

Better Corporate Governance: What, Why and How?

Shyam Sunder, Yale University

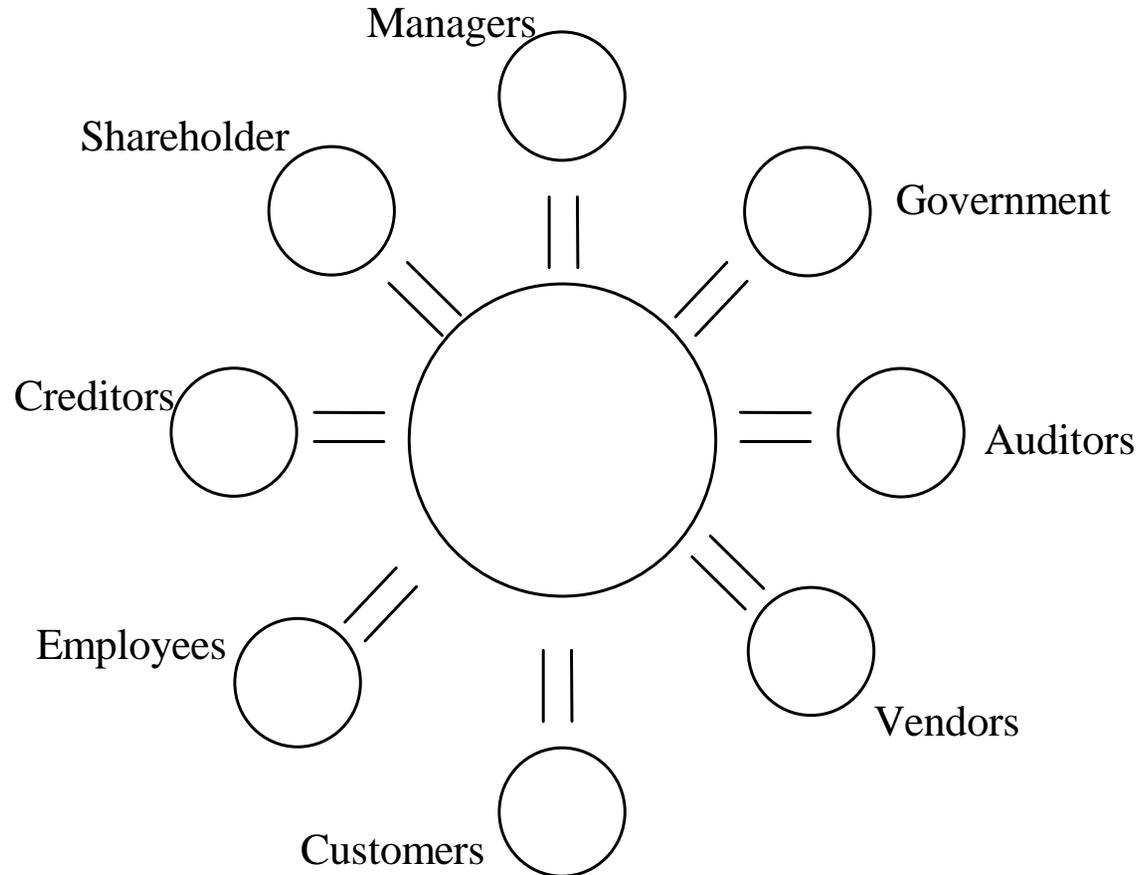
Leon Kozminski Academy of
Entrepreneurship and Management,
Warsaw, Poland

