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Professional Development for the Expert

Course Title

Corporate Structure and Governance

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Credit
3 PDU

Questions
15

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Adaptation Statement

- *This course is chapter 2 titled "Corporate Structure and Governance" adapted from the book titled "Principles of Finance", which can be downloaded for free from the following link: https://open.umn.edu/opentextbooks/textbooks/principles-of-finance*

- *Check additional references and sources (if any) at the end of the course.*

- *This adaptation has reformatted the original text, and may have replaced some images and figures to make the resulting whole more shareable. This adaptation has not significantly altered or updated the original text.*

- *Few modifications have been made for the purpose of presenting this course on this website.*

Corporate Structure and Governance

Chapter Outline

Why It Matters

When someone opens a business, it is because they want to fulfill important personal financial goals. In publicly traded companies, managers and employees work on behalf of the shareholders, who own the business through their ownership of company stock. These managers and employees have an ongoing obligation to pursue projects, policies, and corporate investments that will increase or promote stockholder value over the long term. Although many companies focus on financially related goals, such as growth, earnings per share, and market share, the main financial goal is to create value for investors.

Keep in mind that a company's stockholders are not just an abstract group. Like the sole business owner, they are individuals who have chosen to invest their hard-earned cash in a company. They are looking for a return on their investment in order to meet their own personal long-term financial goals, which might be saving for retirement, a new home, or college education for their children.

In addition to increasing value, it is also important to realize that a firm has important nonfinancial goals. Some examples of these might include the following:

- Expanding sales to existing customers
- Increasing customer loyalty to the weaker brands
- Developing new products for current and potential customers
- Becoming international by setting up an online ordering service

- Improving customer satisfaction with customer services

If managers are to help stockholders maximize their wealth, they must know how that wealth is determined in the first place. One of the main concepts in finance is that the value of any asset is determined by the present value of the stream of cash flows that the asset will provide to its owners over the course of time. In subsequent chapters, we will also be covering stock valuation in depth, and we will see that stock prices are based on cash flows expected in future years, not only on those coming in at the present time.

For these reasons, stock price maximization, which leads directly to maximizing shareholder wealth, requires us to take a long-term view of company operations. It is also important to realize that managerial actions that affect a company's value may not immediately be reflected in the price of a company's stock but rather will become evident in the long-term prospects of the organization.

In the case of privately held companies, smaller firms, and sole proprietorships, there are no shareholders. However, attention to long-term growth and maximizing the value of a firm is just as important a goal to the owners, who are also usually senior management with the company.

2.1 Business Structures

Learning Outcomes

By the end of this section, you will be able to:

- Identify the business form created by most organizations.
- Contrast the advantages and disadvantages that the corporate form has over sole proprietorships.
- Contrast the advantages and disadvantages that the corporate form has over partnerships.
- List and describe characteristics associated with a hybrid business structure.

The Most Common Types of Business Organization

The functions of most executive management teams are very similar for most businesses, and they will not differ in any significant manner based on how they may be structured or organized. However, the legal structure of any company will have a substantial impact on its operations, and it therefore deserves a significant amount of analysis and discussion. The four most common forms of business organizations are the following:

1. Sole proprietorships
2. Partnerships
3. Corporations
4. Hybrids, such as limited liability companies (LLCs) and limited liability partnerships (LLPs)

The vast majority of businesses take the form of a proprietorship. However, based on the total dollar value of combined sales, more than 80 percent of all business in the United States is conducted by a **corporation**.[1] Because corporations engage in the most business, and because most successful businesses eventually convert into corporations, we will focus on corporations in this chapter. However, it is still important to understand the legal differences between different types of firms and their advantages and disadvantages.

Sole Proprietorships

A proprietorship is typically defined as an unincorporated business owned by a single person. The process of forming a business as a **sole proprietor** is usually a simple matter. A business owner merely decides to begin conducting business operations, and that person is immediately off and running. Compared to other forms of business organizations, proprietorships have the following four important advantages:

1. They have a basic structure and are simple and inexpensive to form.

1 Aaron Krupkin and Adam Looney. "9 Facts about Pass-Through Businesses." Brookings. The Brookings Institution, May 15, 2017. https://www.brookings.edu/research/9-facts-about-pass-through-businesses

2. They are subject to relatively few government rules and regulations.
3. Taxation on sole proprietorships is far simpler than on other organizational forms. There are no separate taxes associated with a sole proprietorship, as there are with corporations. Sole proprietors simply report all their business income and losses on their personal income tax returns.
4. Controlling responsibilities of the firm are not divided in any way. This results in less complicated managerial decisions and improved timeliness of necessary corrective actions.

However, despite the ease of their formation and these stated advantages, proprietorships have four notable shortcomings:

1. A sole proprietor has unlimited personal liability for any financial obligations or business debts, so in the end, they risk incurring greater financial losses than the total amount of money they originally invested in the company's formation. As an example, a sole proprietor might begin with an initial investment of $5,000 to start their business. Now, let's say a customer slips on some snow-covered stairs while entering this business establishment and sues the company for $500,000. If the organization loses the lawsuit, the sole proprietor would be responsible for the entire $500,000 settlement (less any liability insurance coverage the business might have).
2. Unlike with a corporation, the life of the business is limited to the life of the individual who created it. Also, if the sole proprietor brings in any new equity or financing, the additional **investor**(s) might demand a change in the organizational structure of the business.
3. Because of these first two points, sole proprietors will typically find it difficult to obtain large amounts of financing. For these reasons, the vast majority of sole proprietorships in the United States are small businesses.
4. A sole proprietor may lack specific expertise or experience in important business disciplines, such as finance, accounting, taxation, or organizational management. This could result in additional costs associated with periodic consulting with experts to assist in these various business areas.

It is often the case that businesses that were originally formed as proprietorships are later converted into corporations when growth of the business causes the disadvantages of the sole proprietorship structure to outweigh the advantages.

Partnerships

A **partnership** is a business structure that involves a legal arrangement between two or more people who decide to do business as an organization together. In some ways, partnerships are similar to sole proprietorships in that they can be established fairly easily and without a large initial investment or cost.

