what remains is called *net income* after taxes. The net income can be returned to the shareholders as cash or kept in the company under the control of the managers. If the net income is kept in the company, it can be used to buy additional assets or pay off debt obligations.

The owners of the corporation can make decisions about acquiring or disposing assets, how to run the day-to-day affairs of the company and what to do with any residuals (net income) by themselves or they can appoint agents to make these decisions for them. These agents, in turn, can appoint other agents. In the usual Anglo-American governance system, the corporation's board of directors (the board) are the agents directly selected by the owners—the shareholders. The owners write contracts (explicit or implicit) with the board who theoretically act in the shareholders' best interests. The board then hires a chief executive officer (CEO) who, in turn, hires other managers and so on down the line, including nonmanagement employees. These managers act as agents for the owners when they write contracts with the suppliers and customers of the company and with other managers and employees. The managers also write contracts with those who supply debt financing—financial institutions, bondholders, lessors, and so on. Potential conflicts of interest abound, even within the ownership group itself.

The Owners

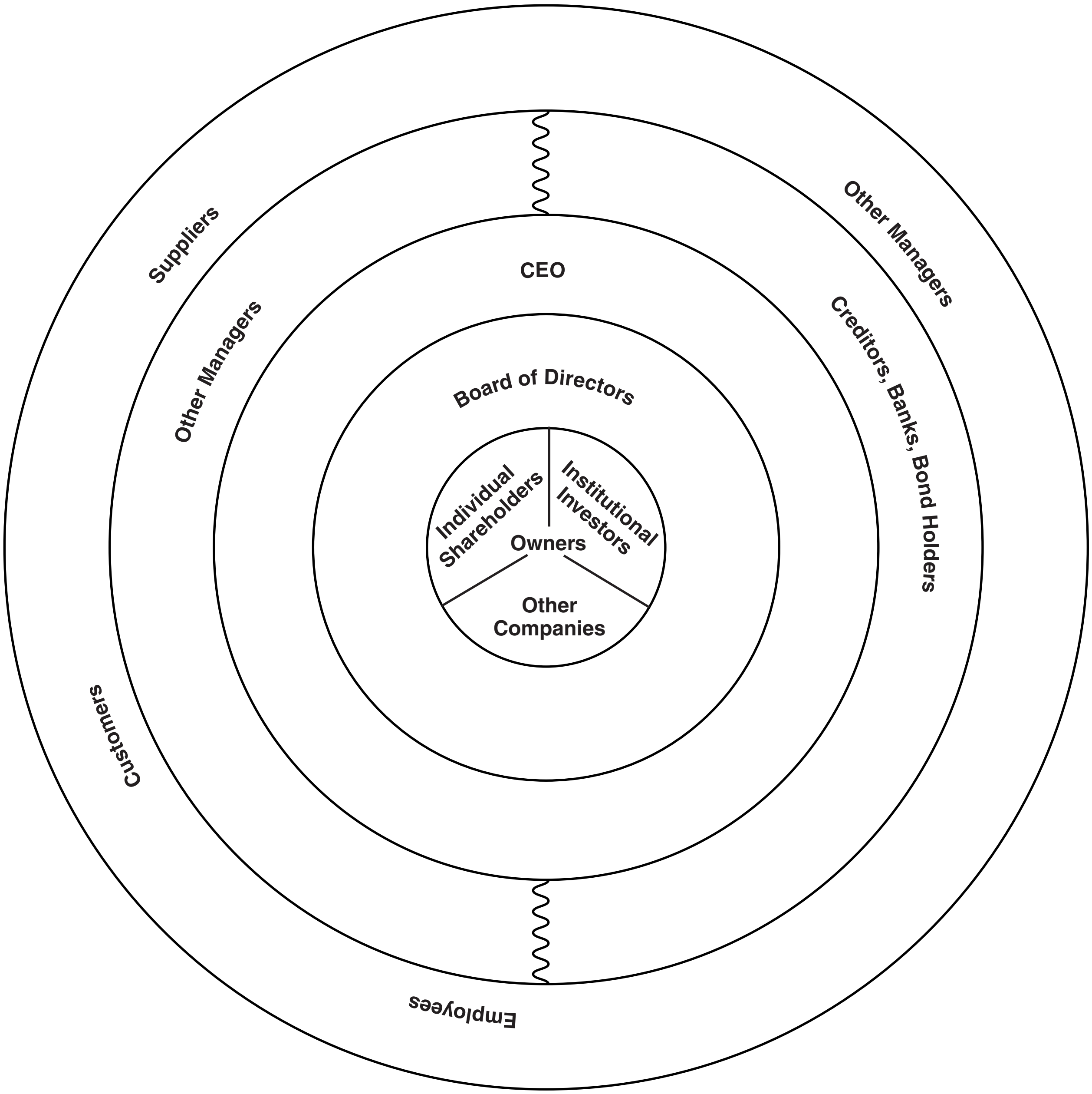
Let's start with the owners. The owners are not a homogeneous group. They include fragmented public shareholders, large private block holders, private and public institutional investors, firm employees and managers, and other firms. Exhibit 1–2 provides information on the composition of stock ownership in a number of large industrial countries with different corporate governance systems.