March 28, 2008

Outline

- Corporate governance is frequently interpreted narrowly to mean the organization, processes and duties of the board of directors
- We take a broader perspective of governance and discuss: :
 - **Organizations**: alliances among various people, each pursuing self-interest
 - **Culture of an organization**: the shared expectations of the behavior of one another held by its participants
 - **Good governance**: balance or match between the culture (mutual expectations) and self-interest of the participants
 - **Why Good Governance? It makes all participants better off**
 - **Elements of Good Governance**: balance among regulation, market forces, and social norms
 - **Threats**: changes in environment, markets, self-interest
 - **Strategic Management**: anticipating and addressing the threats
 - **Organization and Society**: evaluation of organization by the sum of surplus received by all participants
 - **No Holy Grail**: Good governance is a constant struggle to maintain balance under ever-changing conditions; a journey, not a destination

Organization as an Alliance among People



Alliance or Contract

- Each participant promises to contribute resources
- In exchange for the promise of inducements
- A participant enters the alliance if expected inducement is more than the opportunity cost of the contribution
- To succeed, an organization must have a production function such that it can simultaneously satisfy the contracts of all participants
- Otherwise dissatisfied agents abandon the alliance
- Organization collapses unless an alternative set of contracts that satisfies the condition is assembled

Examples of Contracts

- Contract is a mutual expectation or understanding among agents
- Lunch date
- This class
- Promising a delivery schedule to customer
- Explicit or implicit promise of relevant action
- Legal enforceability or written form not necessary
- Social conventions play an important role

Players and the Game

- Individuals have goals; they are the players
- Organization is the game in which individuals play to seek their own goals
- Perspective is applicable to a broad range of organizations—business, government, society, academia

Business Organizations

- For present discussion, consider business organizations
- Consider them as an alliance among contributors of
 - Capital (shareholders, creditors)
 - Labor (employees, managers)
 - Factors (vendors)
 - Cash (customers)
 - Public services (government)
 - Support (Community)
- Each party gets resources in exchange

Accounting in Organizations

- Operating mechanism for contracts
- Necessary to assemble, implement, enforce, modify and maintain the contract set
- Five functions
 - Measure resource contributions from agents
 - Monitor resource outflows to agents
 - Relate inflow and outflow for each agent
 - Maintain liquidity of factor markets
 - Shared knowledge to facilitate contract renegotiation

Measuring Contributions

- Receivables and cashier
- Receiving dock for supplies
- Punch clock and quality control

Measuring Outflows

- Payroll accounts
- Tax accounts
- Cashier
- Shipping

Contract Fulfillment

- Matching resource inflows and outflows to contracts
- Performance evaluation
- Adjusting contracts to resource realizations

Maintaining Liquidity of Factor Markets

- Individuals agents come and go
- Finding replacements for departing agents in appropriate factor markets
- Convincing new people to participate
- Advertising motive in all factor markets

Facilitating Contract Renegotiation Through Shared Knowledge

- Most contracts are finite term contracts
- Motive to bluff at the time of renegotiation
- Ex ante agreement to share some information as shared knowledge
- Shared knowledge cannot be used to bluff others
- Reduces dead-weight losses to society

Culture of Organizations

- Can think of culture of an organization as the shared expectation of behavior of the members of a group
 - Starting meetings on time
 - Wearing a suit to office
- Developed through social interactions
- Mostly bottom-up, not top-down
- Maintained through social, not formal sanctions
- Takes time for new entrants to learn
- The difficulty of maintaining the culture increases as the rate of new entrants increases

Good Governance

- Concept of good governance derived from the concepts of
 - Organizations as alliances or sets of contracts,
 - Expectations,
 - Shared knowledge, and
 - Culture
- An organization or group is governed well when all of its participant find it in their own best interests to do what is expected of them by the other members of the organization

Matching Expectations and Self-interest

- This is a difficult task for management
- Management can influence but not control expectations of people (a large bonus)
- Every action, event, and outcome affects peoples' expectations of the future
- Individual self-interest is not always known to the manager
- Both expectations as well as self-interest change constantly

Why Care for Good Governance

- Good governance is a more reliable route to
 - Creation of wealth
 - A satisfying work environment, and
 - A better life for all participants.
- On occasion, individuals may gain advantage for themselves by surprising others (i.e., behave in ways not expected of them)
- Such advantages tend to be ephemeral
 - Create personal and social anxiety and disruption
 - Are ultimately counterproductive.

