Strategic Management of Enterprise and Digital Innovation

Corporate Governance

15-minute Direct Questions

1) What is governance?

2) What is meant that ownership is separated from managerial control?

3) What are ways to improve governance mechanisms of a corporation.

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Governance

Corporate governance is a complex set of structures designed to provide firm oversight and enforcement of major strategic issues.

Evidence suggests that corporate governance is critical to firms' success and dealing appropriately with this challenge is important.

Corporate governance is the set of mechanisms used to manage the relationships among stakeholders and to determine and control the strategic direction and performance of organizations.

Effective leadership succession plans, appropriate monitoring and direction-setting efforts by the board of directors contribute positively to a firm's performance.

The different influences on strategic purpose

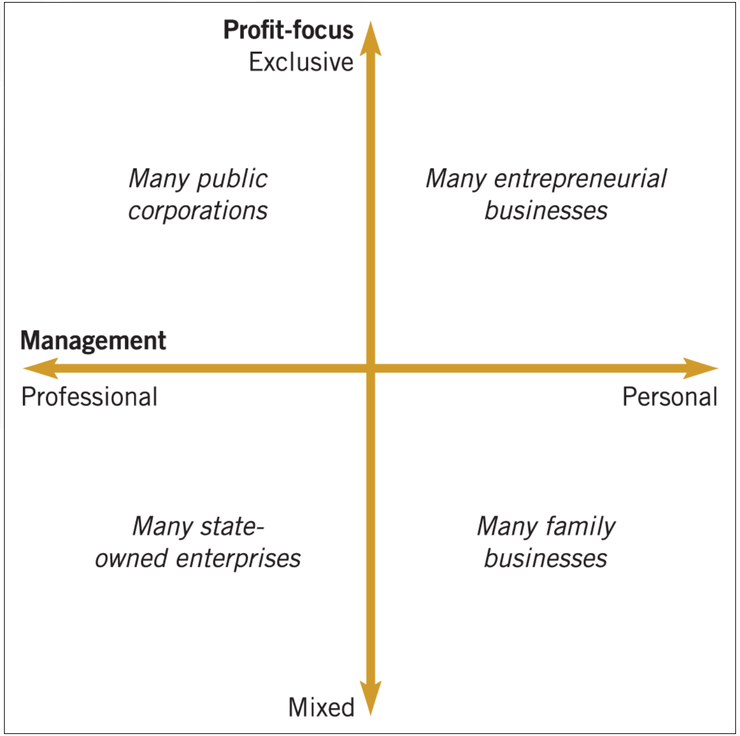
There are many types of ownership:

This section explores the **4 main kinds of ownership** models and the governance issues involved in uniting owners and managers.
PTO:

The four main ownership models are as follows:

Their objective is to **make a financial return for the owners** (profit focus).

Unsatisfied shareholders will sell their shares or seek to remove the managers/ or BOD.



(e.g. Space X)!!

They are common in developing economies (e.g. In China the Gov owns around 60% of stock market. Also in Russia it is above 50% followed by Brazil 25%)

Typically small to medium-sized enterprises (SMEs) but may be very large (e.g. Ford and Walmart)

PS: There are other types of organisation: ***Not-for-profit organisations***
Frequently charitable foundations pursuing a **social mission**

The growing importance of governance

Recently there has been a global emphasis on corporate governance as there is:

1. An apparent ***Corporate failures and scandals , with lack of*** adequately monitoring and controlling top-level managers. **Ex:**
   - **Enron :** hidden debts in Billions $ (2001)
   - **Lehman brothers:** - 600 Bn (2008 GFC)
   - **Wells Fargo Bank-** fake customer accounts (2016)
2. ***Increased accountability*** **to stakeholders** and mainly the shareholders' interests and the need for **CSR** (e.g. green issues).
3. There is evidence that a well-functioning corporate governance system can create a competitive advantage for an individual firm.