Partnerships offer some important advantages over sole proprietorships. Among them, two or more partners may have different or higher levels of business expertise than a single sole proprietor, which can lead to superior management of a business. Further, additional partners can bring greater levels of investment capital to a firm, making the process of initial business formation smoother and less risky.

A partnership also has certain tax advantages in that the firm's income is allocated on a pro rata basis to the partners. This income is then taxed on an individual basis, allowing the company to avoid corporate income tax. However, similar to the sole proprietorship, all of the partners are subject to unlimited personal liability, which means that if a partnership becomes bankrupt and any partner is unable to meet their pro rata share of the firm's liabilities, the remaining partners will be responsible for paying the unsatisfied claims.

For this reason, the actions of a single partner that might cause a company to fail could end up bringing potential ruin to other partners who had nothing at all to do with the actions that led to the downfall of the company. Also, as with most sole proprietorships, unlimited liability makes it difficult for most partnerships to raise large amounts of capital.

Corporations

The most common type of organizational structure for larger businesses is the corporation. A corporation is a legal business entity that is created under the laws of a state. This entity operates separately and distinctly from its owners and managers. It is the separation of the corporate entity from its owners and managers that limits stockholders' losses to the amount they originally invest in the firm. In other words, a corporation can lose all of its money and go bankrupt, but its owners will only lose the funds that they originally invested in the company.

Unlike other forms of organization, corporations have unlimited lives as business entities. It is far easier to transfer shares of stock in a corporation than it is to transfer one's interest in an unincorporated business. These factors make it much easier for corporations to raise the capital necessary to operate large businesses. Many companies, such as Microsoft and Hewlett-Packard, originally began as proprietorships or partnerships, but at some point, they found it more advantageous to adopt a corporate form of organization as they grew in size and complexity.

An important disadvantage to corporations is income taxes. The earnings of most corporations in the United States are subject to something referred to as double taxation. First, the corporation's earnings are taxed; then, when its after-tax earnings are paid out as dividend income to **shareholders (stockholders)**, those earnings are taxed again as personal income.

It is important to note that after recognizing this problem of double taxation, Congress created the **S corporation**, designed to aid small businesses in this area. S corporations are taxed as if they were proprietorships or partnerships and are exempt from corporate income tax. In order to qualify for S corporation status, a company can have no more than 100 stockholders. Thus, this corporate form is useful for relatively small, privately owned firms but precludes larger, more diverse organizations. A larger corporation is often referred to as a **C corporation**. The vast majority of small corporations prefer to elect S status. This structure will usually suit them very well until the business reaches a point where their financing needs grow and they make the decision to raise funds by offering their stock to the public. At such time, they will usually become C corporations. Generally speaking, an S corporation structure is more popular with smaller businesses because of the likely tax savings, and a C corporation structure is more prevalent among larger companies due to the greater flexibility in raising capital.

Hybrids: Limited Liability Corporations and Partnerships

Another form of business organization is the **limited liability corporation (LLC)**. This type of business structure has become a very popular type of organization. The LLC is essentially a **hybrid form of business** that has elements of both a corporation and a partnership. Another form of organizational structure is something called a **limited liability partnership (LLP)**, which is quite similar to the LLC in structure and in use. It is very common to see LLPs used as the organizational form for professional services firms, often in such fields as accounting, architecture, and law. Conversely, LLCs are typically used by other forms of businesses.

Similar to corporation structures, LLCs and LLPs will provide their principals with a certain amount of liability protection, but they are taxed as partnerships. Also, unlike in limited partnerships, where a senior general partner will have overall control of the business, investors in an LLC or LLP have votes that are in direct proportion to their percentage of ownership interest or the relative amount of their original investment.

A particular advantage of a limited liability partnership is that it allows some of the partners in a firm to limit their liability. Under such a structure, only designated partners have unlimited liability for company debts; other partners can be designated as limited partners, only liable up to the amount of their initial contribution. Limited partners are typically not active decision makers within the firm.

Some important differences between LLCs and LLPs are highlighted in Table 2.1.

Limited Liability Corporation		Limited Liability Partnership	
Advantages	**Disadvantages**	**Advantages**	**Disadvantages**
Fewer restrictions on eligibility (only one member allowed; can be professional, although some states disallow professionals)			Only certain professions eligible
Usually more personal liability protection	Limited protection from partners' actions	Personal protection as well as protection from negligence of other partners	
Flexibility in taxation	Earnings included in members' personal taxes	Earnings taxed just once	Must file taxes as pass-through entity

Table 2.1 Advantages and Disadvantages of LLCs and LLPs

LLCs and LLPs have gained great popularity in recent years, but larger companies still find substantial advantages in being structured as C corporations. This is primarily due to the benefits of raising capital to support long-term growth. It is interesting to note that LLC and LLP organizational structures were essentially devised by attorneys. They generally are rather complicated, and the legal protection offered to their ownership principals may vary from state to state. For these reasons, it is usually necessary to retain a knowledgeable lawyer when establishing an organization of this type.

Obviously, when a company is choosing an organizational structure, it must carefully evaluate the advantages and disadvantages that come with any form of doing business. For example, if an organization is considering a corporation structure, it would have to evaluate the trade-off of having the ability to raise greater amounts of funding to support growth and future expansion versus the effects of double taxation. Yet despite such organizational concerns with corporations, time has proven that the value of most businesses, other than relatively small ones, is very likely to be maximized if they are organized as corporations. This follows from the idea that limited ownership liability reduces the overall risks borne by investors. All other things being equal, the lower a firm's risk, the higher its value.

Growth opportunities will also have a tremendous impact on the overall value of a business. Because corporations can raise financing more easily than most other types of organizations, they are better able to engage in profitable projects, make investments, and otherwise take superior advantage of their many favorable growth opportunities.

