Business Ethics, Corporate Governance

Lecture 10:

Ethics, Corporate Social Responsibility, Corporate Governance

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Introduction

Learning outcomes

LO 12-1 Describe the shared value creation framework and its relationship to competitive advantage.
LO 12-2 Explain the role of corporate governance.
LO 12-3 Apply agency theory to explain why and how companies use governance mechanisms to align the interests of principals and agents.
LO 12-4 Evaluate the board of directors as the central governance mechanism for public stock companies.
LO 12-5 Evaluate other governance mechanisms.
LO 12-6 Explain the relationship between strategy and business ethics.

What will the lecture focus at

- Introduction
- Why business ethics
- Business entities
- Agency and stewardship theories
- Corporate governance and its models (also in non-US settings)
- Recap (KvIS)

The business ethics

The business ethics

business ethics
An agreed-upon code of conduct in business, based on societal norms.

Staying within the law is a minimum acceptable standard.

Society expects more.

Non-written rules.

Related to brand, image, „license to operate".

The business ethics

The business of business is business.

„The Social Responsibility of Business Is to Increase Its Profits“

Q: author, year?

Adam Smith, 1759: The Theory of Moral Sentiments (Wealth of Nations: 1776)

„invisible hand of the market“ in both books but extensive use in 20th century by Paul Samuelson.

Noreen Hertz, 2001: The Silent Takeover

Beyond the shareholder approach

The larger pie: stakeholder view and Corporate Social Responsibility (CSR)

Q: Why did shareholder approach prevail and why is stakeholder approach dominant today?

Q: What is CSR?

Q: What are the three pillars of CSR?

The business ethics

Normative, descriptive, and prescriptive use of stakeholder theory and CSR.

Normative: companies should do this because this is the good thing.

Descriptive: companies are doing this.

Prescriptive: if companies do this, these are the consequences.

The business ethics

How to „do“ the business ethics?

- CSR
- Codes of conduct (https://www.muni.cz/en/about-us/official-notice-board/mu-code-of-ethics)
- Walk the talk!

Business entities, the corporation

Owners‘ rights, business entities, IPO, unicorn

Owners: rights, expectations, power

Q: What are the owners‘ rights?

Owners: rights, expectations, power

Company is *„the bundle of rights“* (R. Coase, 1960)

Owners are entitled only **to residual rights** to property and control.

Q: What are the expectations of owners?

Q: How can owners exercise their power?

Owners: rights, expectations, power

The motivation to do business is not always the same.

While for some the main incentive can be the profit, others prefer stability, some want to carry on a family tradition or for some it can be a form of self-realization.

Types of business entities

- Sole proprietorship
- Limited/unlimited liability
- Partnerships/companies/corporations

More at https://en.wikipedia.org/wiki/List_of_legal_entity_types_by_country#

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The corporation

Q: What does mean public versus private company?

Q: What is IPO?

Q: What is an unicorn?

Public stock company:

- Limited liability for investors (owners)
- Transferability
- Legal personality
- Separation of ownership and control

Owners: rights, expectations, power

- Fully involved in sole proprietorship businesses
- Fully involved in companies with unlimited liability, but not necessarily all owners
- Markedly less involved in limited liability companies
- Rarely involved in corporations
  - Sometimes we talk about managerial ownership

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Corporate governance

CG, agency and stewardship theory

The key players

- Owners are the statutory and managing body in sole proprietorships and often in unlimited liability companies
  - Partnership agreement (and law) can determine differently
- Corporate governance laws define the distribution of rights and responsibilities among participants in corporations
  - The ownership and management are definitely separated

Corporate Governance…

…addresses the relationship between owners and management (narrow meaning, based on Berle and Means 1932).

…is "a set of relationships between the company's bodies, its owners, and other stakeholders" (OECD, 1997).

is "the structure and processes by which companies are directed and controlled" (World Bank).

Corporate Governance aims to

- protect the interests of owners (Demsetz 1983, p. 386),
- ensure the return on investment of finance suppliers (Shleifer and Vishny 1997, p. 737),
- reduce agency costs (Mueller 2006),
- higher efficiency, better access to capital, lower risk, insurance against poor management/governance (World Bank, cited from International Finance Corporation).

We can define corporate governance as

"the issue of ownership relationships and systems by which owners exercise their ownership rights and control over the management area of the company; at the same time, corporate governance includes processes, structures, and relationships through which the board oversees the activities of its executive officers"

Hučka, Malý, Okruhlica et al., 2007

Why corporate governance?