Ownership in the United States

In the United States, around thirty-six percent of common stock is owned by private households, also called public investors. Fifteen percent of common stock is owned by other corporations whose objectives may have more to

Exhibit 1–1

A Contracting Schematic of the Modern Corporation



do with retaining business relationships with the company and selling or buying goods from the company than with a public shareholder's objective of share price maximization. Furthermore, the shares of a company owned by other companies are typically voted by the managers of the sharehold-ing firm. These managers are more likely to be sensitive and sympathetic to the needs and employment perils facing their managerial peers. They

Exhibit 1–2

Percent Ownership of Common Stock Shares in Selected Countries, December 1995

	PERCENT OWNERSHIP IN COUNTRY				
Ownership Category	*United States*	*Japan*	*Germany*	*France*	*Great Britain*
Private households	36.4%	22.2%	14.6%	19.4%	29.6%
Companies	15.0	31.2	42.1	58.0	4.1
Governments and public authorities	0.0	0.5	4.3	3.4	0.2
Banks	0.2	13.3	10.3	4.0	2.3
Insurance companies and pension funds	31.3	10.8	12.4	1.9	39.7
Mutual funds and other financial institutions	13.0	11.7	7.6	2.1	10.4
Nonresidents—foreigners	4.1	10.3	8.7	11.2	13.7
Total	100%	100%	100%	100%	100%

Source: Deutsche Bundesbank, Monatsbericht, January 1997.

would tend to vote with company management rather than with the public shareholders on such major issues as acquisitions, takeovers, and antitakeover proposals.

Forty-four percent of shares in the United States are owned by pension funds and mutual funds. These are large institutional investors who, through their large holdings, can influence management and effectively threaten management with removal if the best interests of the fund's beneficiaries or owners are ignored.

One of the largest institutional investors in the United States is Teachers Insurance and Annuity Association-College Retirement Equity Fund (TIAA-CREF), a public pension fund, which owns more than $100 million in terms of market value of the outstanding common stock in each of the 50 largest companies in the country. TIAA-CREF is quite explicit about what it expects from managers. It expects that managers will maximize investment returns for its participants. Furthermore, TIAA-CREF has developed a corporate assessment program to monitor and evaluate governance practices and policies. Among the policies TIAA-CREF requires are shareholder approvals for any actions that alter the fundamental relationship between shareholders and the Board such as "antitakeover" measures and the composition of the Board of Directors itself. Furthermore, TIAA-CREF requires companies to base executive compensation on a "pay for performance" system so as to align the interests of managers with those of TIAA-CREF beneficiaries. When necessary, TIAA-CREF also presses for improved management and operational changes in order to ensure that the investments it makes produce the highest possible returns.

