Corporate governance: How do investors get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do they control managers? Discuss.

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Introduction.

How to get managers to return some profits? How make sure that managers do not invest into bad projects and steal the capital supply? How to control managerial activities? These are the main questions that investors face when financing corporations. The entire mechanism has been developed over time in order to help investors find solutions to these issues and protect their rights.

This mechanism is defined as corporate governance, which is a "set of rules, practices and processes by which firms are controlled." It deals with the ways in which financial investors make sure to get returns on their investments. Corporate governance became a big issue after the loss in public confidence in companies, when accounting fraud bankrupted Enron and WorldCom. (Investopedia 2013) Such examples of managerial expropriation make investors' protection crucial in corporate world. This essay will emphasize the problems faced by investors and managers, and ways how they are solved by corporate governance and legal protection.

I. Problems faced by managers and investors.

In a business world there is a problem faced by entrepreneurs, which can be described in an economic term scarcity. One can have a great business idea, but no financial capital to implement it. This is why corporations usually raise funds from external investors. These investors, or so called creditors, could be wealthy individuals, or group of individuals working for the same capitalists. It is common that financiers of corporations need the qualified professionals to generate returns on their funds as they are not competent enough to do it by themselves. Whether the funds are provided by several small investors or a big investor there are problems that they face in terms of assuring their rights in getting back the investment return, making sure that their money are not invested into unwanted projects, and ensuring that managers are doing a transparent job.

First of all, for managers have to be motivated to do a quality work to proceed on a project. In other words, they should get enough monetary and non-monetary benefits out of the project. Managers should not be taking up the risk for their own benefit, such as big bonuses. However,

there is always risk of managers making inadequate investment decisions. A good example of that is financial crisis of 2007 where firm's risk management and financing policies had significant effect on how firms were impacted during financial crisis. (Erkens, Hung, Matos 2012) To avoid managerial self-dealing some barriers on managers should be introduced. Secondly, managers should receive large enough profits depending on success of their work. In ideal world, this should motivate managers to act for a company's interest rather than their own. Unfortunately, in reality this is not that simple. Due to many factors, both managers and investors tend to deviate from the agreement, which causes difficulties when creating and enforcing the rules.

Another issue that investors usually face is what by George Akerlof was described as "asymmetric information": when one party has better information than another party. Usually when investors fund the firm, they do not have perfect information about how it operates. For example, manager knows better about corporation's real value, or has more information about the project riskiness than an external investor. Investors hire managers and trust their competency for the investment choices; however they always face a moral hazard problem where they do not know if manager is not going to invest into bad projects or just take their money and walk off.

II. Corporate governance.

One of the modern solutions to the problems described in section one is corporate governance. Schleifer and Vishny (1997) notice that corporate governance is not a perfect mechanism; however, the best one world had come up so far. The effectiveness of corporate governance varies across the countries depending on the historical circumstances, cultural and legal differences: from well-established in advanced economies (US) to nearly no governance like Russia. This means, there is no such thing as universal corporate governance.

II.I. Contracts

One of the tasks for corporate governance is to help investors decide how they are going to get managers to return some of the profits. It deals with so called principal – agent (agency) problem. Agency problem refers to the difficulties that investors have in assuring that their funds are not expropriated or wasted on "bad" projects. Agency problem matters not only

because of monetary incentives of managers, but also because theycare about the reputation as it may affect their future projects. (Schleifer, Vishny 1997)

A common way of dealing with agency problem is by restrictions on managers' activities. In most cases, investors and managers sign a contract (legal treaty) that determines what the manager does with the funds, and how the returns are divided between him and investors. Ideally, such contract would be complete, meaning that it defines what the manager does in each scenario and how the profits are allocated. However, complete contracts are infeasible in most cases as it is difficult to foresee future events. Due to these issues, the manager and the investor have to allocate so called residual control rights. La Porta, Lopez-de-Silanes, Schleifer and Vishny (2000) define these rights as 'the rights to make decisions in circumstances are not foreseen fully by the contract." One way the contract could be formed is that investors provide financing to managers, but retain control of all the residual rights. In the case of unexpected event, investors to corporation are the ones who decide what to do. However, most of the investors are not qualified enough to make such decisions. This is the reason why they hire the managers. As a result, managers usually end up having majority of residual control rights; hence they have discretion to choose the allocation of funds. There are some limits on this discretion for managers defined in the contract, but the fact is that managers have most residual rights. In practice this situation is quite complicated. (La Porta, Lopez-de-Silanes, Schleifer, Vishny 2000)