Still an important and current topic. Milestones:

- Cadbury Report
- a series of scandals around the turn of the millennium: Enron, Tyco, Global Crossing, WorldCom, Xerox...
- in the Czech Republic problematic cases mainly TV Nova, IPB, squeeze outs
- The Business Corporation Act of 2012 effective from 2014
- currently e.g. ČEZ and other publicly traded Czech companies

The agency theory

Principal-Agent problem

adverse selection

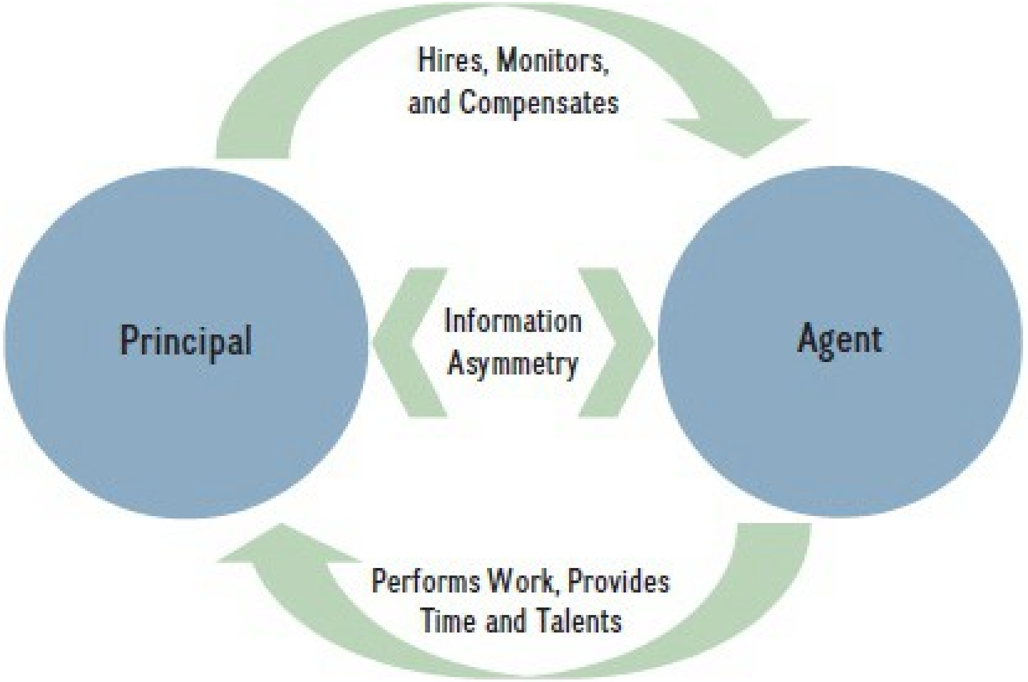
A situation that occurs when information asymmetry increases the likelihood of selecting inferior alternatives.

moral hazard

A situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs incur to the other party.

Information asymmetry

Agency costs



The stewardship theory

Stewardship theory is an alternative to agency theory in corporate governance, emphasizing the role of managers as stewards of the company who act in the best interests of the shareholders.

Managerial Motivation:

1. Unlike agency theory, which assumes managers are self-interested, stewardship theory posits that managers are motivated by intrinsic rewards such as personal satisfaction, recognition, and the success of the organization.
2. Managers are seen as trustworthy and committed to the company's goals.

Alignment of Interests:

1. The theory suggests that the interests of managers and shareholders naturally align, reducing the need for extensive monitoring and control mechanisms.
2. Managers are viewed as stewards who prioritize long-term organizational success over short-term personal gains.

The stewardship theory

Corporate Governance Implications:

1. Governance structures under stewardship theory are less focused on stringent controls and more on enabling and supporting managers.
2. Boards of directors are seen as partners in governance, working collaboratively with managers to achieve organizational goals.

Performance Outcomes:

1. Stewardship theory argues that when managers are trusted and empowered, they are more likely to act in the best interests of the company, leading to better performance and higher shareholder value.
2. It suggests that intrinsic motivation and a sense of duty can drive managers to achieve superior results.

Corporate governance: the models

Anglo-American, Continental, Japanese, comparison

Anglo-american model

So-called one-tier, or external control model

General meeting elects the Board of Directors (BoD)

- part of them are insiders (executive directors), part of them outsiders (non-executive or independent directors)
- BoD chairman is often also CEO (so-called „duality“)

Required are liquid stock markets and low ownership concentration.

Control is exercised, among others, through the exit system.