Ownership in Other Countries

Note that ownership structures in Japan, Germany, and France are quite different from the United States and Great Britain. Private individuals own a relatively small percentage of outstanding stock, especially in Germany; and, other companies own a relatively larger portion—over 50 percent in France. So, the dominant shareowners in Germany, Japan, and France are other corporations, with the shares being voted by management and not by the public shareholders or institutional investors representing public shareholders. In Germany and Japan, banks also own sizeable amounts of stock in the same companies to which they make loans. While these ownership patterns may solve some governance and conflict of interest problems, they create others. For example, do the banks in Germany vote their shares in the best interest of the public shareholders or in the best interests of the banks as creditors of the company? People have argued both sides of this question.

Ownership Conflicts of Interest

Ownership conflicts of interests may emerge within ownership classes as well as across ownership classes. Some owners are in a better position to influence management than others; some owners have more information than other owners; and some owners may be more concerned about the survival of the firm than other owners. Large blockholders, especially if they have controlling interest in the firm, can negotiate acquisitions or sales of assets or the company. This power disadvantages the "small" public shareholders unless the investors are protected with appropriate security regulations and laws. For example, in some countries large blockholders can sell their interests to an acquiring company at one price leaving the small shareholders no alternative but accepting whatever the acquiring company offers to pay them for the now illiquid stock they own as a minority in the target (acquired) company.

Voting Rights

Some shareholders are also more equal than others when it comes to voting rights attached to their ownership claims—what are called different classes of common stock. Although not especially common in the United States, corporations may issue different classes of common stock with one class having more voting rights than others. For example, Ford Motor Company has two classes of common stock; Class A with 60 percent of the voting rights and Class B with 40 percent of the voting rights. Class A shares are owned by the public while Class B shares are owned by Ford family interests. Dow Jones, the publisher of the *Wall Street Journal*, also has two classes of shares. Class B shares carry ten votes per share while Class A shares are only one vote per share.

Governance systems, coupled with legal protection and security regulations governing the dissemination of information and insider trading regulations, can be designed to protect the small or public investors' equity positions. Without such protections, small investors are reluctant to buy common stock and ownership tends to be concentrated in the hands of a few. But, what is the "democratic" solution to voting rights and how is that related to a broader governance objective of how a particular governance structure inhibits or advances democratic pluralism? Should each shareholder have only one vote regardless of the number of shares she owns or should each share carry one vote so that someone who owns 100 shares has not one but a hundred votes?

The early American answer was one vote per owner regardless of the number of shares owned by the individual or, at least, a limit on the number of votes any one owner could cast, what is called *graduated voting*. This graduated voting scheme found its way into the charters of the First and Second Bank of the United States and was intended, according to Alexander Hamilton, to prevent a few principal stockholders from monopolizing the power and benefits of the bank to their own benefit. Graduated voting was also common in the railroads and manufacturing firms organized in the early and middle years of the nineteenth century. For example, under legislation passed by Virginia, voting was standardized in joint stock companies such that one vote per share was given for the first twenty shares a person owned; then, one vote for every two shares owned from 21 to 200 shares; one vote for every five shares owned from 201 to 500 shares; and, one vote for every ten shares owned above 500. This arrangement lasted until the Civil War (Dunlavy, 1998).

Since the Civil War, most U.S. corporations have adopted the one-share-one-vote arrangement. We examine why and the implications of this voting procedure in Chapter 8.

The Board of Directors

Corporations in the United States are incorporated under state law. Under state laws, the board of directors is responsible for managing the affairs of the company in the best interests of the shareholders—as interpreted by the courts of that state, of course. The directors are elected by the shareholders and, under state law, are expected to demonstrate unyielding loyalty to the company's shareholders (the duty of loyalty) and exercise due diligence in making decisions (the duty of care). But, the extent to which directors have effectively done so is hotly disputed and open to interpretation.