II.II. Management control

Investment protection is crucial in order to assure the profit returns to the investors. The data show that countries with poor investor protection typically exhibit more concentrated control of firms than those countries with good investor protection. There are several approaches how investors ensure their rights into collecting the returns on their investment. The first approach is to give investors power through legal protection from expropriation by managers. Examples of this are protecting minority rights or legal prohibitions against managerial self-dealing. This can take forms more than just taking cash out, but also such ways as transfer pricing. Even worse scenario is selling the assets and not just output of the company to the manager-owned businesses at the below market prices. The second approach, which has already been described in the previous section, is ownership by large investors (concentrated ownership): matching significant control rights with significant cash flow rights. (Schleifer, Vishny 1997)

Starting with the legal protection approach, when investors finance firms, they usually are given some rights or powers that are protected by laws and regulations. The examples of such rights are disclosure and accounting rules, which provide investors information they need to use other rights. The protected shareholder rights include: receiving dividends on pro - rata terms, voting for directors, participating in shareholders' meetings, subscribing to new issues of securities on the same terms as insiders, suing directors on majority for suspected expropriation, calling extraordinary shareholders' meetings, etc. Laws that protect creditors mainly deal with bankruptcy and reorganization procedures, and include measures that enable creditors to repossess collateral, to protect their seniority, and to make it harder for firms to seek court protection in reorganization. These laws and regulations and their enforcement are essential elements of corporate finance. If investor rights, for example voting rights of shareholders or liquidation rights of the creditors are protected and effectively enforced, investors are willing to finance the corporations. (La Porta, Lopez-de-Silanes, Schleifer, Vishny 2000) Moreover, in some countries they have enforced so called "duty of loyalty". It is a rule that puts directors and managers in a position of trust and they must remain away from any act that breaches their obligation of trust. Duty of loyalty helps to avoid the situation in which managers constantly threaten shareholders, in circumstances that have not been specified in the contract, to take ever less efficient actions unless they are bribed not to. (Investopedia 2013)

The second approach is ownership and control rights. The problem with the latter approach is that contracts which managers and investors sign regarding the rights cannot require too much interpretations if they are to be enforced outside the court. For example, in the US, the role of courts is more extensive than anywhere in the world, but even there they have business judgment rule that keeps the courts out of the affairs of corporations. Business judgment rule is a regulation that protects the corporation's board of directors from the misleading allegations about how it conducts business. Secondly, in the cases where funds are collected from many small investors, these investors lack information and are too small to use the control rights they have. As a result, the power that managers usually have is more extensive than they would have if courts and finance providers would get involved in detailed contract enforcement. On the other hand, if corporation is finance by a large scale investor these problems can be reduced. Commonly large investors would have large control rights of the company. The central

mechanism to control managers is board of directors. This reduces the managerial expropriation problem. (Schleifer, Vishny 1997)

III. Fixed payments and bonuses for managers

It is obvious that in order to perform in their best possible ways, managers need to get monetary and non-monetary profits out of the project. These profits should be a motivation for them not to get involved into activities which are not the firm's best interest, such as expropriating its money. We have already discussed legal protection and contracts that puts some limitations on managerial activity. In this section we will be analyzing the monetary benefits as a way of motivating managers' performance.

First of all, the practice which is not very common in business world is to pay a fixed salary to the manager. The reason why this is not the best practice is because it gives less incentive for the manager to put effort as he knows he is still getting same fixed wage every period of time. Moreover, if there are no deadlines and restrictions imposed, manager has freedom to plan his work. Even if he does his job, it might not be done as efficiently as the investors would expect.