Until recently, laws against close connections between companies and their banks in the USA.

Anglo-american model: ownership patterns

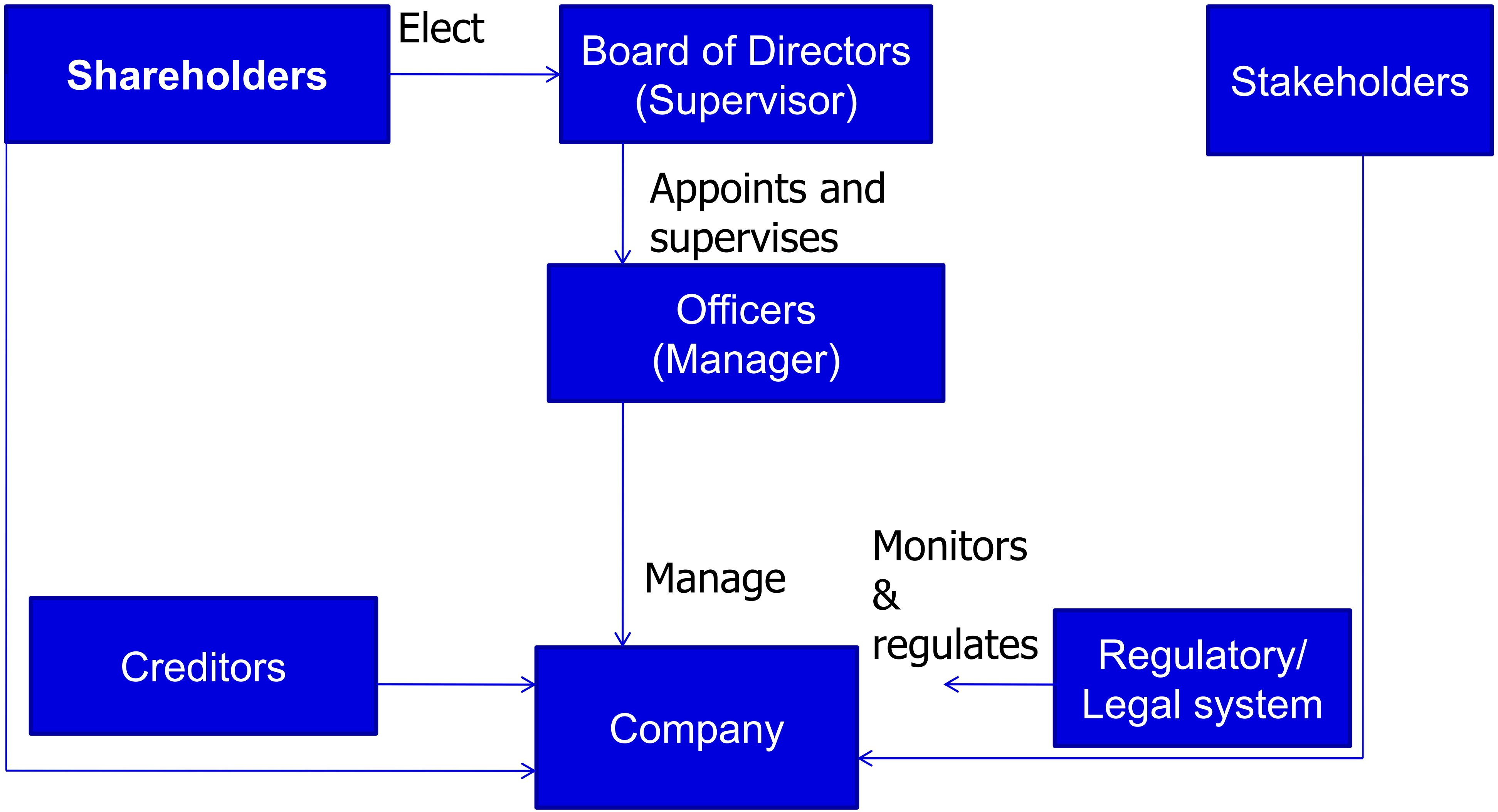
In 1990, institutional investors held approximately 61 percent of the shares of UK corporations, and individuals held approximately 21 percent. (In 1981, individuals held 38 percent.)

In 1990, institutions held 53.3 percent of the shares of US corporations.

