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Concepts and Cases

Strategic Management

Competitiveness & Globalization

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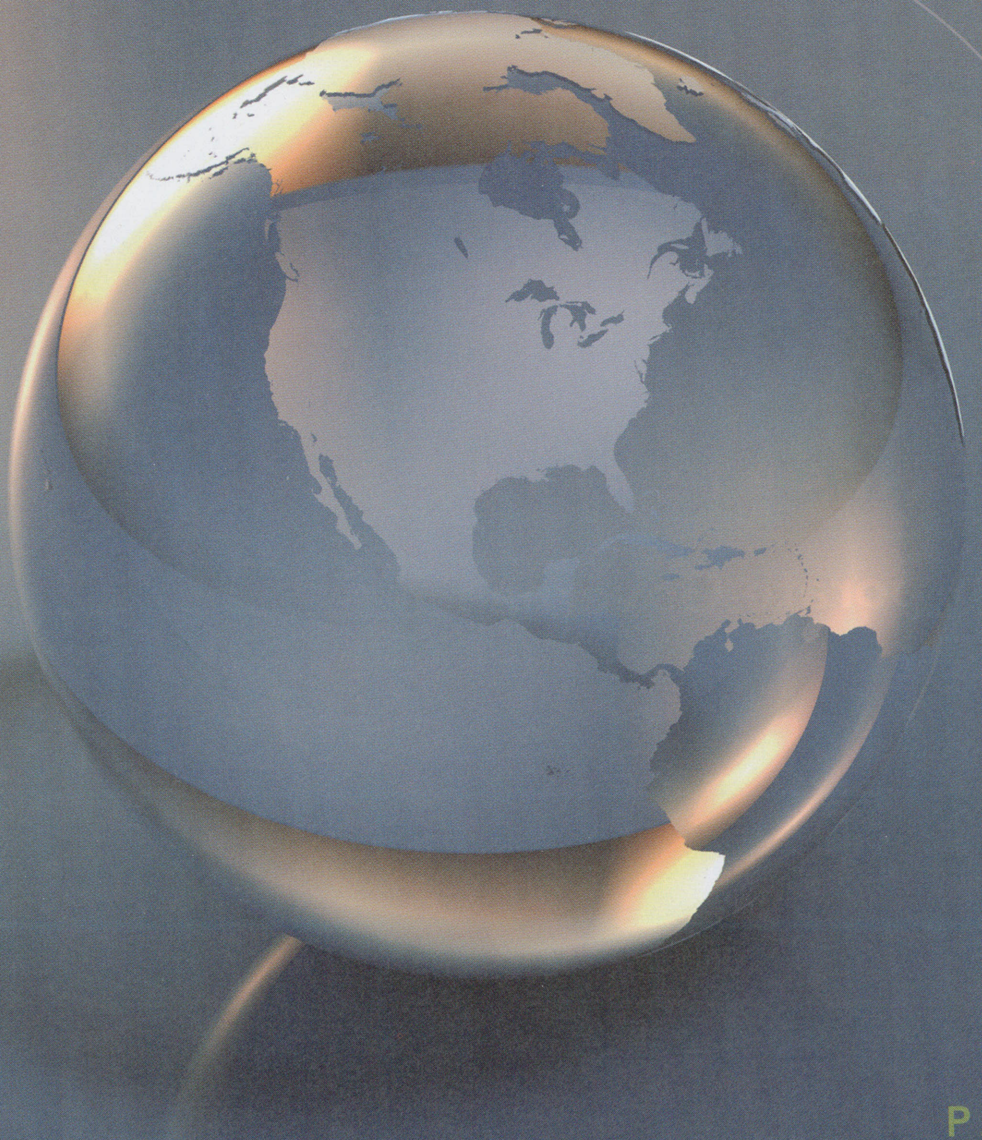
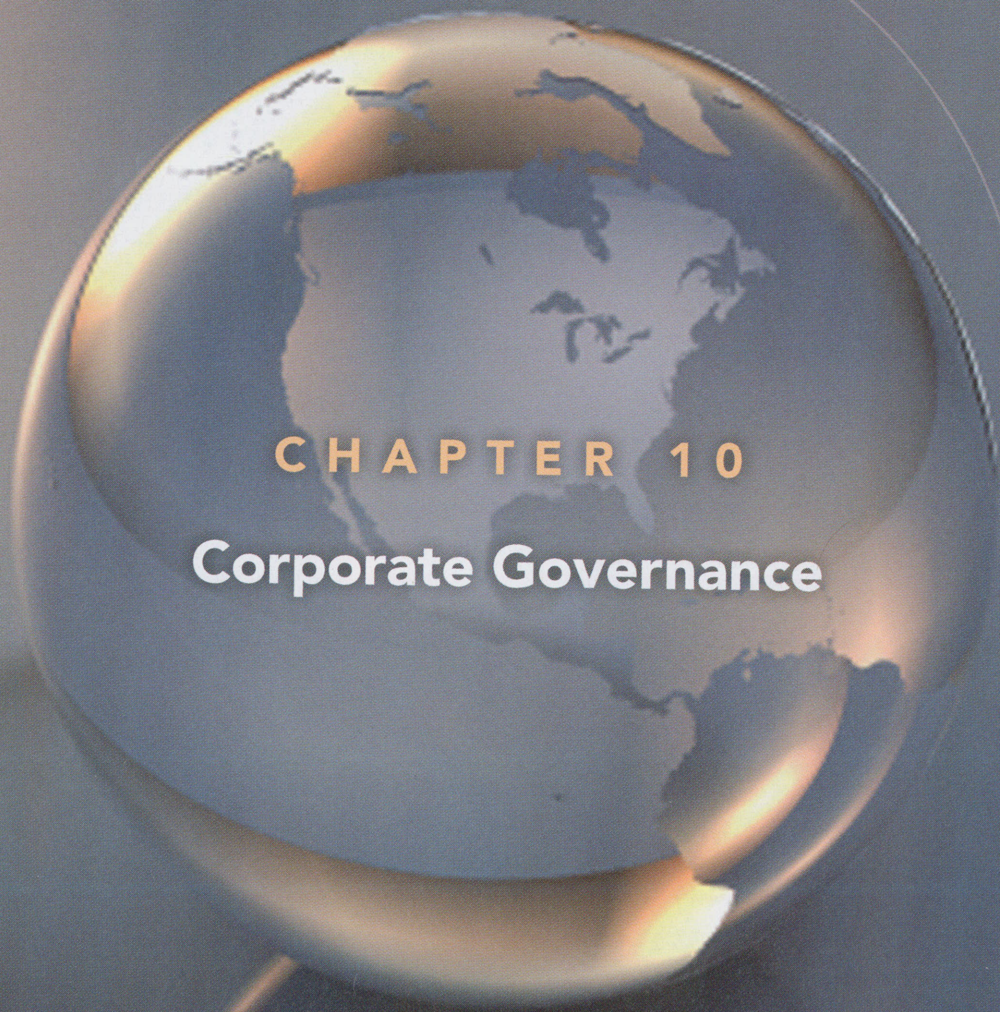


