Towards an Analytical Framework for Corporate Governance

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Introduction

This note summarises a larger paper on this topic by the same author. The Boardroom Practice (TBPL) associates several of its diagnostic and advisory products with the framework explained below.

> *Governance, especially corporate governance is today's "hot topic". It should be. Effective governance offers unparalleled potential to improve total social well being dramatically all the way from the smallest trust to the international aid arena.*

Both the positive (what is) and the normative (what should be) literature presently stresses the need to improve governance. From the woes of Enron and Tyco, the failings of the "disclosure professions" (accounting , auditing) in this area, through the protests of minority shareholders and beneficiaries, to the political discomfort about misspent social policy allocations and into the frustration of crisis aid workers, poor governance is seen as a major culprit which if brought to heel could be persuaded to yield up the best of outcomes.

> *The present approach though, is fragmented, unsystematic, conceptually weak and riddled with stifling, subjective moral exhortation.*
>
> *We can and ought to do better…..*

Commentary on and recommendations about corporate governance are rarely couched in any strong analytical framework. There is little rigorous analysis of (a) what goes wrong (b) why it goes wrong, or (c) what might be done to improve matters. Instead we have, for the most part, stern warnings and pleas based around various allegations about morality, honesty, integrity or the lack of these ill defined qualities. These do not pass, however loudly shouted nor however eminent those doing the shouting are, for serious analysis of the issues.

> *To understand Governance, we need to know what it is, what functions it serves and why it exists.*
>
> *Only then can we improve existing governance arrangements and design better ones.*

What's the Fuss About?

Governance arrangements arise because people frequently choose to have others (agents) act on their (principals) behalf. We regularly opt to have others represent us, act for us, guard our assets, take care of our interests or otherwise act for us. We choose to use agents to act for principals. Agency arrangements are amongst the most efficient sets of relationships which societies have evolved. Governance is what allows agency relationships to function properly.

Principal-agent relationships are a smart institutional arrangement. They improve choice and allow welfare improving activities for many who would otherwise miss out.

Examples of benefits from agency relationships abound:

In capital markets:

- Let the poorest investor access the skills of Warren Buffett
- Enable the most naïve of investors access the world's best capital asset allocators
- Let the most meagre of workers access the debt markets
- Let entrepreneurs with no managerial skills deliver their inventions

In health markets:

- Allow the weakest of children to be nurtured by the best of carers
- Let the sickest of patients access the best of medical care
- Let the lowliest community members access the mana of chiefs

In education markets:

- Enable the genius of Einstein to be revealed to the newest of physics students
- Let the illiterate learn to read and write or otherwise access information

In professional services markets:

- Allow the legally ignorant access the finest of legal brains
- Allow the ill informed to assess insurable risks
- Allow those without requisite skills to obtain high quality services

Agency arrangements or principal-agent relationships make sense because they make use of the comparative advantage which people have. They let the specialised knowledge and skills of the few be put at the service of the many. This is the most basic of economic principles.

So agency is found in every culture, every epoch of history and every part of the globe

But There are Costs – Agency Costs

Like everything else, agency arrangements and principal-agent relationships involve costs. Dangers and risks lurk – not for any mysterious reason but for the most obvious of reasons:

The interests of the agent and the principal are not always the same and may diverge – at the expense of the agent. The cost of that divergence is called an Agency Cost and is ever present in some degree or other.

The examples are obvious – the broker has his fees to consider, the company manager has the empire he has built up to consider, the doctor has the "mystique" he has created to consider when divulging medical information, the teacher has his "tricks" to think of, the trustee has his "values" to consider when seeing a child educated. The list goes on.

Whenever an agent indulges his interests in some way that is not in the best interest of the principal, or when principals step outside the contract agreed with agents, agency costs arise.

Enter Governance

With this understanding we can now understand the purpose of governance and what it is.

Governance arrangements arise and exist to regulate the relationship between principal and agent with the object of minimising agency costs and maximising principals' benefits.

Governance arrangements take the form of some kind of agreement – perhaps as dictated by the law or regulations accompanying the law, perhaps by way of a formal or informal contract, perhaps by way of tradition and agreed code of behaviour. There are numerous forms of governance arrangement depending on the type of agency arrangement involved.

Simplifying but in a comprehensive manner, this governance "contract" whether explicit, implicit or both consists of five critical components.

The Essentials of Governance

Component	Description & Examples
Articulation:	*The specification and communication of the Principals interests* Statement of Corporate Intent, Trust Deed, company Constitutional statement, resolution stating objectives, Golden share, shareholders agreement, objectives in Charter, informal investors agreement, all types of statement setting out agreement on the objectives of the Principals – both commercial and non commercial.
Accountability	*The means by which Principals are held to account by agents.* Shareholder reporting, disclosure requirements accounting legislation, management contracts, performance indicators, board evaluations, trustee evaluations, remedies and sanctions, Court decisions, codes of conduct - all mechanisms used to hold agents to account.
Agent Attributes	*The characteristics of the agents and their suitability for the job.* Skills, experience and competence of directors, trustees and agents. Interests and potential conflicts, ability, track record, legal history and qualification, tradition and expectation, reputation – all attributes strong, weak, advantageous, disadvantageous which agents bring to the governance contract.
Agent Incentives	*The incentive mechanisms or devices used to align the interests of the Principal and the agent.* Remuneration, nature of remuneration, shares, options, valuation mechanisms, criteria for remuneration, reputational capital, term of office, conflict with personal incentives, diversification effects, exit options – all mechanisms which create, modify, attenuate, strengthen or affect incentives for agent behaviour.
Adaptability	*The means for changing, modifying and evolving the governance arrangements.* Processes enabling change in the governance contract. Legal alteration processes, elections, meeting processes, support / opposition mechanisms for changing governance rules, Court decisions, legal dictate, regulation, codes of practice, custom and usage – all means by which the contract can be altered.

Conclusion

Seat of the pants governance based on pragmatism, meeting formats and bare compliance with the law is unlikely to advance the welfare of principals be they shareholders, beneficiaries or others. An understanding of why governance has evolved as a practice and what makes it function effectively is a fundamental pre requisite to improving the outcomes it generates.

The framework set out above provides a conceptual underpinning from which the adequacy of governance can be assessed on a case by case basis in different situations. From that steps toward improvement might be made.