Anglo-american model: trends and issues

- Growing share of institutional owners, decreasing share of individuals
- Voting behavior of institutional owners at AGMs
- Concentration of power in the hands of one person or small group of persons
- Excessive executive compensation
- Regulatory framework reacts

Interactions among key players



Continental model

So-called two-tiered model, or internal control model

General meeting elects supervisory board and management board

- in some countries supervisory board names members of management board
- it is common that part of the supervisory board is elected by employees (up to 50%, sometimes depends on the firm size)

Management board is the statutory body and is responsible for „daily“ management of the company, supervisory board si responsible for the strategic control.

Control is exercised, among others, through the voting system.

The connection between the company and a bank can be very close.

Continental model: ownership patterns

Banks	27%
Pension funds	3%
Other companies	41%
Individual owners	4%
Foreign investors	19%

Continental model: trends and issues

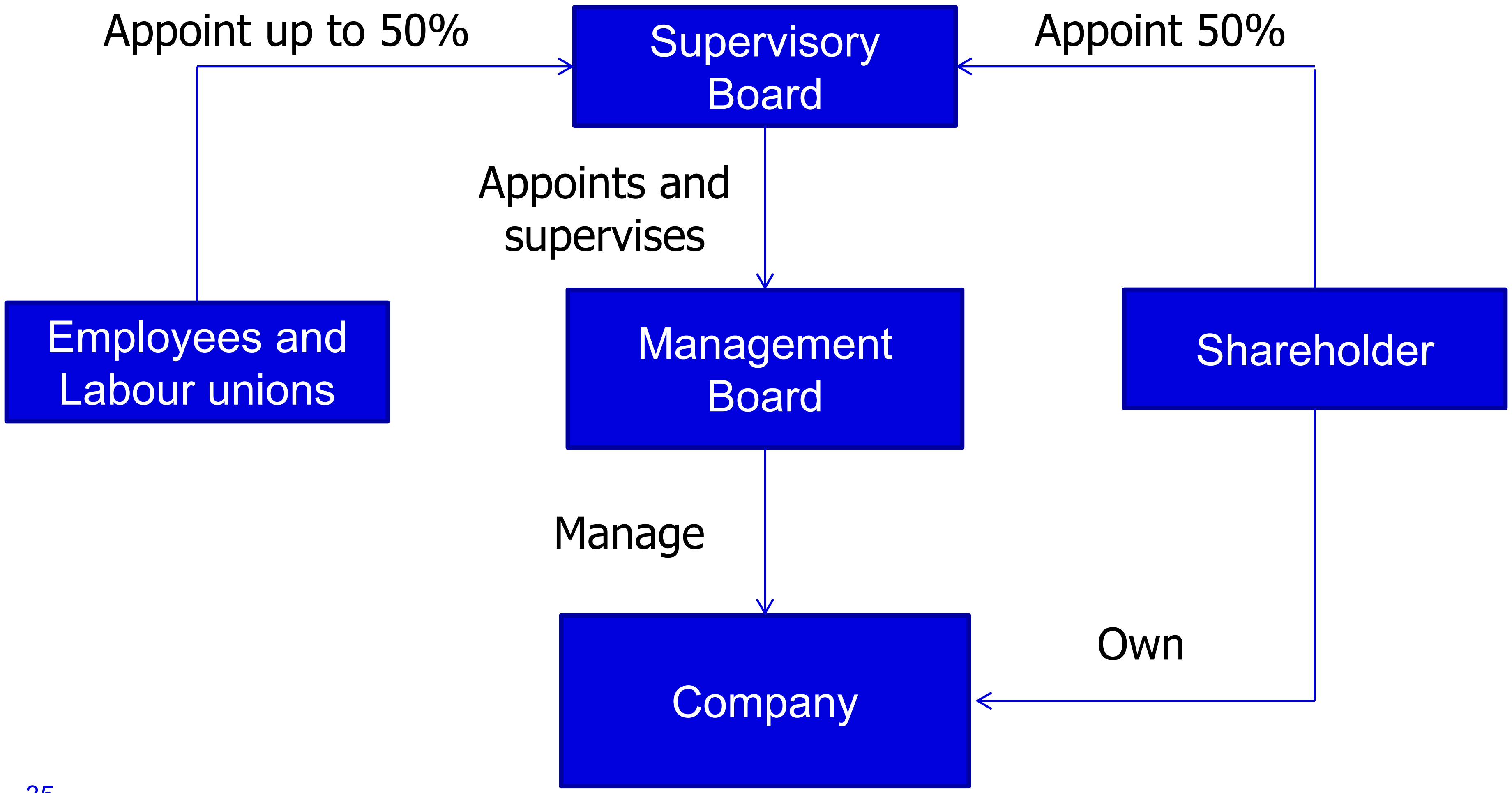
- The ownership concentration still increases
- Capital markets are illiquid