The value of any asset will, to a large degree, depend on its liquidity. *Liquidity* refers to asset characteristics that enable the asset to be sold or otherwise converted into cash in a relatively short period of time and with minimal effort to attain fair market value for the owner. Because ownership of corporate stock is far easier to transfer to a potential buyer than is any interest in a business proprietorship or partnership, and because most investors are more willing to invest their funds in stocks than they are in partnerships that may carry unlimited liability, an investment in corporate stock will remain relatively liquid. This, too, is an advantage of a corporation and is another factor that enhances its value.

Incorporating a Business

Many business owners decide to structure their business as a corporation. In order to begin the process of incorporation, an organization must file a business registration form with the US state in which it will be based and carry on its primary business activities. The document that must be used for this application is generally referred to as the **articles of incorporation** or a corporate charter. Articles of incorporation are the single most important governing documents of a corporation. The registration allows the state to collect taxes and ensure that the business is complying with all applicable state laws.

The exact form of the articles of incorporation differs depending on the type of corporation. Some types of articles of incorporation include the following:

- **Domestic corporation** (in state)
- **Foreign corporation** (out of state or out of country)
- **Close (closely held) corporation**
- **Professional corporation**
- **Nonprofit corporation** (several different types of nonprofits)
- **Stock corporation**
- **Non-stock corporation**
- **Public benefit corporation**

It is important to note that articles of incorporation are only required to establish a regular corporation. Limited liability corporations require what are referred to as *articles of organization* (or similar documents) to register their business with a state. Some types of limited partnerships must also register with their state. However, sole proprietorships do not have to register; for this reason, they are often the preferred organizational structure for a person who is just starting out in business, at least initially.

Articles of incorporation provide the basic information needed to legally form the company and register the business in its state. The state will need to know the name of the business, its purpose, and the people who will be in charge of running it (the **board of directors**). The state also needs to know about any stock that the business will be selling to the public. The websites of various **secretaries of state** will have information on the different types of articles of incorporation, the requirements, and the filing process.

2.2 Relationship between Shareholders and Company Management

Learning Outcomes

By the end of this section, you will be able to:

- Explain the difference between principals and agents.
- List and discuss various stakeholders associated with a company and its operations.
- Explain how management impacts the operations and future of a company.

Stakeholders

A **stakeholder** is any person or group that has an interest in the outcomes of an organization’s actions. Stakeholders include employees, customers, shareholders, suppliers, communities, and governments. Different stakeholders have different priorities, and companies often have to make compromises to please as many stakeholders as possible.

Shareholders’ Roles and Composition

A shareholder or stockholder can be a person, company, or organization that holds stock in a given company. Shareholders typically receive dividends if the company does well and succeeds. They are entitled to vote on certain company matters and to be elected to a seat on the board of directors. One advantage of being a shareholder is that creditors cannot compel shareholders to pay for any of the company’s financial obligations or debts. However, being a shareholder includes responsibilities such as appointing the company’s directors, deciding on director compensation, setting limits on directors’ power, and monitoring and approving the company’s financial statements.

Types of Shareholders

There are two types of shareholders: common shareholders and preferred shareholders. Common shareholders are any persons who own a company’s common stock. They have the right to control how the company is managed, and they have the right to bring charges if management is involved in activities that could potentially harm the organization. Preferred shareholders own a share of the company’s preferred stock and have no voting rights or involvement in managing the company. Instead, they receive a fixed amount of annual dividends, apportioned before the common shareholders are paid. Though both common shareholders and preferred shareholders see their stock value increase with the positive performance of the company, common shareholders experience higher capital gains and losses.

Shareholders and directors are two different entities, although a director can also be shareholder. The shareholder, as already mentioned, is a part owner of the company. A director, on the other hand, is the person hired by the shareholders to perform oversight and provide strategic policy direction to company management.

The Differences between a Shareholder and a Stakeholder

The terms *shareholder* and *stakeholder* mean different things. A shareholder is an owner of a company because of the shares of stock they own. Stakeholders may not own part of the company, but they are in many ways equally dependent on the performance of the company. However, their concerns may not be financial. For example, a chain of hotels in the United States that employs thousands of people has several classes of stakeholders, including employees who rely on the company for their jobs and local and national governments that depend on the taxes the company pays.

Before a company becomes public, it is a private company that is run, formed, and organized by a group of people called *subscribers*. A **subscriber** is a member of the company whose name is listed in the memorandum of association. Even when the company goes public or they depart from the company, subscribers’ names continue to be written in the public register.

Role of Management

Corporations are run at the highest level by a group of senior managers referred to as the board of directors (BOD). The BOD is ultimately responsible for providing oversight and strategic direction as well as overall supervision of the organization at its highest managerial level. From an operational standpoint, the practical day-to-day management of a company comprises of a team of several mid-level managers, who are responsible for providing leadership to various departments in the company. Such managers may often have different functional roles in a business organization. The primary roles of any management group involve setting the objectives of the company; organizing operations; hiring, leading, and motivating employees; and overseeing operations to ensure that company goals are continually being met.

It is also important that managers have a long-term focus on meeting growth targets and corporate objectives. Unfortunately, there have been many examples of companies where the managerial focus was shifted to short-term goals—quarterly or fiscal year earnings estimates or the current price of the company stock—for personal reasons, such as increased bonuses and financial benefits. Such short-term thinking is often not in the best interest of the long-term health and objectives of companies or their shareholders.

2.3 Role of the Board of Directors

Learning Outcomes

By the end of this section, you will be able to:

- Describe the oversight functions performed by boards.
- Define an independent board member.
- Compare arguments for and against having independent board members.
- Describe ways boards can become diverse.

Functions of a Board of Directors

A board of directors is a group of people who are elected to represent shareholders, and these directors are then ultimately responsible for running the company. Every public company is legally required to install a board of directors. Nonprofit organizations and many private companies often establish a board of directors as well, even if they are not legally required to do so.

The board is responsible for protecting shareholders' interests, establishing management policies, overseeing the corporation or organization, and making decisions about important issues. The board of directors acts as a fiduciary for shareholders. The board is also tasked with a number of other responsibilities, including setting company goals, creating dividend and stock option policies, hiring and firing chief executive officers (CEOs), and ensuring that the company has the resources it needs to perform well.