Theoretically, the board of directors is elected by the owners to represent the owners' interests. But, in addition to the problems created by differential voting rights and the composition of the owners themselves, other problems arise. These governance problems include the composition of the Board and control over the process for electing the board.

Typically, the board is comprised of both inside and outside members. Inside members hold management positions in the company. Outside members are not managers of the company. Often, the outside members are referred to as independent directors, although this characterization is misleading because some outside members may have direct connections to the company as creditors, suppliers, customers, or professional consultants. These latter may be described as quasi-independent members. The governance issue is: who do the inside and quasi-independent members represent? Both groups have a vested interest in the survival of the firm and, quite possibly, its growth at the expense of the shareholders. To put it starkly, would the management insiders vote to fire themselves? If not, can the shareholders vote the insiders (or anyone else) out of office?

Again, in theory, the answer is yes. But, the proxy (voting) machinery is controlled by the existing board and management. So, the control over "voter registration" lists as well as the dissemination of proxy ballots rests in the hands of the incumbents who clearly have a conflict of interest in implementing the voting process.

We examine the role of the board of directors at length in Chapter 8.

Corporate Executives and Senior Managers

Reporting to the board in our governance structure is the chief executive officer, and, reporting to this person are other managers, including division managers. We are now inside the organization's bureaucracy where conflicts of interest abound with respect to allocation of capital, consumption of perquisites, status, and turf wars. Here, the governance task is how to control these conflicts and focus competing managers' attention on shareholder concerns. These organizational governance problems extend beyond the managers of the company to its nonmanagerial employees.

Governance-related issues that loom large within the organization are managerial pay and performance and the rules for allocating capital within the firm. Should managerial pay be tied to performance? And, if so, how should performance be measured? What about allocating capital within the company? How can this allocation be done so as to serve the interests of the shareholders and resolve conflicts of interest among competing management teams within the company? Increasingly, managerial pay and performance evaluation as well as capital allocation schemes are being connected to the company's stock price performance and its cost of capital. Whether these schemes actually work, though, remains controversial.

Creditors

We have connected debt financing to the firm through the contracts creditors write with the managers—presumably acting as agents for the shareholders in this process. From a legal perspective, the duties and obligations of management, and, therefore, the owners, to the creditors are typically spelled out in the loan agreement. Potential conflicts of interest between creditors (bondholders) and owners (shareholders) have long been recognized and have been dealt with through positive and negative covenants as well as through the maturity and repayment terms of the debt. Should the firm default on the debt, the creditors effectively become the new owners of the company.

More recently, debt financing has also come to be viewed as a way of reducing or mitigating conflicts of interest between managers and shareholders. Essentially, debt financing is seen as a way of discouraging managers from growing the firm at the expense of the shareholders and keeping cash in the company rather than distributing it to the shareholders. Interestingly, creditors are likely to approve of managers keeping cash in the company because it would improve the creditor's financial position.

Relationships with Suppliers and Customers

Contracting arrangements also exist between the managers and the company's suppliers and customers. While it is widely recognized that suppliers and customers are corporate stakeholders, the connections between suppliers and customers, shareholder wealth maximization, and the survival of the firm are not always clear or unambiguous. We think the basic governance problem with respect to these stakeholders—especially suppliers—is how to get them to make investments, or other costly commitments, that benefit the company but that could be lost if the company engages in opportunistic behavior or fails. For example, an automotive company such as Daimler-Chrysler or Nissan would benefit by having its parts suppliers locate near its assembly facilities and would also benefit if its parts suppliers invested in product development and technology specifically directed toward Daimler's or Nissan's vehicles. But, why would a parts supplier do so if it thought that once the investment was made, Daimler would opportunistically try to recontract so as to lower prices because, after having made the investment, the supplier could recover it only by agreeing to these new prices and delivery terms? Or, why would a supplier make Daimler-specific investments if he thought Daimler was financially weak and would not be able to honor its contractual obligations?