  - therefore capital allocation is not perfect

- European commission wants to encourage individuals to invest in securities

  - however the typical European behavior saved EU from larger impact of 2008 financial crisis

Interactions among key players



Japanese model

So-called Keiretsu. Model with even higher interconnectedness among the key players than the continental model. The key players are:

1. Main bank (a major inside shareholder)
2. Affiliated company or affiliated keiretsu (a major inside shareholder)
3. Management
4. Government
5. Outside shareholders
6. Independent (external) directors

Typical is very high ownership concentration and cross-shareholding

Japanese model: ownership patterns

Banks + insurance companies	43%
Other companies	25%
Foreign investors	3%

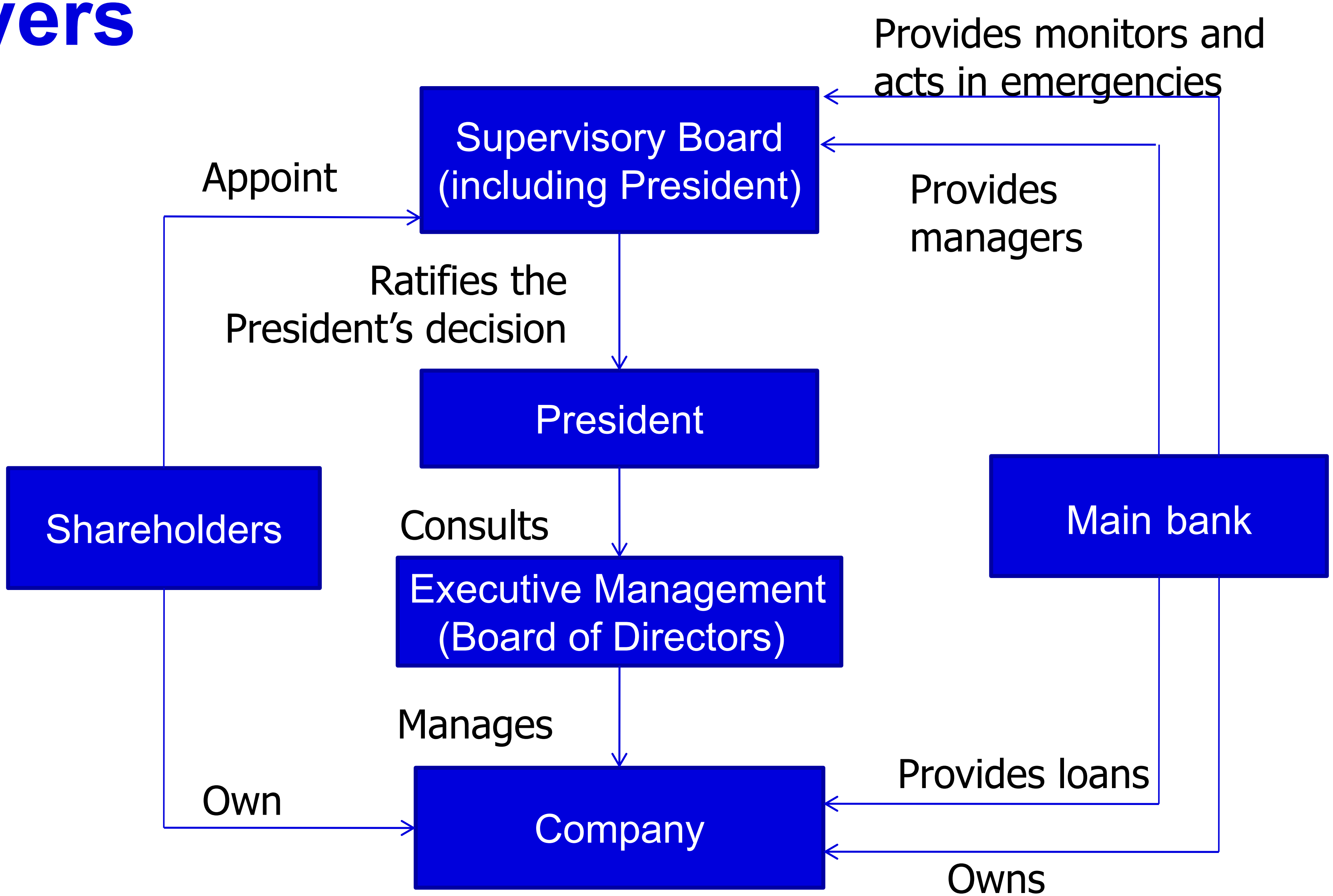
Japanese model: trends and issues

Very non-transparent for outsiders

Very rigid

The strong crossholding of equity and debt and strong business relationships can work in favor of competitiveness, but also against it