Basic Structure of a Board of Directors

The bylaws of a company or organization determine the structure, responsibilities, and powers given to a board of directors. The bylaws also determine how many board members there are, how the members are elected, and how frequently the board members meet.

The board must represent shareholder and management interests, so it is best for the board to include both internal and external members. Usually, there is an internal director and an external director. The internal director is a member of the board who is involved with the daily workings of the company and manages the interests of shareholders, officers, and employees. The external director represents the interests of those who function outside of the company. The CEO often serves as the chairman of the company's board of directors.

Figure 2.2 Corporate Boardroom (credit: "495 Express Lanes Board Room" by Fairfax County Chamber of Commerce/flickr, CC BY 2.0)

International Structure of a Board of Directors

The structure of a board of directors varies more outside of the United States. In Asia and the European Union, there are commonly executive and supervisory boards. The executive board is made up of company insiders who are elected by employees and shareholders. In most cases, the executive board is headed by the company CEO or a managing officer. The supervisory board oversees daily business operations and acts much like a typical US board of directors. The chair of the board varies, but the board is always led by someone other than the prominent executive officer.

Oversight: Corporate Governance

Corporate governance is a discipline that focuses on how a company conducts its business and the various controls that are implemented to ensure proper procedures and ethical behavior.

Although many companies and managers do operate with a fair and honest philosophy, others will try to exploit the temporary benefits of actions that fall outside ethical behavior. Companies do not always adhere to laws. You may have seen or read news stories about false reporting of earnings, failure to reveal financial information, or payments of large bonuses to top executives shortly after a company files for bankruptcy.

In one infamous example, the insurance giant AIG paid for a lavish trip to California for top employees of the company immediately after declaring that the company was insolvent. It asked for and received financial support from the US government in the bailout of 2008.[2]

At other times, a company may cross the line between legal and illegal and violate the law in order to increase profits. Because of the potential for human self-interest and greed, governments have enacted laws and regulations that require specific actions of a company or restrict its activities in an effort to ensure fair competition and ethical behavior.

Often, Congress enacts laws and regulations in response to major economic or other highly visible events. Following the great market crash of 1929, the US government created a new set of rules and regulations governing the issuing and trading of securities, the Securities Act of 1933 and the Securities Exchange Act of 1934. The government also created the **Securities and Exchange Commission (SEC)** to oversee these laws and regulations.

The new laws required that firms make available specific financial information to current owners and prospective owners and that the SEC approve the initial sale of securities to the public. More recently, following a series of major ethical lapses at some firms, the US government enacted new legislation in 2002. One of the most sweeping acts is the Sarbanes-Oxley Act (SOX), which requires, among other things, the following:

- That the CEO and chief financial officer (CFO) must attest to the fairness and accuracy of the company's financial reporting
- That the company implements and maintains an effective structure of internal controls responsible for the reporting of financial results
- That the company and an external public accounting firm confirm the effectiveness of the controls over the most recent fiscal year

In addition, SOX created the Public Company Accounting Oversight Board, outlining the prohibited activities of auditors. It also set a requirement that the SEC issue new rulings that establish compliance with the act.

Board of Directors Oversight and Corporate Governance

Because of the widely publicized control breakdowns at Wells Fargo Bank and recent regulatory actions, boards of directors of public companies and financial institutions have been directed to improve oversight and

2 Scott Vogel. "You Paid for It: AIG's Retreat Destination, Up Close." *Washington Post*. October 9, 2008. http://voices.washingtonpost.com/travellog/2008/10/disaster_tourism_comes_to_cali.html

corporate governance. Boards are evolving from focusing primarily on the needs of top key individuals to considering broader aspects of ethics, values, and corporate culture. Boards now oversee the monitoring systems being put in place and may take on direct responsibilities related to senior management.

The Role of the Audit Committee

A strong independent audit committee (AC) is an important part of the corporate governance efforts of any firm. The AC is formed by the board of directors as a separately chartered subcommittee of the board of directors. It reports regularly to the BOD and assists the board by assuming responsibilities for critical corporate financial matters, such as reviewing audit plans and findings, approving external public accountants, and coordinating the efforts of both internal and external financial reviews and audits. The audit committee provides expertise in all financial and accounting matters for a company, and it is therefore a critical part of a company's corporate governance efforts.

Some important functions of the audit committee include

- confirming the accuracy of the firm's financial reporting;
- verifying that systems of internal control and risk management are operating effectively;
- ensuring compliance with legal and regulatory requirements;
- verifying the qualifications, independence, and performance of the external public auditing firm; and
- coordinating the activities and performance of the internal audit function.

The role of the audit committee has significantly expanded over the years, and it has become exceedingly important with the enactment of the Sarbanes-Oxley Act. Due to this increase in importance and recognition, several boards have shifted some of the audit committee's responsibilities to separately chartered committees in order to create a balance of duties and ensure that those duties are effectively focused on and efficiently executed. Some of these additional committees have been known to include a compensation committee, a disclosure committee, and a governance committee, and they all have related objectives that need to be documented within the charter of each of the individual committees. It is important for the different committees to have close working relationships so that the audit committee can help each one fulfill its responsibilities to senior management, the greater board of directors, shareholders, and other stakeholders.

The audit committee performs an internal audit to review the organization's corporate governance process and to communicate any recommendations for changes. The audit committee will usually follow up and monitor the process put in place to implement any changes or necessary improvements. As with any other corporate function, the audit committee's role is greatly affected by the legal, institutional, financial, cultural, and political circumstances that impact the company.

Importance of Improving Oversight and Governance

It is crucial to today's corporate environment that firms do not lose sight of achieving and maintaining strong and efficient oversight and governance. This is true despite the litany of other important items on the busy agendas of most boards.