The Anglo-American governance solution to these relational issues generally emphasizes well specified contractual terms. Other governance systems, however, such as the Japanese, have historically relied on long-standing relationships with individuals in respective companies and unwritten expectations of reciprocal actions. Still other arrangements for dealing with this governance related problem is to have cross-ownership in each other by the automotive company and its suppliers so that opportunistic behavior on the part of one party has negative financial consequences for that party. Still another arrangement is to share and exchange managers.

What some observers would describe as convergence of governance systems to a market-based as opposed to a bank- or relationship-based governance system is disrupting supplier, employee, and customer implicit contracts in many countries. For example, Nissan Motor, a Japanese automobile manufacturer, brought in a Frenchman, Carlos Ghosn, to restructure its operations. His plan was to cut 21,000 jobs, close five factories, and scrap half the supplier base to make Nissan competitive in global markets. The plan was described as "another blow to the *keiretsu* system of business relationships [governance structures]. Until recently, these cozy ties . . . helped support a network of friendly companies bound by mutual shareholdings and personal contracts" (Harney, 1999).

GOVERNANCE ISSUES AND APPLICATIONS: CORPORATE OBJECTIVES

Examine the annual report of your company, its competitors, suppliers, and customers. Does the CEO's "Message to Our Shareholders" or "Letter . . ." contain an explicit statement about whether the company strives to maximize its stock price? Such a statement may appear in many disguises. For example, Mark Linebaugh, the CEO of Community Financial Group, Inc., says that the company "focused on its mission to provide its shareholders with long-term value for their investment."

Or, it can be very blunt. To the question "What can shareholders expect this fiscal year?" William R. Johnson, the President and CEO of Heinz says in the 1999 Annual Report, "Be assured that whatever we do will be directed first and foremost towards increasing shareholder value [read stock price]."

How would you evaluate whether management had achieved their stated objectives?

LEGAL AND INSTITUTIONAL ISSUES

The major legal and institutional issues in corporate governance are laws pertaining to shareholder rights, financial transparency, and regulations governing the issue and trading of securities. With respect to shareholder rights, the critical issues are protecting the rights of the minority shareholders from majority or large block shareholders. These rights include making sure that minority shareholders cannot be forced to sell or exchange their shares in mergers and acquisitions for less than the majority shareholders as well as rights pertaining to voting and access to information.

Financial *transparency* refers to the provision of information concerning the financial affairs of the company and the operation of financial markets. In the absence of reliable and trustworthy information about the financial affairs of a company, individuals would be reluctant to buy the securities (stocks and bonds) of a company. So, financial disclosure laws, such as requiring the publication of financial statements, are important factors that shape a corporate governance system and its performance.

Financial market transparency is also important for the efficient functioning of financial markets. Investors need to be confident that trading is "fair" and that insiders or others with private information do not take advantage of their privileged position and that market prices cannot be manipulated.

The United States has adopted laws that protect shareholders and that require transparency with regard to financial reporting and the functioning of financial markets. A federal agency, the Security and Exchange Commission (SEC), was created in 1934 to enforce these laws, monitor financial markets, and oversee the sale the new securities. In addition, individual states have their own security laws—called *blue sky laws* to prevent unscrupulous people from selling the blue sky—and regulatory agencies.

We return to legal and institutional issues in corporate governance in Chapter 9.

An Organic Version of the Modern Corporation

When Berle and Means wrote about the separation of management and ownership in the modern corporation, they were concerned with how to make the corporation compatible with democracy in a world where the managerially controlled corporation had replaced the simple market economy of the nineteenth century. The allure of the premodern corporation era was that it allowed workers to become owner-managers of small firms. This governance structure (ownership arrangement) supported the moral development of the individual and encouraged his active participation in the market and politics because he had a vested interest in protecting his property from the opportunistic behavior of others. It also motivated the owner-manager to act in a socially responsible manner towards his neighbors so as to preserve his property.