Japanese model: interaction among key players



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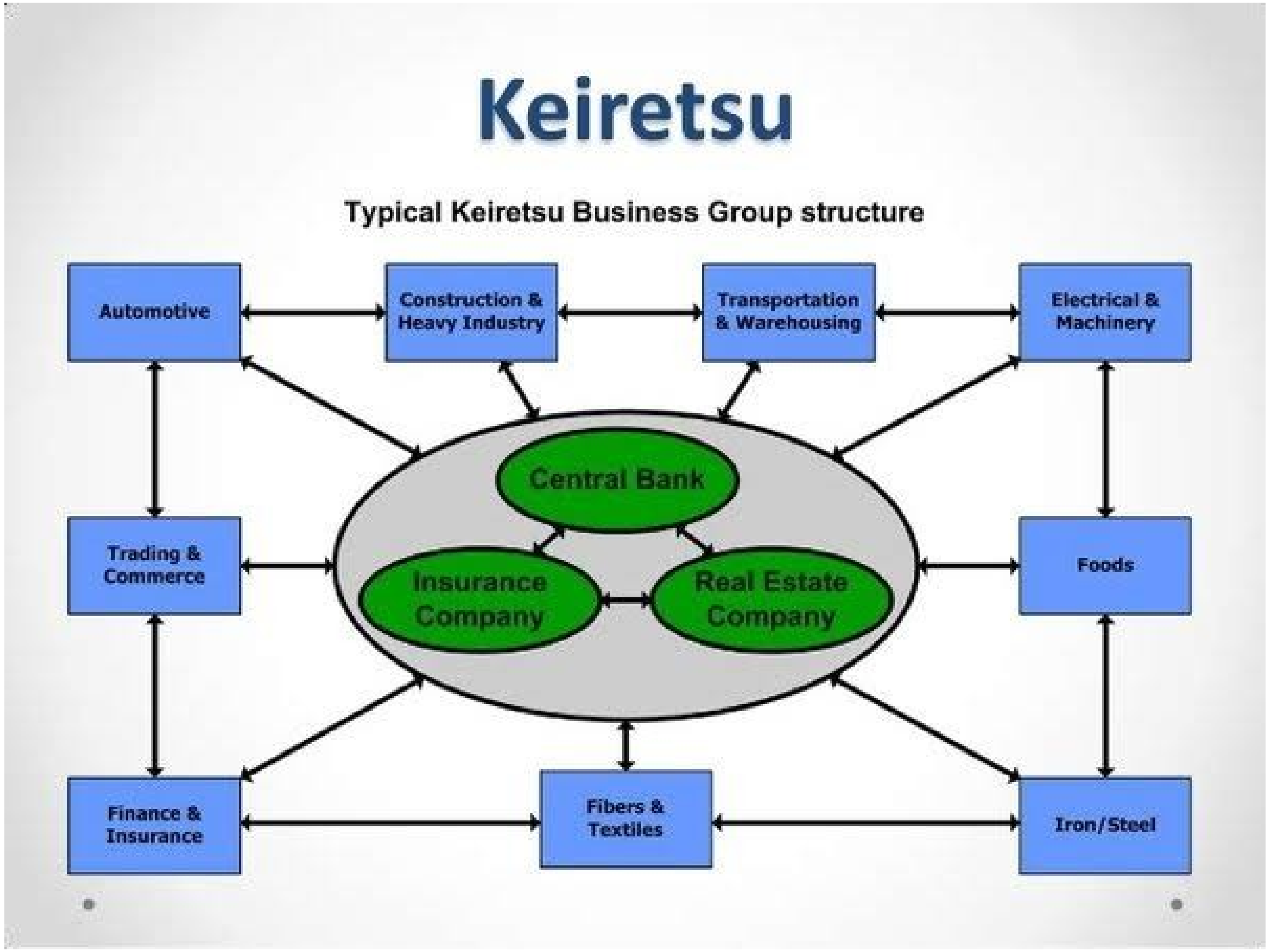
Japanese model: example of a Keiretsu



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A comparison: ownership patterns

Anglo-Saxon System

- **UK 1990**: Institutional ownership 61%
- **US 1990**: Institutional ownership 53%

- **UK 1981**: Individual ownership 38%
- **UK 1990**: Individual ownership 21%

- **UK 2016**:
  - Foreign ownership 53.9%
  - Individual ownership 12.3%
  - Banks 2.5%
  - Other financial institutions 27.7%
  - Companies 2.2%

Continental Europe

- Banks 27%
- Pension funds 3%
- Companies 41%
- Individual ownership 4%
- Foreign ownership 19%

Japan

- Banks 43%
- Companies 25%
- Foreign ownership 3%

Source: Dagala J. C., Statistical Office of Great Britain.