Keeping a focus on the critical ethics of management, as well as the traditional focus on the importance of ethics to the overall organization, is not only timely in this day and age but also sound business practice. The importance of establishing a comprehensive system of checks and balances cannot be overemphasized. Beginning with the chief executive officer, these checks and balances need to progress through senior management, and they ultimately include the board of directors itself. Similar checks and balances need to then filter down though the rest of the entire firm. By taking the appropriate steps to improve corporate oversight and governance, overall business risk can be mitigated and future operational problems reduced. Additionally, such steps can lead to the positive effects of achieving sustainable operational and financial benefits for a company and its shareholders.

LINK TO LEARNING

PepsiCo

PepsiCo is a global leader in the food and beverage industry. It has also been noted for its excellence in corporate governance. Take a look at the PepsiCo website (https://openstax.org/r/pepsico). Why do you think the company has won numerous awards and was featured in Fortune's annual Blue Ribbon Companies list for 2021?

The Importance of Independence in Boards of Directors

An independent board of directors is composed of individuals who have no material interest in the company other than their directorship. They maintain their independence by only accepting compensation from the company for their BOD services. They also have their own information sources, instead of relying on information provided by senior management of the company. It is considered a corporate governance best practice to have independent members serve on boards of directors for both publicly and privately held companies.

In most cases, board members have no affiliation with activities or organizations that could result in conflicts of interest. An example of this might be a scenario in which a board is considering the formation of a partnership or alliance with an organization that is directly associated with one of its board members. In such an instance, a director might be excused from participating in that decision process, particularly if it is clear that it would lead to potential conflict.

A board with a majority of independent directors can bring expertise and objectivity, which

- helps assure ownership that the company is being run legally, ethically, and in the best interest of shareholders;
- allows for both independence and objectivity regarding senior managerial representatives and limits situations in which a key decision maker might have a vested interest or an "ax to grind"; and
- enables board members to advance discussions with no hidden agendas for self-advancement or other self-profiting motives.

The Importance of Diversity in Boards of Directors

As mentioned earlier, diversity can be an important quality for any board of directors. Increasingly over recent years, corporate management has begun to appreciate the value of diversity in boards of directors. This has resulted in a significant increase in the total number of women and people of color in boardrooms in the United States. However, many business observers believe that corporate governance practices have a long way to go in this respect. Increasing representation has now grown to become a high priority for most businesses and organizations around the world.

Board members face many challenges in making decisions effectively and efficiently as possible. Because of such challenges, the potential objective of diversifying the boardroom competes with other worthy topics and objectives such as improving cybersecurity, advancing customer service, identifying and reducing risk, improving community relations, and positioning strategically within an industry. This has left corporate governance experts and researchers in a situation where they find themselves "playing catch-up" to adequately diversify.

2.4 Agency Issues: Shareholders and Corporate Boards

Learning Outcomes

By the end of this section, you will be able to:

- Define the concept of agency costs.
- Discuss conflicts of interest between board members, company management, and employees.
- Define each component of ESG.
- Discuss the findings indicating how ESG policies impact stock returns.

Agency Problems and Issues

Agency problems refers to conflicts that occur when an **agent** (manager) who is entrusted with following the interests of the **principal** (shareholder or owner) of an organization abuses their position to further their own personal goals. In the field of corporate finance, agency problems are often related to a conflict of interest between the management of a company and its shareholders.

For many years, this has been a very common problem that has been seen in nearly every kind of organization, irrespective of it being a church, a club, a not-for-profit organization, a multinational corporation, or any other government agency or institution. As with most problematic issues in business, agency problems can be resolved, but only if organizations are willing to take the appropriate steps to resolve them.

Every company has its own set of goals and objectives, but it is important to note that the employee and personal goals of managers may differ and may not align with the goals and objectives of stockholders (ownership). Because these differences exist, and because all parties have a desire to maximize their own wealth, agency problems can often arise, having a negative impact on company profits, stock price, and the goodwill of the shareholder base.

There are three primary types of agency problems, discussed below.

> **CONCEPTS IN PRACTICE**
>
> **Example of an Agency Problem**
>
> ABC Co. used to sell organic shampoo for $15, but the stockholders of ABC lobbied for an increase in the selling price of the shampoo from $15 to $18. This was to increase earnings and, ultimately, their own personal wealth through an uptick in stock price. However, as a result of this unnecessary rise in the price of the shampoo, customers were disappointed, and a majority of them wound up boycotting the product. Additionally, some of the consumers who continued to purchase the product noticed a decline in the overall quality of the shampoo and were also very disappointed. In this scenario, agency problems surfaced between stockholders and loyal customers of the company.

Stockholders versus Management

Large corporations typically have a substantial number of stockholders forming their ownership. It is essential for an organization to separate the management of a company from this ownership in order to avoid this type of agency problem.

Segregating ownership from management can be advantageous for an organization. Doing so will usually not have any effects on normal business operations. At the same time, the company can employ different experts and professionals to manage key operations of the business.

However, a drawback to this is that hiring outsiders may eventually become troublesome for shareholders. External managers who are brought into a company may end up making self-serving decisions or even misusing company funds. This could eventually result in declining bottom line results and company share prices, which would then lead to conflicts of interests between stockholders and company management.

An example of an agency problem between management and shareholders occurred at WorldCom in 2001, when their CEO used company assets to underwrite several personal loans.[3] As a result of these inappropriate actions, the company took on additional debt that negatively impacted WorldCom's capital structure, liquidity, and ultimately its stock price. From this example, we can see how individual greed on the part of agents, executives, or corporate management can lead to significant agency problems.

Investors versus Creditors

If a company decides to engage in risky investments and projects in order to drive organizational profitability, these increased risk levels could threaten the company's ability to service (repay) their debts, leading to possible default.

This additional risk could also result in creditors taking steps to devalue such debts, which in most cases refers to company bond issues. In the end, if these riskier projects end up failing and the company loses money, investors (bondholders) may also experience financial risk as bonds go into default or otherwise lose market value. This then becomes a potential agency problem between bondholders (investors) and creditors.