Comprehensive Perspective on Governance

- Rules, incentives, communication, monitoring, and enforcement are used to align participant behavior and expectations
- Consider two traders
 - Buyer expects to have the appropriate goods delivered
 - Seller expects to be paid
 - When expectations of all participants are met, the system is being governed well
- The concept extends well beyond the traditional scope of governance limited to the board of directors and senior executives
- Good governance applies to all participants, including employees, managers, shareholders, customers, vendors, directors, and others

Elements of Good Governance

- Good governance requires a well-thought out balance between
 - Government (laws and regulations) on one hand, and
 - Guidance from the market forces on the other
 - A good system of governance recognizes that both government actions as well market forces are susceptible to failure
 - Total dependence on either is unlikely to provide a satisfactory outcome
- Supplemented by self-discipline
 - A system of social norms
 - Trust in the business community, and
 - Vigilance on part of the shareholders
- All three components are necessary to improve governance.

Threats to Good Governance

- Established systems of good governance are threatened by
 - Changes in environment
 - Changes in markets in which the organization transacts, and
 - Self-interest of the participants
- A contract set which is *in* good governance today, may not be *in* good governance tomorrow if the conditions change
- People for who such changes render participation in the alliance disadvantageous seek to leave. If these people are essential to the alliance
- Their departure may make the alliance undesirable for others too, possibility of cascading departures and collapse of the organization
- A fixed set of contracts cannot remain in balance (expectational equilibrium) except by sheer chance

If Individual Condition Is Not Met

- People who do not expect to get from the organization at least the opportunity cost of their contributions will go elsewhere
- This is the definition of opportunity cost
- Shareholders will not buy your stock if they can higher risk-adjusted return elsewhere
- Customers will not buy your goods if they can get better price or quality elsewhere
- Employees will not work for you if they can get better compensation and job prospects elsewhere

If Aggregate Condition Is Not Met

- Firms runs out of resources to meet its obligations (expenses exceed revenue)
- Some agent(s) disappointed because the promises made to them are not fulfilled
- These agents quit (and probably impose additional costs on the organization—e.g., law suits)
- If these individuals were essential for the production function of the firm, their departure makes things worse
- If they were not essential, the firm did not choose the optimum production function

No Coercion

- Matching of agent actions to what others expect of them should not be achieved through coercion
- It has to be created through socially legitimate incentives and motivational methods
- What is legitimate varies across societies
- Performance-based compensation may be considered coercive in some societies but not in others

Not Based on Misunderstanding

- Participant actions and others' expectations of them may just happen to match due to misunderstanding
- Such a match is not sustainable; it disappears as soon as the participants get better information
- A match based on misunderstanding does not imply good governance

Not Based on False Promises

- A match may sometimes be obtained through false promises—e.g., Ponzi schemes
- Again, these are not sustainable
- Disclosure of truth destroys the organization
- Such a house of cards is not good governance

Disintegration of Organizations

- When actions do not match the expectations, people are disillusioned and quit
- Organizations disintegrate
- Miscalculation, coercion, misunderstanding, or misrepresentation by agents destroy governance

Functions of Top Management

- This function goes by many labels (long term planning, strategic management, etc.)
- It always amounts to the same thing:
 - Monitor your environment
 - Anticipate changes in factor and product markets
 - Redesign contracts to be *in* control under the new conditions
 - Renegotiate contracts
 - Communicate and implement new contracts
- Perpetual revision of corporate plans to retain their desirability from the point of view of all participants

Let Me Summarize

- Good governance is a key concept in management
- Alliance or contract model of organizations can help understand good governance

Culture and Governance

- Culture of a group can be thought of as expectations its members hold about the behavior of others in the group
- An organization has good governance if the behavior of its members corresponds to the expectations of others
- Good governance is a state of balance between expectations and actions