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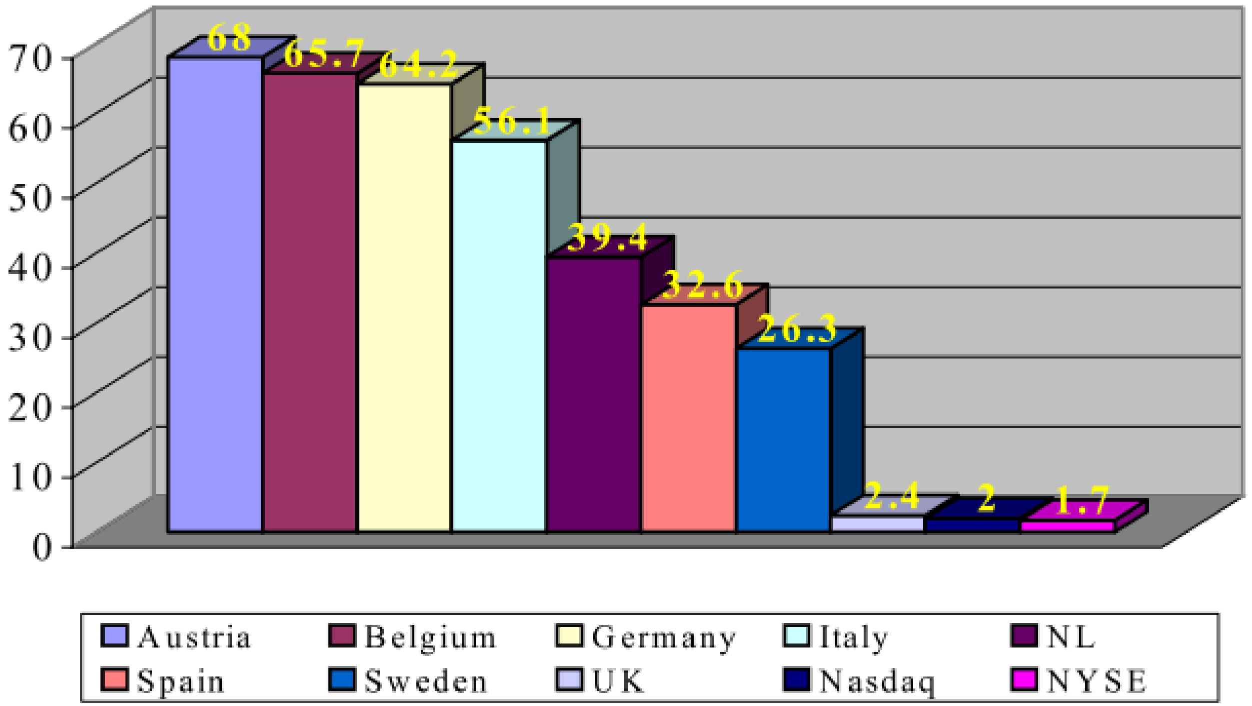
A comparison: ownership patterns

Figure 3. The ownership structure in the EU vs. the US (percentage of listed companies under majority control)



Source: Lannoo K., Khachaturyan A., 2004.