The 'Principal–Agent' model

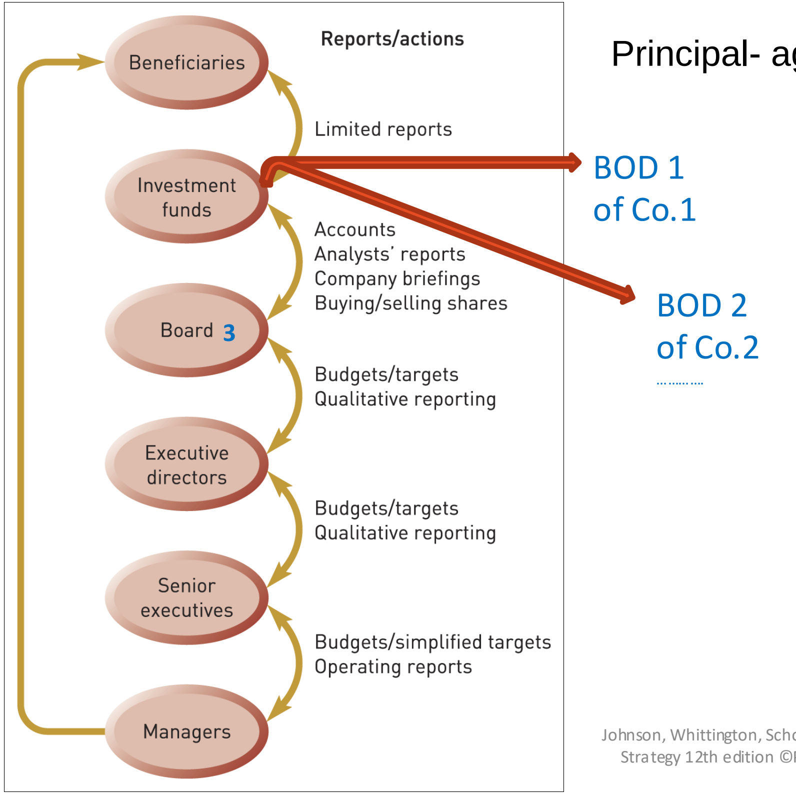
- Governance can be seen in terms of the principal–agent model
- Principals (ex: investors) pay agents (ex: Investment funds) to act on their behalf.
- A major problem occurs when Agents act in their own self-interest.
- And here comes the role of the (BOD) Board of Directors:

  - Direct meaning of Governance

- https://youtu.be/zpxBeq6W2i8 (Mogensen 2010)

The governance chain

In a very large public corporation, there are principals and agents at every level.



Johnson, Whittington, Scholes, Angwin and Regner, Exploring Strategy 12th edition ©Pearson Education Limited 2020

The chain of corporate governance: typical reporting structures

Source: Adapted from David Pitt-Watson, Hermes Fund Management.

Governance issues arise from:

- ***Knowledge imbalances***: *Usually* agents know more than principals about what can and should be done.

- ***Monitoring limitation***: it is very difficult for the principal to closely monitor the agent's performance especially if they have diverse investments.

- ***Miss-aligned incentives***: without appropriate incentives agents may pursue their own objectives.

How problems arise in corporate governance:

https://youtu.be/V0zemSfMWSQ?t=46 *(*Mogensen 2013)

- **What could happen if the BOD (Board of Directors) doesn't do well?**

- 1- Shareholders can vote for the board of directors according to the number of their shares, and can elect new members.
  - (but a majority is needed)

- 2- Dissatisfied shareholders may sell their shares, leading to a drop in the company's share price and an increased threat to directors of takeover by other firms.

- Note: **Common shares or ordinary shares** usually grant <u>voting rights</u>, allowing shareholders to have a say in important matters such as the election of directors, mergers and acquisitions, and other significant corporate decisions. However, they <u>DON'T have guaranteed dividend</u>

- **Preferred shares,** on the other hand, usually carry <u>NO voting rights</u>. in exchange for other benefits, such as a <u>**guaranteed fixed dividend**</u>.

- ***Short-termism*. ** In order to satisfy the shareholders, the BOD may be encouraged to focus on **short-term gains** at the expense of long-term projects, such as R&D.