Stockholders versus Other Stakeholders

Situations may arise in which stockholders of a firm find themselves in conflicts of interest with other stakeholders of the company. For example, employees of a firm might be asking for a general wage increase. If such a wage increase were voted down by stockholders, this could result in key employees departing the organization, eventually leading to poorer business results and the dissatisfaction of other stakeholders in the company as company profits decline. In such an example, we see the agency problem of stockholders versus other stakeholders.

A more specific example of such an agency problem occurred in 2011, when Oregon-based food and gift basket company Harry & David was forced to file for bankruptcy.[4] This was a direct result of the company being purchased through a leveraged buyout that left the company saddled with a tremendous amount of debt. However, the most important factor leading to the company's failure was the actions of Steven Heyer, who was a friend of the new owners and had been hired as CEO. Heyer, who was awarded an exorbitant executive salary, was also allowed to sink the company into further debt. Harry & David has since emerged from bankruptcy under new leadership. But this example should serve as a cautionary tale of what can happen when stockholders are able to put their interests ahead of those of other stakeholders in a corporate environment.

CONCEPTS IN PRACTICE

Infamous Agency Problems

Enron

Enron is one particularly infamous example of an agency problem. Enron's directors were responsible for protecting and promoting investor interests, but they failed to carry out their regulatory and oversight responsibilities, enabling the company to venture into illegal activity. The company's resulting accounting scandal resulted in billions of dollars in losses to its investors.

At one time, Enron had been one of the largest companies in the United States. Despite being a multibillion-

3 Anshita Kohli. "Worldcom Scam: The Fall of the Biggest US Telecommunication Company." The Company Ninja. JD Learning Ventures, May 26, 2020. https://thecompany.ninja/worldcom-scam/

4 Beth Kowitt. "Harry & David's Failed Mr. Fix-It." *Fortune*. April 1, 2011. https://fortune.com/2011/04/01/harry-davids-failed-mr-fix-it/

dollar company, Enron began losing money in 1997. It had also started incurring a tremendous amount of debt. Fearing a drop in stock prices, Enron's management team tried to disguise the problems by misrepresenting them through inappropriate accounting methods, which resulted in confusing and misleading financial statements.

Disaster started to unfold in 2001, when common stock prices fell from $90 to under $1 per share. The company filed for bankruptcy in December 2001, and criminal charges were brought against several key Enron employees, including former CEO Kenneth Lay and former CFO Andrew Fastow. Jeffrey Skilling was subsequently named CEO in February 2001, but he ended up resigning six months later.

Bernard L. Madoff Investment Securities LLC

Ponzi schemes are common examples of the agency problem. **Agency theory** claims that a lack of oversight and incentive alignment greatly contributes to these problems. Many investors fall into Ponzi schemes thinking that taking fund management outside a traditional banking institution reduces fees and saves money.

Even though established financial institutions reduce risk by providing oversight and enforcing legal practices, some Ponzi schemes simply involve taking advantage of consumer suspicions about the banking industry and financial markets. In this type of environment, the consumer cannot ensure that an agent is acting in their best interest. Investments are made under limited or, in many cases, completely nonexistent oversight.

Bernie Madoff's scam is probably one of the most infamous examples of a Ponzi scheme. Madoff's fraud started with friends, relatives, and acquaintances in New York, but it ultimately grew to encompass major charities such as Hadassah, universities such as Tufts and Yeshiva, institutional investors, and wealthy families in Europe, Latin America, and Asia. The cash losses of Madoff's scheme were recently estimated to be between $17 billion and $20 billion. The returns he promised were higher than what most investment firms and banks were offering—so promising that almost all of his investors ignored any concerns they may have had and basically looked the other way. Madoff paid for any redemption requests with money that had been newly invested.

Madoff's Ponzi scheme fell apart when he could no longer pay his investors. He was criminally charged, convicted, and given a 150-year prison sentence. Madoff died in April 2021 while serving his prison term.

(Sources: Diana B. Henriques. "Bernard Madoff, Architect of Largest Ponzi Scheme in History, Is Dead at 82." *New York Times*. April 14, 2021. https://www.nytimes.com/2021/04/14/business/bernie-madoff-dead.html; Chase Peterson-Withorn. "The Investors Who Had to Pay Back Billions in Ill-Gotten Gains from Bernie Madoff's Ponzi Scheme." *Forbes*. April 14, 2021. https://www.forbes.com/sites/chasewithorn/2021/04/14/the-investors-who-had-to-pay-back-billions-in-ill-gotten-gains-from-bernie-madoffs-ponzi-scheme/; Adam Hayes. "The Agency Problem: Two Infamous Examples." Investopedia. Dotdash, updated April 15, 2021. https://www.investopedia.com/ask/answers/041315/what-are-some-famous-scandals-demonstrate-agency-problem.asp)

How to Resolve Agency Problems

Ultimately, agency problems result from the differences among the interests of a company's management, other stakeholders of the firm, and its ownership or stockholders. When perpetuated, these differences may eventually result in lasting conflicts of interest. In order for companies to avoid such problems, it is imperative that they address the underlying problems of these differences. This will help ensure that normal business operations are not being adversely impacted by the agency problem.

While there is no surefire way to resolve all conflicts of interest and agency problems, some measures that can help mitigate such issues include the following:

- Offering incentives to management for strong performance and ethical behavior
- Awarding decision makers with stock packages, commissions, and other long-term compensation packages to encourage long-term thinking and matching of company objectives with shareholders' priorities
- Penalizing poor performance, shortsightedness, and unethical behavior

The prevailing belief in agency theory is that when a business creates organizational incentives that encourage hard work on projects that will benefit the company in both the short and long term, more employees will be encouraged to act in the business's best interest.

Another means of resolving agency problems is through a hostile takeover of the organization. Even the threat of such a takeover may be effective in reducing or eliminating these conflicts of interest. A hostile corporate takeover tends to unify and discipline a management or agent group, thus fostering a union of agent and shareholder interests. When such a potential threat or outright ownership change is introduced to a company, its managers are more likely to act in the best long-term interests of the shareholders in order to maintain their leadership positions within the company.