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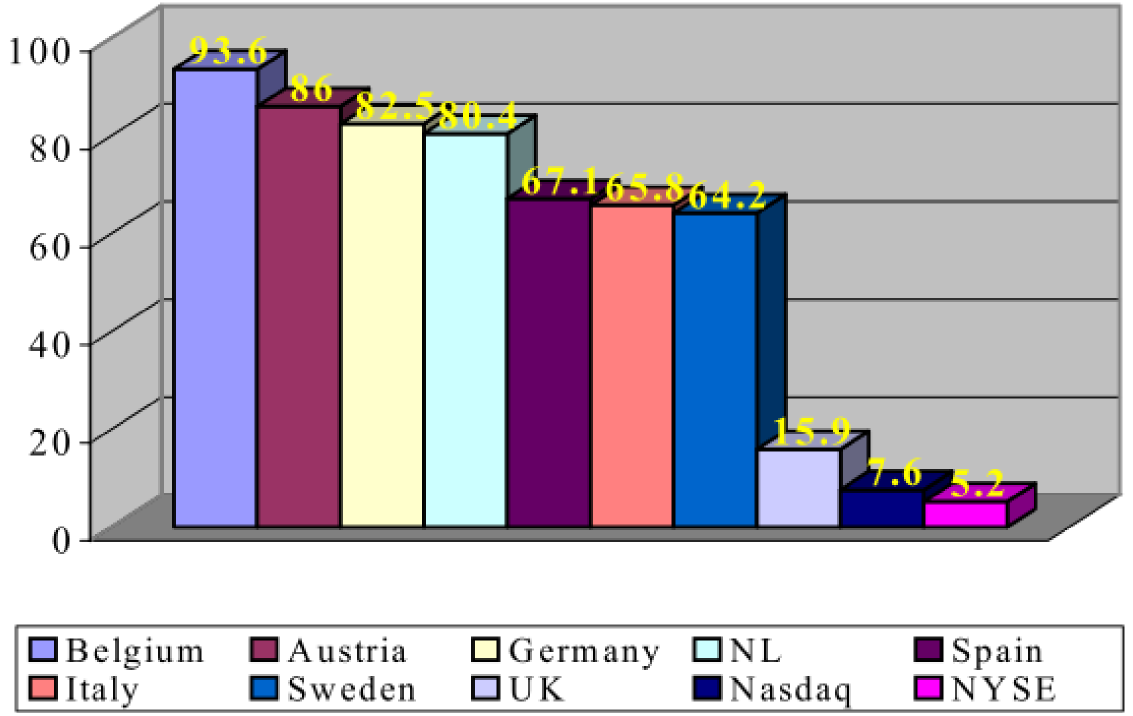
A comparison: ownership patterns

Figure 4. The ownership structure in the EU vs. the US (percentage of companies with a blocking minority of at least 25%)



Source: Barca & Becht (2001)

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Comparison of systems - governance models

System	Anglo-Saxon	Continental
Check	external	Inside
Model structure of administrative authorities	Single level	two-level
Executive administrative authority	Executive Directors of the Board of Directors	Board of Directors
Controlling administrative authority	external members of the Board of Directors	Supervisory Board
Duality of control and executive roles	Maybe	Impossible
Independence of the supervisory authority	Low	high
Committees of the administrative authorities	mandatory	Recommended
Representation of banks in administrative bodies	low to prohibited	high
Employee representation on the governing bodies	Unusual	usual to compulsory
Influence of political interests	Unwanted	Indirect
Monitoring by owners	indirect, passive	direct, active
Relative costs of monitoring	high	Low
Method of management by owners	exit	vote

Comparison of systems - environment

System	Anglo-Saxon	Continental
Cultural environment	Individual	Collective
Capital markets	large and liquid	small and illiquid
Investment horizon	short-term, speculative	long-term, strategic
Concentration of ownership	Low	high
Representation of institutional investors	high	Low
Prototype of the conflict	principal vs. agent	majority vs. minority owner
Legal system	common law	continental law
Legal protection of owners	high	Low
Cross-ownership	exists	very significant
Risk of hostile takeover	exists	vanishing

Source: Hučka 2007, Körner 2008, Mueller 2006, modified.

Comparison of systems - financing

System	Anglo-Saxon	Continental
Main method of financing	share capital	credit
Main source of funding	market	bank
Relations with the bank	free	tight
Accumulation of bank roles	low to prohibited	frequent
Transaction costs of financing	high	Low

Let‘s wrap it up

The KvIS is comming

KvIS

- Summary of the lecture
- Max 1 bonus point (3 questions, 1/3 point for the correct answer)
- Remember to submit your answer a few seconds ahead (lag)

Literature

What to study: Rothaermel Ch 12

Literature used for the slides:
Coase R. H. (1960) ‘The Problem of Social Cost’, *Journal of Law and Economics* 3: 1–44.
Hertz N. (2001) The Silent Takeover: Global Capitalism and the Death of Democracy.
Friedman M. (1970) The Social Responsibility of Business Is to Increase Its Profits.

Graphics (interactions among key players, 3x) borrowed from Dushyant Maheshwari`s lecture Models of Corporate Governance, retrieved from SlideShare.
Ownership patterns data obtained from Joy Clarisse Dagala`s Chapter 4: Models of Corporate Governance, retrieved from SlideShare

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