Corporate Governance
Sub-categories: Principles and issues in corporate governance; Shareholders

Question

The chairman of a UK listed company met with a representative of an institutional investor, which is a large shareholder in the company and which has adopted the UK Stewardship Code.

At the meeting the investor expressed the concern of his organisation about the failure of the company to increase the annual dividend to shareholders, and its anger that dividends had been reduced in the most recent year even though there had been large salary increases for employees and substantial bonus payments to top executives.

The investor admitted that he believed in the agency theory of the relationship between shareholders and company directors, and that in his view the Stewardship Code did not go far enough in encouraging shareholder activism. He also believed that there should be much closer monitoring of boards of directors by shareholders and their representatives.

The chairman replied that his board’s approach to governance issues could be described as an enlightened shareholder approach, and that the company should not prioritise dividend growth as a policy objective.

Required:

(a) Describe the main elements of agency theory, including the nature of monitoring costs.

(b) Compare agency theory with the enlightened shareholder approach to corporate governance, and indicate (with reasons) why they are incompatible with each other.
(c) With reference to agency theory and the UK Stewardship Code, explain how the chairman and the investor could proceed in the spirit of compromise.

(12 marks)

(Total marks 25)
Answer

This question begins by testing factual knowledge of agency theory, but presents a challenge in parts (b) and (c) by asking for comparisons between different approaches to corporate governance.

Making comparisons can be difficult, about the various different approaches to corporate governance.

Part (a)
Points that could be made in this answer:

(1) Agency theory (as applied to companies) was developed by Jensen and Meckling.
(2) The theory is based on the concept of the separation of ownership of companies (equity shareholders) from control (executive management or the board of directors).
(3) Managers/directors are the agents of the shareholders, and as such should act in the interests of the shareholders.
(4) They should also be made accountable for the exercise of the authority they have been given to act in the interests of the shareholders. The chief methods of providing accountability are through the annual report and accounts and AGM.
(5) However, they have their own personal interests, which may be in conflict with those of the shareholders. Managers are driven by self-interest.
(6) Agency conflicts can arise in several ways. For example, they may put personal benefits ahead of returns to shareholders, focus on the short term rather than the longer term, seek to retain and reinvest profits for growth rather than pay dividends.
(7) Managers are also unlikely to put as much effort into their work as the shareholders would put in if they were running the company themselves.
(8) Because managers act as agents for the shareholders, shareholders incur certain ‘agency costs’. These include bonding costs (providing incentives to managers to motivate them to act in the interests of shareholders, for example by paying bonuses linked to profitability) and monitoring costs.
(9) Monitoring costs are the costs of checking that managers are fulfilling their functions properly. They include the costs of auditing the financial statements (to obtain reassurance that management have given them a true and fair view of the company’s affairs) and the cost of appointing non-executive directors.
The main problem with providing a good answer to this question is the challenge of providing a reasonably complete answer. Try to put as many points as possible into your answer plan, and cover these points clearly and fully in your answer.

**Text reference for Part (a):** Chapter 1 paragraph 4

**Part (b)**
Agency theory has been explained in the answer to part (a). Part (b) asks for a comparison of agency theory and the enlightened shareholder approach, and the most suitable approach to an answer would be to provide a brief explanation of the enlightened shareholder approach and then make the comparison.

There are just 5 marks for this part of the question, so having explained the enlightened shareholder approach, it might be assumed that the comparison required by the question is fairly brief and basic.

Points that could be made in this answer:

1. When a company adopts an enlightened shareholder approach to corporate governance, the board of directors acts in the interests of the shareholders, but in an enlightened way, which means that they also give recognition to other stakeholders, such as employees, lenders, customers and society in general.
2. According to agency theory, the directors of a company will act in their own self interests.
3. It is therefore difficult to see how companies are able to pursue a genuinely enlightened approach, if the agency theory view is taken that directors do not have concerns for others.
4. Agency theory is more compatible with the traditional ‘shareholder value’ approach to governance, which is based on the view that the objective of companies should be to maximise shareholders’ wealth. This explains the conflict between stated corporate objectives (shareholder interests) and management self-interests.

**Text reference for Part (b):** Chapter 1 paragraph 5.
Part (c)
Without going into extensive details or explanations, it would be useful to begin this part of the answer with a brief explanation of the Stewardship Code, and what it is.

This question is similar to part (b), because it calls for a comparison. Comparisons can be difficult to make, therefore the number of points required for a good answer will be fewer than for other types of examination question.

Suggested outline answer

(1) The UK Stewardship Code was written for institutional investors (and fund managers) in the UK, although foreign investors in UK companies are also encouraged to subscribe to it.

(2) The Code is based on the view that although shareholders should not be involved in the management of their company, they should be prepared to take action to protect their own interests.

(3) The Stewardship Code promotes the idea of more engagement by shareholders with their companies, which is a form of monitoring.

(4) One of the principles of the Code is that institutional investors should monitor the companies in which they invest as a regular process, not just taking action when issues of concern arise.

(5) Another principle of the Code is that investors should have clear guidelines or policies for escalating their activities as a means of protecting their interests (shareholder value) when they have concerns about the company’s strategy or governance.

(6) The Code would therefore seem to be based on the view that unless shareholders are active in pursuit of their own interests, there may be weaknesses in corporate governance and management of their company may fail to act in shareholder interests.

(7) This is consistent with the view in agency theory, that management will act in their self-interest unless incentivised to act in shareholder interests or unless their activities are monitored.

Text references for Part (b): Chapter 1 paragraph 4 and Chapter 8 paragraph 7.