- **BOD have the ultimate responsibility for the success or failure of an org.** as well as the benefits received by shareholders and stakeholders.
- ➔ BOD must be concerned with **strategy**. They should engage in the strategic management process.
- ***Delegation*****:** **strategy** can be delegated to management; with the BOD supervising, receiving and approving plans and decisions.

- **The typical BOD duties include:**
  - Ownership linkage
  - Setting policies and processes
  - Monitoring
  - They can also be good PR and help in fundraising
- In most cases, **the BOD makes decisions, or advise** on key issues such as:
  - Mergers
  - Dividends distribution, VS investment in R&D and innovation developments when opportunity arises
  - Hire senior managers and set their pay.

Accepted good practice for boards includes:

- ***Operating 'independently'* of MGT** –
- ***Being well competent*** to be able to scrutinise the activities of managers.
- Having ***time*** to do their job properly.
- ***Behaving appropriately (Ethically)*** given society's expectations for trust, collective responsibility and performance.

How BOD members are nominated?

- Board of Directors (BOD) members are typically nominated and elected through a process that involves both current board members and shareholders. The process varies by company and jurisdiction, but here's a general overview of how it usually works:

1. **Nomination by the Nominating Committee:** Most companies have a **nominating or governance committee** within the board that oversees the process. This committee identifies and screens potential candidates based on their skills, experience, diversity, and alignment with the company's strategic goals. They seek individuals who can bring valuable insights and contribute to board functions such as finance, industry knowledge, or risk management.
2. **Recommendations by Shareholders:** Shareholders, especially large institutional investors, can also suggest candidates for the board. In some jurisdictions, shareholders with a certain percentage of ownership (e.g., 3-5%) are allowed to formally nominate individuals to be considered for board positions. In many cases, shareholders may simply recommend candidates informally or work with the nominating committee.
3. **Board Approval of Nominees:** After vetting candidates, the nominating committee will present a list of recommended nominees to the full board. The board reviews and approves the final slate of nominees to be put forward for election.
4. **Shareholder Voting:** During the company's annual general meeting (AGM), shareholders vote on the board nominees. In public companies, each share typically represents one vote, so shareholders with more shares have a greater influence on the outcome. In some cases, shareholders vote on each director individually, while in others, they may vote on the entire slate of nominees at once.
5. **Election Results and Appointment:** Candidates who receive a majority of shareholder votes are elected to the board. Once elected, directors typically serve terms of one to three years, after which they may be re-nominated and re-elected if they, the board, and the shareholders agree.
6. **Special Circumstances and Proxy Fights:** In some cases, there may be disagreements over board nominees, leading to **proxy fights** where activist shareholders attempt to replace some or all board members with their own nominees. This can happen if shareholders are dissatisfied with company performance or governance.

- In private companies or controlled corporations (like family-owned businesses), the process may be less formal, with major shareholders or founders directly appointing board members without a shareholder vote.

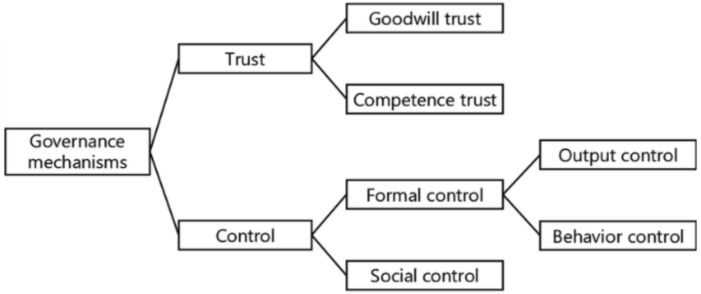
Some Ex. of Conflicts of expectations

- In order to grow, short-term profitability, cash flow and pay levels may need to be sacrificed.
- 'Short-termism'
- New developments may require additional funding through share issue or loans. In either case, financial independence may be sacrificed.
- Public ownership of shares will require more openness and accountability from the management.
- Cost efficiency → → → can mean job losses.
- ~~High CSR~~ → → → can induce higher costs.