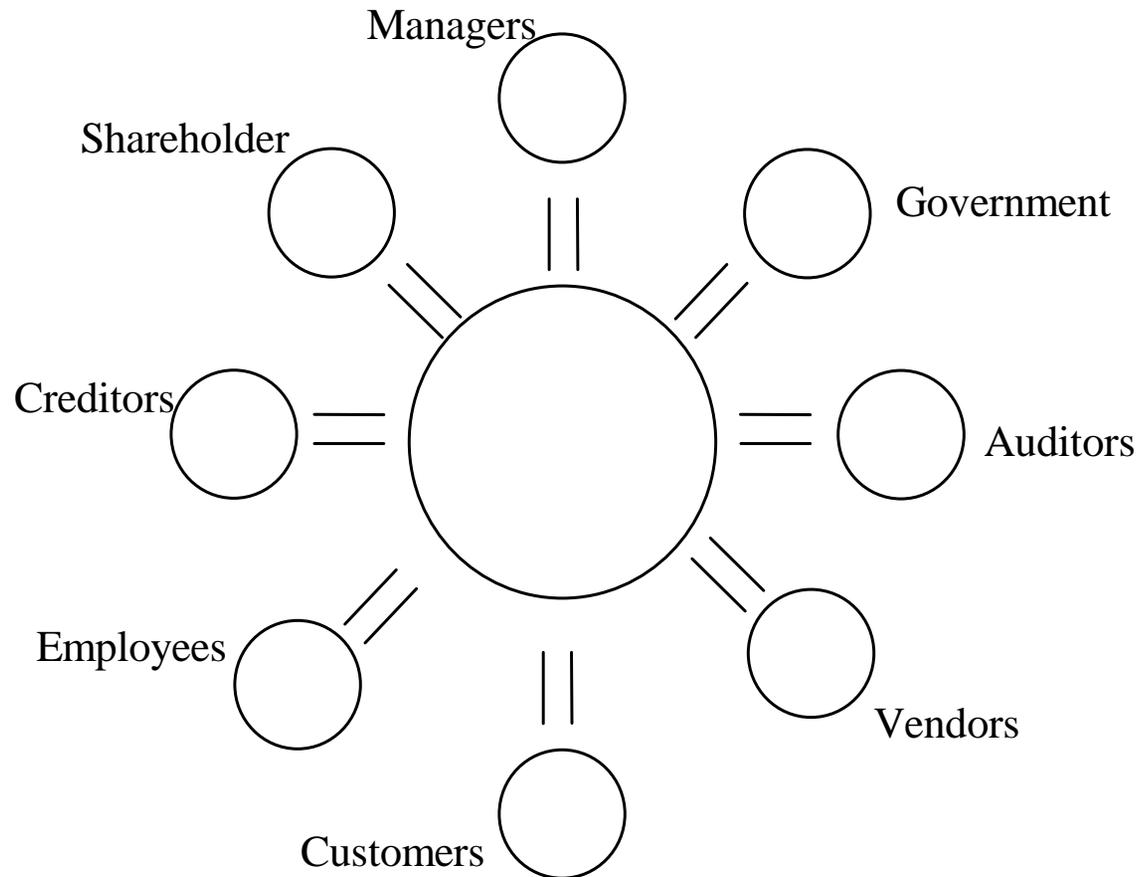
What's Management For

- Changing environment threatens good governance
- Top management must anticipate and deal with these threats to good governance
- Set of feasible corporate plans is too large to contemplate and analyze
- Due to time limitations, managers search in the neighborhood of existing plans and settle on satisficing solutions
- Simon's boundedly rational behavior

Organization and Society

- We have looked at organization from the point of view of the individual participants so far
- How do we evaluate the organization from the point of view of the society as a whole?
- Let us return to the model of organization as an alliance among people
- Remember, each participant contributes and receives resources
- Each participant earns an income from participation
- This income = (the value of resources received - the opportunity cost of the resources contributed)