By better aligning *agent* (management) and *principal* (ownership) goals, agency theory attempts to bridge any gulfs among employees, employers, and stakeholders that are created by the principal-agent problem. While it is recognized as being nearly impossible for companies to eliminate the ongoing agency problem, it is also recognized that it is possible to minimize its negative effects.

Impact of ESG Ratings

In recent years, many publicly traded companies, as well as many that are privately owned, are being evaluated and rated according to environmental, social, and governance **(ESG)** factors. These ratings and evaluations are primarily conducted by third-party organizations. As a result, the investment community is using these reports and ratings to an ever-increasing degree in order to measure and assess corporate ESG factors and performance.

Environmental, social, and governance issues have become an important part of the investment community's evaluation of publicly traded companies. Each component of what is now referred to as ESG has equal importance in ongoing corporate evaluations, as per Figure 2.3 below. It is critical for the senior management of any corporation to stay abreast of any and all ESG issues as they arise and take immediate corrective action when necessary.

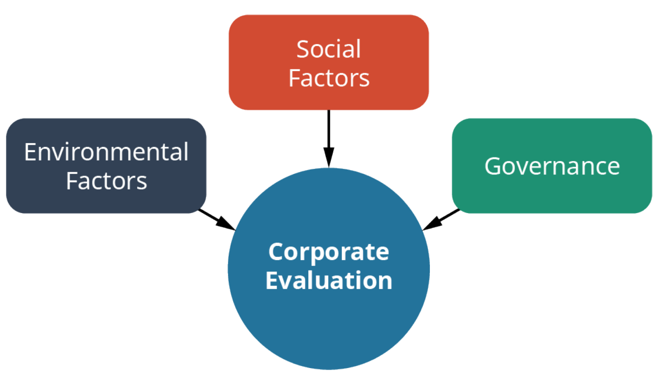

Figure 2.3 Importance of ESG Factors to a Business Concern

ESG measurements and assessments have become very important to firms, as they often become the basis of formal and informal buy recommendations by investment professionals. ESG ratings were originally developed to assist in determining the general risk of ESG factors for any public company, but they have since grown to become unique scores used by investors to gauge the potential attractiveness of investment in the subject company. Because of the nature of these factors, firms that are rated with high ESG metrics are believed to represent superior investments and to have proactive management teams focused on creating long-term value of company stock.

Thus, with investors increasingly using ESG scores to form their investment strategies, the consequences of a poor rating can have a negative impact on a firm's share price and result in substantial problems. In any case, it is important to note that ESG is only a starting point from which it is possible to gather indicators on a business and its direction. In the end, it does not present the entire story of a firm. Any investment decisions about the company in question should include a significant amount of additional data.

2.5 Interacting with Investors, Intermediaries, and Other Market Participants

Learning Outcomes

By the end of this section, you will be able to:

- Define the investor relations function.
- Discuss how the investor relations office interacts with investors, regulators, and other corporate stakeholders.
- Describe the topics most often discussed during a quarterly conference call.
- Explain how press release information impacts company stock prices.

Investor Relations

Within the general field of corporate public relations is a specific subdivision referred to as **investor relations (IR)**. IR involves elements of communication, marketing, and finance and is designed to control the flow of information from the management of a public corporation to its investors and stakeholders.

Because the investment community plays such a critical role in the overall growth and success of any corporation, it is imperative that firms maintain strong and open relationships with their shareholder or potential investor audience. IR was developed to take responsibility for achieving and maintaining these crucial relationships.

Investor relations are quite different from typical public relations practices. A firm's IR group must work very closely with the accounting and legal departments, as well as with members of the senior management team, such as the CEO and CFO.

As might be expected, IR has far more regulatory obligations than standard public relations functions, largely due to corporate reporting requirements enforced by the SEC and the **International Financial Reporting Standards (IFRS)**. IR became significantly more important in 2002, when the United States Congress passed the Sarbanes-Oxley Act (SOX), also known as the Public Company Accounting Reform and Investor Protection Act. This legislation resulted in requirements that dramatically increased the extent of financial reporting for any publicly traded company. SOX was enacted in an attempt to prevent the occurrence of corporate financial scandals such as the one notoriously committed by the Enron Corporation that we discussed earlier.

In summary, investor relations functions have responsibilities including, but not limited to,

- coordinating live shareholder meetings and press conferences;
- disseminating financial information to the investment community;
- conducting briefings to the financial analyst community;
- publishing the **quarterly report** and **annual report**; and
- addressing any issues that arise as a result of financial disclosure.

The best time to form an internal IR function or to engage an IR firm is when a company begins the process of becoming publicly traded through an initial public offering, or IPO.

Quarterly Earnings Conference Calls

As a result of the Securities Exchange Act of 1934, all publicly traded companies are required to file certain financial reports with the SEC. The underlying purpose of these requirements is to provide shareholders and the investment community with important operational and financial information on a regular basis and in a transparent manner. Reports filed with the SEC include the annual Form 10-K, quarterly Form 10-Qs, and current periodic Form 8-Ks, in addition to proxy reports and certain shareholder and affiliate reporting documents. Quarterly 10-Qs are an ongoing and regular reporting requirement of publicly traded companies and are to be filed within 45 days following the end of each fiscal quarter.

Depending on a company's size and the complexity of its operation, a firm is likely to issue an earnings **press release** and conduct a **conference call** with the investment community within this same 45-day period. There is no legal requirement for companies to do either of these things, but experts in IR view these communications tools as best practice. They can add context and commentary to the reported financial results.

It is important for companies to do their planning and not enter a quarterly earnings conference call unprepared. There is a multitude of available resources for companies to analyze and review in preparation. Among such resources are industry reports prepared by government agencies; the financial reports and earnings calls of competing organizations, both within and outside of a company's primary industry; and financial research reports prepared by various covering analysts, who follow the specific company and are employed by financial brokerage firms.