Corporate Mechanisms of Governance

Organisations usually have 3 mechanisms of corporate governance:

1. **Ownership oversight:** where shareholders keep managers accountable.
2. **The board of directors:** that ensure governance on the organisation and balance it with shareholders' interest.
3. **Executive compensation:** that makes it in the managers' best interest to put the organisation first.



Hitt (2019)

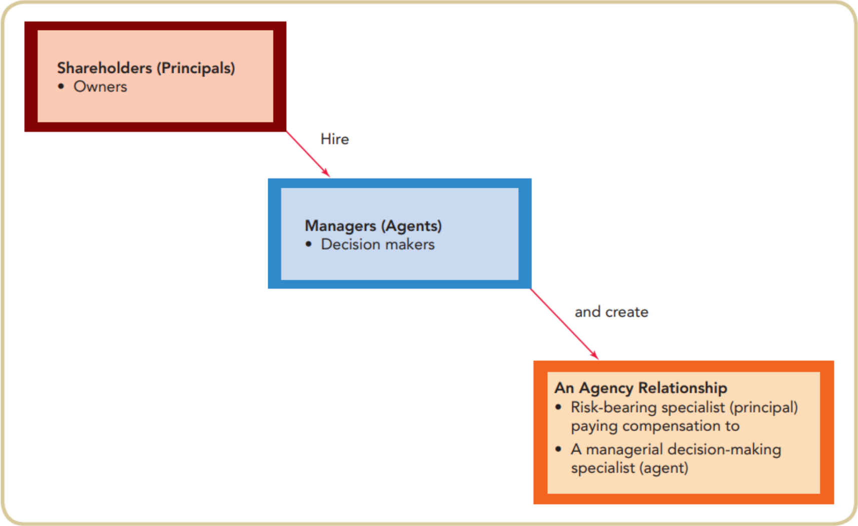
Agency Relationship

The separation between owners and managers creates an agency relationship (when specialists are hired to take decisions).

This element of governance is needed so that:

- A firm maximises the benefits from hiring specialized knowledge.
- And minimize the risk of managerial opportunistic behaviours.

Figure 10.1 An Agency Relationship



Hitt (2019)

Separation of Ownership & Management

Separation of management control and ownerships benefits both by:

- Shareholders can gain return on the money they invest without active work.
- Managers can bring in specialization to the decision-making process that the owners might not have.
- By working together, they can keep each other accountable for the better of the organisation.

Conflict Owners and Managers

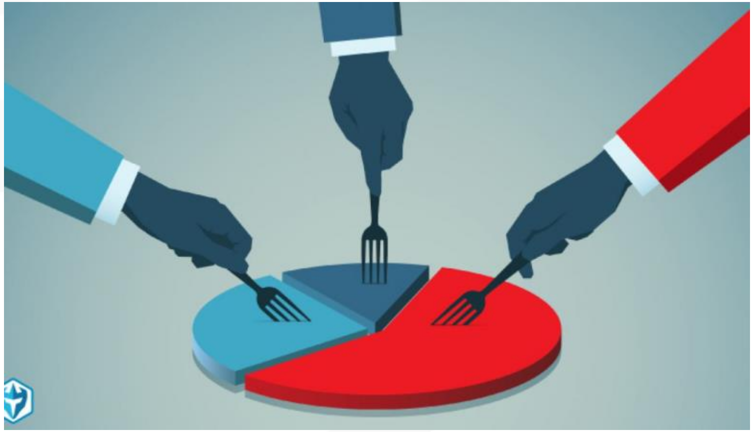
There is a tendency that owners and managers tend to have diverging views that result in conflict:

- Shareholders may want to exploit a market that is more lucrative and has the potential of higher returns.
- Managers may feel that the internal capabilities and culture may have different priorities than high return markets.

Both perspective are needed. Unless the firm moves fast to tap into a high return market, the competition will. On the other hand, rushing to enter a market unprepared can damage the reputation and value of the organisation.