Organization as an Alliance among People



Economic Income to Investors

- Return on investment – the opportunity cost of capital invested (i.e., residual income)
- Shareholders are not the only ones who earn an income from the organization
- We can apply similar perspective to other participants in the firm

Economic Income to Employees

- Wages, benefits, and enhancement of human capital – opportunity cost of time

Economic Income to Customers

- Customer's "investment" in the form in the form of search, learning, negotiation, payments, settlement of disputes
- Expected PV of benefits from goods received should exceed the PV of investments
- Includes immediate transaction as well as the consequences of the transaction for resource flows associated with any future transactions (reduction in time, cost, search etc. for later transactions)
- In a perfect product market, consumer's surplus from the firm is zero (may be +ve from industry)

Economic Income to Government

- Various levels of government provide mostly non-priced services plus some priced goods
- Resources from taxation
- Income from the firm to the government from providing priced services is the same as for vendors
- Income from the firm to the government from providing non-priced services is taxes plus fees minus O.C. of resources spent on providing services

Income from the Organization to Community

- Local, national and global
- Most exchanges in form of externalities
- Income from the firm to the community is the sum of net externalities plus the net payments

Income from Organization to Society

- Extensive income is the sum of income to all participants, government, community (including positive and negative externalities)
- Income to shareholder is included in extensive income
- But extensive income (to society as a whole) also includes income to all other parts of society
- Components of extensive income accrue to various participants and serve as criterion for their respective decisions
- Extensive income is the appropriate criterion for social policy and decisions

No Panacea for Good Governance

- Good governance is a constant struggle to design and redesign the organization's alliance in response to changes in its environment
- There is no single solution that fits all
- No solution remains effective for long.
- Ensuring that the self-interest of each participant is aligned with what he or she is supposed to do should be the top priority of the directors and senior management of organizations.

Summary

- Corporate governance is frequently interpreted narrowly to mean the organization, processes and duties of the board of directors
- We take a broader perspective of governance and discuss: :
 - **Organizations**: alliances among various people, each pursuing self-interest
 - **Culture of an organization**: the shared expectations of the behavior of one another held by its participants
 - **Good governance**: balance or match between the culture (mutual expectations) and self-interest of the participants
 - **Why Good Governance? It makes all participants better off**
 - **Elements of Good Governance**: balance among regulation, market forces, and social norms
 - **Threats**: changes in environment, markets, self-interest
 - **Strategic Management**: Anticipating and addressing the threats
 - **Organization and Society**: evaluation of organization by the sum of surplus received by all participants
 - **No Holy Grail**: Good governance is a constant struggle to maintain balance under ever-changing conditions