PART 3

Strategic Actions: Strategy Implementation



CHAPTER 10

Corporate Governance

Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define corporate governance and explain why it is used to monitor and control managers' strategic decisions.
2. Explain why ownership has been largely separated from managerial control in the corporation.
3. Define an agency relationship and managerial opportunism and describe their strategic implications.
4. Explain how three internal governance mechanisms—ownership concentration, the board of directors, and executive compensation—are used to monitor and control managerial decisions.
5. Discuss the types of compensation executives receive and their effects on strategic decisions.
6. Describe how the external corporate governance mechanism—the market for corporate control—acts as a restraint on top-level managers' strategic decisions.
7. Discuss the use of corporate governance in international settings, especially in Germany, Japan, and China.
8. Describe how corporate governance fosters ethical strategic decisions and the importance of such behaviors on the part of top level managers.

IS CEO PAY OUTRAGEOUS, IRRESPONSIBILE, OR GREEDY?

In 2008, the ten most highly paid CEOs earned a total of $472.2 million. Furthermore, seven of these CEOs who worked at the same companies in 2007 received an increase in pay of approximately 26 percent over the previous year. Placing this in perspective, an average of $47.22 million was paid to these CEOs in a year when most large firms—including theirs—lost significant market value, and many experienced net losses. In 2008, we learned that the U.S. economy and, indeed, much of the rest of the world, was in a deep recession. In fact, it is perhaps the worst since the Great Depression in the 1930s. Many believe that this recession was largely caused by irresponsible and greedy strategies followed by top-level managers in the financial services and real estate industries. In addition, the corporate governance system failed to rein in these managers, who took extreme risks causing billions of dollars in losses. Real estate values plummeted in many parts of the country, there were a substantial number of mortgage foreclosures, unemployment increased substantially, and the stock market took a nosedive.