Investment Meetings and Conferences

Organizing the **annual meeting** of shareholders, investor roadshows, and investment conferences is no easy task for any corporation, though all of these audience-facing events are critical to maintaining strong relations with shareholders and the investment community. It is important to reach shareholders and investors on an almost personal basis by crafting a successful and interesting investment story. For effective investor relations, key messages supporting any ownership or potential investment case should be clear and consistent. These key messages should be embedded within the company's materials and should form the basis of presentations, the corporate website, and annual reports. They should also be reinforced via concrete examples during annual meetings, roadshows, and investor presentations.

Figure 2.4 Quarterly Investor Relations Presentation (credit: "MAPFRE" by Castilla y León Económica/flickr, CC BY 2.0)

Corporations have found that using senior management's time efficiently is also important to investor relations. By targeting the ownership and potential investing audience, senior executives can make the best use of their time and improve their interactions with the investing public during these events. If smaller companies outsource the investor meeting planning process, the third-party firm should be thoroughly grounded in the client's corporate culture.

The most productive investor and shareholder meetings begin with a strong, understandable corporate introduction and continue by delivering an engaging story that demonstrates the company's successes, a track record of growth, and the high probability of favorable future prospects. Additionally, it is important for a company's senior management to end any meeting with feedback from the investor audience and set timelines for follow-up. There will always be times when something unexpected may happen and the addition of information or impromptu changes to scheduled agendas may occur. It is at times like these when understanding the body language and facial expressions of an audience can be critical in producing a favorable outcome of the meeting.

It is unlikely that the decision to invest or to remain an investor will be made based on a single corporate event, but impressions, good or bad, will certainly factor into such decisions over a period of time. Thus, it is important for IR officers to understand the importance of follow-up communication with their audience.

Purposes of Corporate Press Releases

Press releases have always been a vital tool in the communications toolkit of an IR professional. Various social media channels are also becoming increasingly popular for delivering company information and news. However, the press release remains a standard medium for most companies to communicate corporate news, results, and ideas.

Press releases can be written with various intentions. Whether to release financial information, unveil new products or services, announce changes in management, or a host of other reasons, all communications have a different objective. Not all press releases are created equally, and they have varying degrees of effectiveness. Any press release should contain information in easy-to-understand language that is free of corporate jargon and as concise as possible. Press releases may be viewed by multiple audiences, such as customers, stakeholders, investors, potential investors, and the general public, which is vital to consider when drafting a press release.

According to PR Newswire statistics, press releases that contain multimedia content have been known to substantially increase press release views.[5] Using infographics and charts where possible and relaying the key messages in short, easy-to-digest points make a press release easier for the reader to take in. Quotes from senior management can provide valuable insight, but they should not provide any new information; they should simply extend or expand on a subject already mentioned and further back up a claim.

2.6 Companies in Domestic and Global Markets

Learning Outcomes

By the end of this section, you will be able to:

- Explain why corporations expand beyond domestic borders.
- Determine how different strategic decisions may influence corporate performance.

5 "Multimedia Content Distribution." PR Newswire. Cision, accessed August 27, 2021. https://www.prnewswire.com/products/multimedia-distribution-options.html

Important Differences among Domestic, International, and Global Organizations

If a company becomes global or multinational in scope, fundamental analysis of the organization by the investment community can become more complex. In order to better understand a company, it is important to determine what laws affect the company's governance process and which set of accounting rules is used to fashion its financial reports.

Domestic companies operate completely or for the most part within the borders of the United States. While such organizations may import raw materials and supplies from other nations or end up exporting their finished products to other countries around the world, in the end, these international activities represent only a very small portion of their overall business activities.

Domestic companies are typically governed by US accounting and securities laws that have been established by the SEC. Further, financial reporting for these domestic organizations is to be completed using **Generally Accepted Accounting Principles (GAAP)**.

International firms, while based in the United States, will typically maintain significant levels of international investment and conduct operations that may be quite diverse, both geographically and culturally. For such international firms, parent company accounting will usually adhere to GAAP standards. Conversely, non-US subsidiaries of such international firms may be regulated by laws dictated by their host countries. These will often differ significantly from those in the United States.

In recent years, accounting regulations in countries outside the United States have come under the jurisdiction of International Financial Reporting Standards (IFRS). It should be noted that guidelines and regulations under IFRS and those under GAAP can differ significantly. As a result of these regulatory differences, any specific divergences in accounting or governance practices between foreign subsidiaries and a US parent company should be clearly stated and disclosed in the parent company's financial reports.

Global firms have substantial operations and investments in different countries (**global markets**), and they may have no single center or basis of operational activity. In such cases, regulations for corporate governance are usually determined by the laws of the country in which the parent company has been established. While there are some global firms that report their financial statements according to GAAP standards, usually to satisfy the informational needs of US investors, most global parent companies' financials will adhere to IFRS reporting standards.

Difference in Financial Reporting: GAAP versus IFRS

Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) were designed with similar objectives in mind: to provide a common and structured set of guidelines to assist in the preparation of accurate and unbiased financial reporting for public corporations.

Yet despite these commonalities in purpose, there are important differences between them. Among these are differences in inventory accounting and reporting, guidelines for consolidation of subsidiaries, and the accounting and reporting of minority interests.

LINK TO LEARNING

GAAP and IFRS

Learn more about US GAAP reporting from the SEC website (https://openstax.org/r/corpfin-manual), and learn about international standards from the IFRS website (https://openstax.org/r/ifrs-org).

SEC Reporting and EDGAR

EDGAR (Electronic Data Gathering, Analysis, and Retrieval system) is the primary system for collecting and indexing documents submitted by companies to the SEC under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

LINK TO LEARNING

EDGAR System

The SEC's EDGAR system (https://openstax.org/r/edgar-html) contains millions of corporate and individual filings. It benefits investors, corporations, and the US economy overall by increasing the efficiency, transparency, and fairness of the securities markets. The system processes about 3,000 filings per day, serves up 3,000 terabytes of data to the public annually, and accommodates 40,000 new filers per year on average.[6]

6 "About EDGAR." US Securities and Exchange Commission. Modified March 23, 2021. https://www.sec.gov/edgar/about