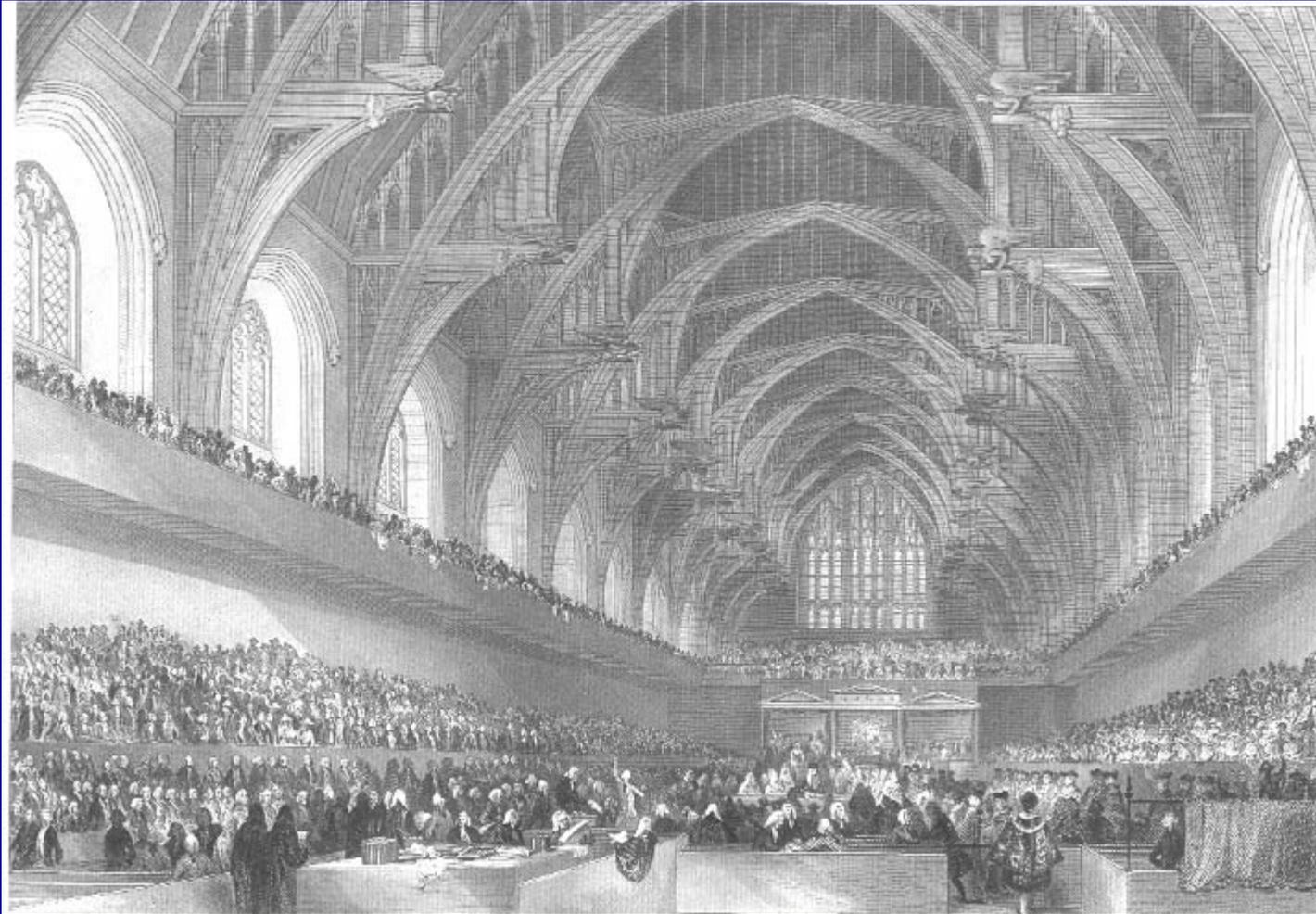
An Old Problem

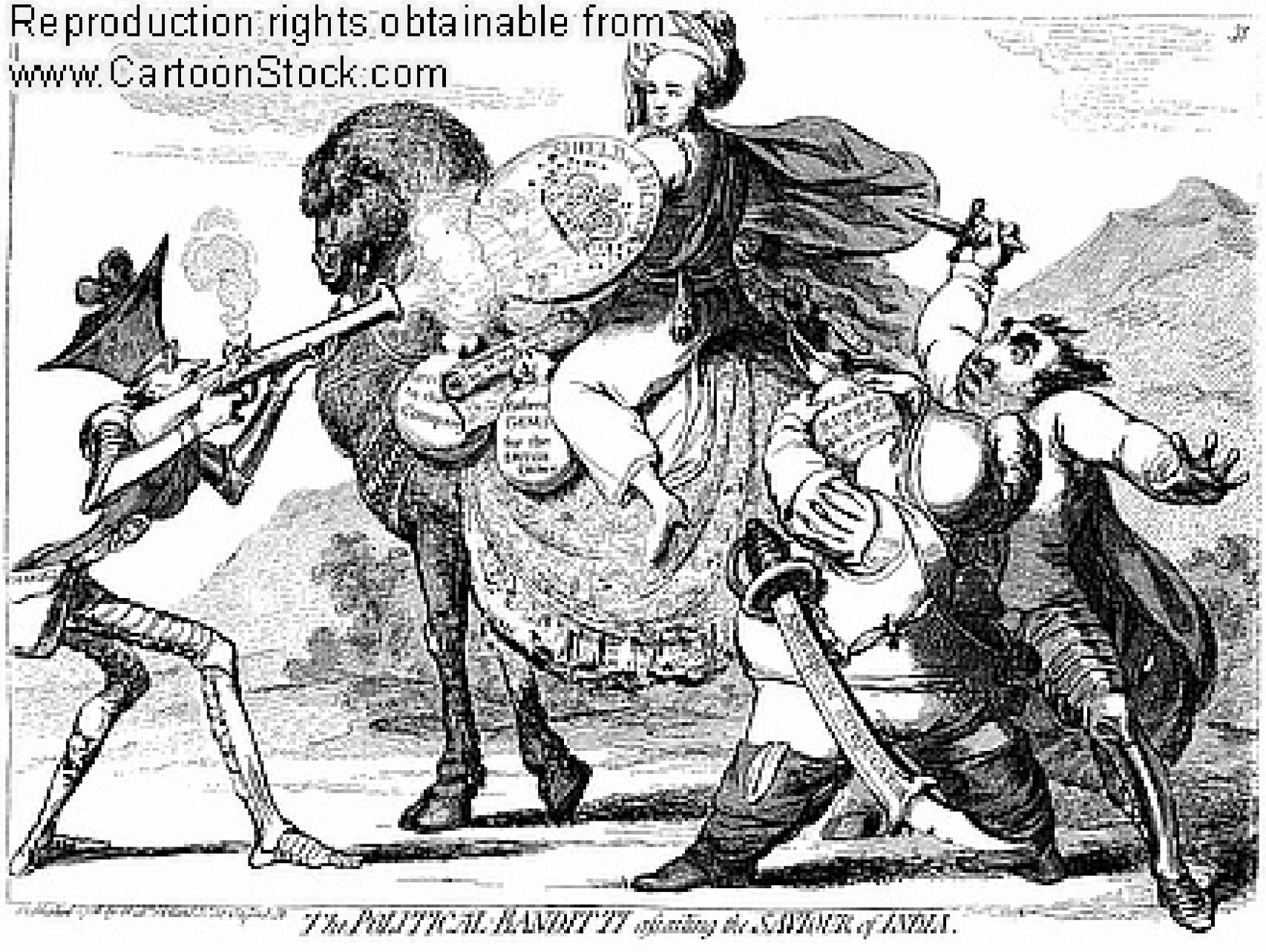
- Governance problems are as old as human civilization
- The greatest corporation in the history of the world had serious governance problems throughout 258 years of its existence: Trial of Warren Hastings

Westminster Hall

Trial of Warren Hastings

London: Published for the Proprietor by J. Mead, 10, Gough Square, Fleet Street







STATE JUGGLERS,

*As the jugglers must be steady, so must the people
Keep their eyes on the ground
And not be dazzled by the show
Of a state of things that is not so*

H. J.

Perfect Permanent Solution Unlikely

- Just because we have no easy or permanent solutions, it does not mean we can give up trying to address the governance problem
- Constant striving and vigilance is the price all of us must pay for the great benefits organizations enable us to reap
- Democracy does not function well without combination of citizen docility and vigilance
- Also true of corporate governance; it requires the participants, especially the minority shareholders to exercise intelligent watch for the system to function efficiently

Thank You!

www.som.yale.edu/faculty/sunder



Thank You!

Shyam.sunder@yale.edu

www.som.yale.edu/faculty/sunder