Ownership Concentration

Ownership concentration: defined as the number of large of large-block shareholders (shareholders with a high percentage of power) and the total percentage of the firm's shares they own.



When there are many large block shareholders, they:

- Are in a **better position to hold management accountable.**
- Have strong **voting rights**
- **Can override management** decision making.

Board of Directors

The board of directors is a group of elected individuals whose primary responsibility is to act in the owners' best interests by formally monitoring and controlling the firm's top-level managers.

The quality of board of directors will influence the quality of execution, direction of organisation and the reputation of the organisation.

Case Example: Meta Corporate Guidelines

The Meta Corporate Governance Guidelines are intended to assist the Meta Board in the exercise of its governance responsibilities.

https://investor.fb.com/leadership-and-governance/corporate-governance-guidelines/default.aspx

I. Responsibilities of the Board of Directors

The Board acts as the management team's adviser and monitors management's performance. The Board also reviews and, if appropriate, approves significant transactions and develops standards to be utilized by management in determining the types of transactions that should be submitted to the Board for review and approval or notification.

The Board is responsible for selecting and appointing the Chief Executive Officer and Chairperson of the Board, as well as the Lead Independent Director of the Board, if any. The Chief Executive Officer shall select and appoint all other officers of Meta, subject to approval of such appointments by the Board or a committee thereof if required under the company's Bylaws, applicable law, or other legal or regulatory requirements.

Each member of the Board (each, a "director" and collectively, the "directors") is expected to spend the time and effort necessary to properly discharge such director's responsibilities. Accordingly, a director is expected to regularly attend meetings of the Board and Board committees on which such director sits, and review prior to each meeting the material distributed in advance for such meeting. A director who is unable to attend a meeting (which it is understood will occur on occasion) is expected to notify the Chairperson or the chairperson of the appropriate committee in advance of such meeting.

Case Example: Carl Icahn & EBay: READ ALONE

PayPal was part of eBay when Carl Icahn became a shareholder of eBay.

Carl Icahn drove a push to separate PayPal as he figured that eBay was hogging the potential of growth from PayPal.

Management pushed back arguing that PayPal is a backbone to the organisation.

In 2014, PayPal was formed into a spinoff organisaiton and it gained independence. PayPal grew whilst eBay shrank.

Impact of Governance on Innovation

Using the Pentathlon Framework, the impact of governance on innovation can be analysed:

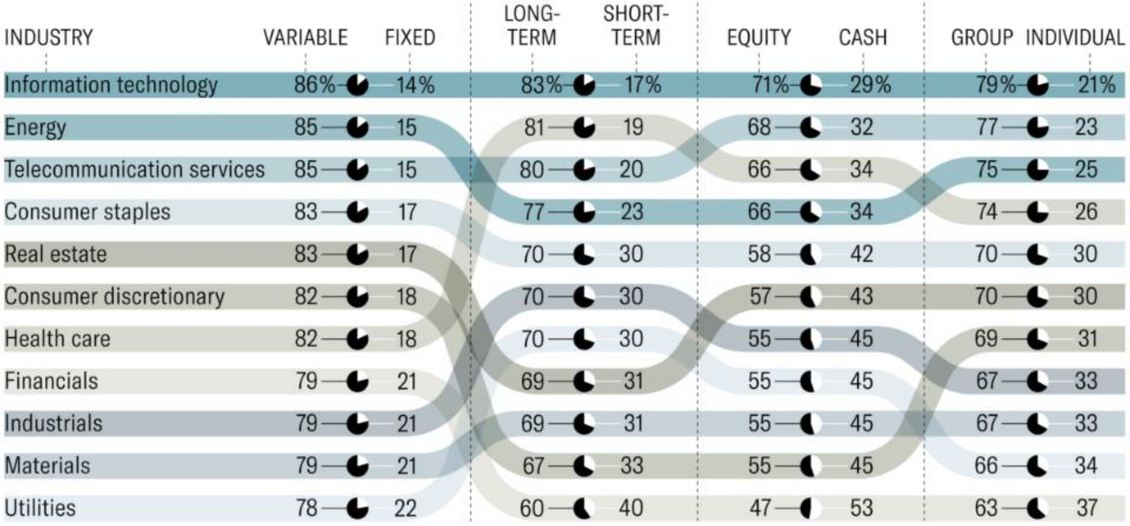
- **Innovation Strategy Priorities:** shareholders or managers can influence innovation strategy thus impacting the priorities for innovation.
- **Idea Generation Allocation:** rigid controls or absence of governance can result in missing opportunities or unethical behaviour.
- **Impact On Selection:** with the right governance, innovation will align to the best interest of the customers.
- **Quality of Implementation:** good governance supports the firm to implement the innovation according to what is needed.
- **People, Organisation and Culture:** governance needs to focus on supporting that environment that balances creativity, value and monetization