Because of all these reasons, there is more common practice which is performance bonuses for managers in addition to fixed payments. Logically extra payment for a good job performance should encourage managers to do best of their ability. As John Nelson (2005) argued, "the implicit assumption that shareholders gain utility only through the return on their shares, firm performance becomes equivalent to the shareholder's allocation of firm value." However, empirical and psychological research produces very interesting results. Antle and Smith (1986) empirical research showed a very mixed results of corporate executives' performance when they are rewarded with bonuses. From the psychological point of view, Dan Pink in his TEDGlobal 2009 talk "Dan Pink: The puzzle of motivation" discovered that traditional rewards are not as effective as we might think. For example, bonuses technique works only if the task is mechanical or if there is a clear problem solution. In the situations where there is no exact right or wrong answers the system of bonuses fails. As experiments showed, people who are offered bonus concentrates on the task too much and fails to find the creative solution. Usually they take longer to complete the task than those who are not offered bonus at all. In the world of business there is never a clear task. (Pink 2009) Managers have to be innovative and creative in order to

succeed. This is why bonus system fails here affecting both: managers' performance and companies' productivity. Summing up monetary bonuses for corporations' managers is not the best strategy to discourage them from expropriation of investors' funds.

IV. Structure of ownership

Eng and Mak (2003) defined the structure of ownership as "the level of monitoring and therefore the level of disclosure." The ownership structure depends on the proportion of shares held by managers and bondholders. To be more exact, the proportion of shares held by CEO and executive directors is managerial ownership. Bondholder ownership is the proportion of shares which substantial shareholders own. (Eng, Mak 2003) An interesting note is that bonuses that include companies' shares can be a much more effective in reducing managerial expropriation. It makes a perfect sense. When managers perform well and projects are successful share prices increase, which brings them profit and makes them satisfied.

Bengt Holmstrom and Steven N. Kaplan (2001) found the evidence that from 1980 to 1996, large institutional investors nearly doubled the share of the stock market they owned from under 30 percent to over 50 percent. This stockholder boom is still continuing nowadays. This trend shows that the professional investors have strong incentives to generate greater stock returns, and they monitor a significantly large fraction of US corporations. The move towards more shareholder and market dominance is also noticeable in the way corporations reorganized themselves. They have been moving towards decentralization. Large organizations are trying to find ways to offer employees higher-powered incentives. In addition, the boundary between markets and managers seems to have shifted. Also there has been an increase in external capital market share of the reallocation of capital. However, corporate managers still reallocate large amounts of resources in the economy through internal capital and labor markets. As managers have shifted authority to the markets, the scope and independence of their decision making have narrowed. (Holmstrom, Kaplan 2001)

Another point to mention is the level of monitoring and disclosure. Eng and Mak (2003) found that "voluntary disclosure is negatively associated with managerial ownership and blockholder ownership. When managerial ownership is low, there is an increased need for monitoring. Similarly, there is an increased need for monitoring in diffused ownership (low blockholder

ownership)."(Eng, Mak 2003) The board of directors carries a responsibility to monitor management decisions. Fama and Jensen (1983) argued that the more non – executive outside directors are on board, the better is monitoring of activities and limitations of managerial opportunism. External directors who are not aligned so closely to the management may be more persistent to encourage firms to disclose information to outside investors. This means that having more outside investors on board increases the information available to outside investors due to voluntary disclosure. (Eng, Mak 2003) When outside investors have more information about share prices and management forecasts of earnings they may be more likely to trust corporation and invest in it, which is beneficial for both managers and investors.

Conclusion.

In this essay we highlighted some mayor problems that managers and investors face in business world. Such problems include management control and how investors make sure they get profit return. We have analyzed the mechanism of corporate governance, which is main way of solving these issues. Moreover, we touched on a legal approach where managers have barriers imposed on them by signing legal contracts with investors that defines their rights in particular events. As we noticed it is not a perfect system, however so far the best we have in current corporate world. Lastly, we discussed fixed payment and bonus methods as a way of improving managerial performance. As it appeared when managers get their bonuses as companies shares it increase their incentives to succeed. When using this strategy the aims of managers and investors are closer together towards improvement of firm's efficiency. As we have seen, there are other factors that affects managerial expropriation and there is always some freedom and creativity they have. Summing up, there is also a space for improvement of the system. In the 21st century's world of technology quantity and quality of information is increasing which helps to reduce the problem of asymmetric information which hopefully makes current system better and more transparent.

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