Consequently, the concerns of Berle and Means and others focused on the societal role of the corporation. They were concerned with reconciling the emergence of the modern corporation with American notions of the moral development of its citizens, democratic pluralism, and economic opportunities—what is loosely described as corporate social responsibility. They were also concerned with how economic efficiency fit into this equation and were seeking ways to reconcile economic efficiency objectives with political economy objectives.

The conflicts of interest we have identified were important to writers in the Berle and Means era in the context of how to make managers serve the interests of the community at large and not themselves. The writers were seeking ways to advance the development of character and democracy in America—ways that included enhancing economic efficiency by preventing managers from squandering "society's" economic resources. Who was to say that the only or most desirable way to get economic efficiency was to have managers ultimately serve the interests of shareholders? Shareholder wealth maximization was a means to an end rather than the end itself.

Corporations were to serve more fundamental societal interests than making people rich. They existed to provide jobs, develop the citizen's personality, and if not preserve, at least not hinder, the operation of democratic institutions. And, for Berle and other members of Roosevelt's brain trust, to prevent the collapse of capitalism in the face of the Great Depression. For the modern corporation to serve these societal objectives implied that there were benefits to having a company survive as a social organization—benefits that would be lost if the firm disappeared. From a social welfare perspective, then, corporate governance is ultimately tied to finding ways to ensure that managers do not waste economic resources within the overriding social responsibility functions of the firm, functions that require the firm to become a organic entity. The ways of doing this and the implications for managers are what we address in this course.

recap

Corporate governance, broadly defined, is about the set of legal, cultural, and institutional arrangements that determine what corporations do, who controls them, and to whom they are accountable. Broad definitions explicitly incorporate corporate governance questions into a larger question of how to organize economic activity so as to achieve societal objectives usually grouped under the umbrella of corporate social responsibility. More narrow definitions focus on purely economic efficiency objectives such as maximizing owner wealth that may or may not be tied back into societal objectives.

From an economic efficiency perspective, basic corporate governance problems arise from the separation of management and ownership because managers may run the company in the best interests of themselves and not the owners' or the public's interest. These problems can be analyzed using financial agency theory. Financial agency theory describes a governance system whereby the size of the firm is prevented from growing beyond that which is economically efficient and through which the self-interest of managers and other contractual members of the firm are held in check by the shareholders. The role of the shareholders is to monitor the performance of management to ensure managers are acting in the shareholders' best interests which are equated with economic efficiency at the societal level and stock price maximization at the shareholder level.

Review Questions

1. A narrow definition of corporate governance focuses on: 1. (b)
(a) the whole set of legal and cultural arrangements that determines what public corporations can do.
(b) the way suppliers of finance assure themselves of getting a return on their investment.
(c) the purely cultural and historical issues of governance.
(d) how to organize economic activity in general.

2. A major problem arising out of the separation of owners and managers is: 2. (c)
(a) it becomes difficult to sell shares of common stock to the general public.
(b) banks refuse to lend money to companies whose owners are not their managers.
(c) mangers can serve their own interests at the expense of the owners.
(d) institutional investors will not buy stock in firms that are not owner-managed.

3. A major function of shareholders in a financial agency model of corporate governance is to: 3. (a)
(a) monitor and discipline managers.
(b) represent the interests of creditors.
(c) represent the interests of labor.
(d) make sure the firm grows as large as possible.

4. The owners of a publicly held corporation are the: 4. (c)
(a) bondholders.
(b) managers.
(c) common stockholders.
(d) employees.

5. In the United States, the board of directors theoretically represents the interests of: 5. (b)
(a) the managers.
(b) the shareholders.
(c) the creditors.
(d) all of the stakeholders of the corporation.