HR Impact On Compensation Planning

HR people are tasked with taking care of establishing a compensation scheme and ensuring it is effective by:

- Developing and applying a compensation philosophy/strategy.
- Communicating and explaining the compensation plan.
- Designing a robust compensation strategy.
- Balancing quality of life considerations with the needs of organisation.
- Assessing the results of compensation plan.
- Developing the efficacy of compensation management.

Compensation By Industy



Note: Data reflects the compensation of the five highest-paid executives at each of the companies in the Russell 3000.

Abbott, S., Marino, M.R., Aksoy, M., (2021)

Case Example: Tesco

Tesco, is a large commercial organisation. They have established a corporate governance framework that illustrates the different governance groups and sections to manage the organisation.

https://www.tescoplc.com/investors/corporate-governance/

Questions of CSR:
The CSR **internal** aspect

Should organisations be responsible for . . .

INTERNAL ASPECTS
Exployee welfare . . . providing medical care, assistance with housing finance, extended sick leave, assistance for dependants, etc.?
Working conditions . . . job security, enhancing working surroundings, social and sporting clubs, above-minimum safety standards, training and development, etc.?
Job design . . . designing jobs to the increased satisfaction of workers rather than just for economic efficiency? This would include issues of work/life balance?
Intellectual property . . . respecting the private knowledge of individuals and not claiming corporate ownership?

Should organisations be responsible for . . .

EXTERNAL ASPECTS
Environmental issues . . . reducing pollution to below legal standards if competitors are not doing so? . . . energy conservation?
Products . . . dangers arising from the careless use of products by consumers?
Markets and marketing . . . deciding not to sell in some markets? . . . advertising standards?
Suppliers . . . 'fair' terms of trade? . . . blacklisting suppliers?
Employment . . . positive discrimination in favour of minorities? . . . maintaining jobs?
Community activity . . . sponsoring local events and supporting local good works?
Human rights . . . respecting human rights in relation to: child labour, workers' and union rights, oppressive political regimes? Both directly and in the choice of markets, suppliers and partners?

As an employee or a manager: You detected that the strategy of the organisation is unethical, what can you do?

- The responsibility of an individual who believes that the strategy of the organisation is unethical can choose to:
- \- Ignore it
- \- Resign
- \- or take action =>
- ***'Whistle-blowing'*** – divulging information to the authorities or media about an organisation if wrong-doing is suspected.

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Summary

- Governance are the mechanisms a firm uses to ensure people work for the highest benefit of the firm.
- Governance can support the organisations to align its behaviour and decisions towards a successful implementation of innovation.
- Due to regulations and some opportunistic managers, there is increased pressure to improve governance.
- Thus, governance can become too rigid in a way that can either stifle creativity or reduce margins.
- Different groups within the organisations come together to be able to bring different perspectives and keep each other accountable.
- Incentives are an important tool to support people to align their behaviour with the strategy of the organisaiotn.

Discussion Questions

Let’s test our knowledge!

- What is governance?
- What is the role of governance in relationship to innovation?
- What are the mechanism for governance?
- What is the disadvantage of too much governance?
- How can organisation use incentives to control innovation?
- Why is compensations of top management important for innovation?
- What are the 4 dimensions of compensation of innovation?

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