Julia Hiebaum/Alamy

In this context, top executive pay came under intense criticism. In recent years, supposedly knowledgeable people argued that top-level managers were being paid for performance. If so, how could they earn such high compensation when their companies were performing poorly? Many CEOs earn more than 100 times the amount received by their firm's lowest-paid employee. Despite the average increases for the highest-paid CEOs, the median salary and bonuses for CEOs of the largest 200 U.S. firms decreased by 8.5 percent in 2008, but their total direct compensation only fell by 3.4 percent. The decline in the financial services industry was much greater, as could be expected. Still, the median value of perks provided to CEOs in 2008 increased by about 7 percent. "Perks" include many possible benefits, such as club memberships, free personal travel in company jets, bodyguards, and chauffeured cars. In fact, the CEO of Occidental Petroleum received $400,000 worth of financial planning. This was a part of his compensation in 2008, which totaled $30 million. While this benefit for financial planning is only 1.33 percent of his total pay for the year, $400,000 is greater than the total annual household income for most U.S. citizens.

In a survey conducted by the *Financial Times*, respondents from France, Germany, Italy, Spain, the United Kingdom, and the United States stated that they believed that business leaders were paid too much. The lowest percentage believing that top-level managers were overpaid was about 75 percent in France, while almost 90 percent in Germany felt they were overpaid. When the feelings of the general public are combined with the poor performance of companies in a weak economy, pundits often blame an inadequate system of corporate governance. This concern is amplified by reports of bad strategic decisions of business leaders blamed for creating the economic crisis. Thus, governments and others have begun to explore the governance mechanisms including compensation systems, boards of directors, ownership, and disciplining from the markets. It is likely that new regulations will be proposed and adopted to control what the public perceives to be irresponsibility and greed on the part of business leaders.

Sources: V. Tong, 2009, As pay falls, CEOs get more perks, YAHOO! News, http://news.yahoo.com, May 1; 2009, The pay at the top, *The New York Times*, http://www.nytimes.com, April 16; R. Milne, 2009, Sharp divide on executive pay, *Financial Times*, http://www.ft.com, April 13; J. S. Lublin, 2009, CEO pay sinks along with profits, *Wall Street Journal*, http://www.wsj.com, April 6; T. Carr, 2008, An ethical analysis of CEO compensation, *Fast Company*, http://www.fastcompany.com, November 28; A. Cohen, 2008, CEO pay; outrageous—and bad for MBA programs, *Fast Company*, http://www.fastcompany.com, April 6.

As the Opening Case illustrates, governance mechanisms designed to ensure effective leadership of firms to develop and implement strategies that create value for stakeholders is challenging. However, corporate governance is critical to firms' success and thus has become an increasingly important part of the strategic management process.[1] If the board makes the wrong decisions in selecting, governing, and compensating the firm's strategic leader (e.g., CEO), the shareholders and the firm suffer. When CEOs are motivated to act in the best interests of the firm—in particular, the shareholders—the firm's value should increase.

As suggested in the Opening Case, many people now believe that CEOs in the United States are paid too much; the hefty increases in their incentive compensation in recent years ostensibly come from trying to link pay to their firms' performance. However, research also suggests that firms with a smaller pay gap between the CEO and other top level managers perform better, especially when collaboration among top management team members is more important.[2] The performance improvement in these cases is due to better cooperation among the top management team members. Other research suggests that CEOs receive excessive compensation when corporate governance is the weakest.[3]

Corporate governance is the set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organizations.[4] At its core, corporate governance is concerned with identifying ways to ensure that strategic decisions are made effectively.[5] Governance can also be thought of as a means to establish harmony between parties (the firm's owners and its top-level managers) whose interests may conflict. In modern corporations—especially those in the United States and the United Kingdom—a primary objective of corporate governance is to ensure that the interests of top-level managers are aligned with the interests of the shareholders. Corporate governance involves oversight in areas where owners, managers, and members of boards of directors may have conflicts of interest. These areas include the election of directors, the general supervision of CEO pay and more focused supervision of director pay, and the corporation's overall structure and strategic direction.[6]

Recent emphasis on corporate governance stems mainly from the failure of corporate governance mechanisms to adequately monitor and control top-level managers' decisions. This situation results in changes in governance mechanisms in corporations throughout the world, especially with respect to efforts intended to improve the performance of boards of directors. A second and more positive reason for this interest comes from evidence that a well-functioning corporate governance and control system can create a competitive advantage for an individual firm.[7] Thus, in this chapter, we describe actions designed to implement strategies that focus on monitoring and controlling mechanisms that are designed to ensure that top-level managerial actions contribute to the firm's strategic competitiveness and its ability to earn above-average returns.

Effective corporate governance is also of interest to nations.[8] Although corporate governance reflects company standards, it also collectively reflects country societal standards.[9] As with these firms and their boards, nations that effectively govern their corporations may gain a competitive advantage over rival countries. In a range of countries, but especially in the United States and the United Kingdom, the fundamental goal of business organizations is to maximize shareholder value.[10] Traditionally, shareholders are treated as the firm's key stakeholders, because they are the company's legal owners. The firm's owners expect top-level managers and others influencing the corporation's actions (e.g., the board of directors) to make decisions that will maximize the company's value and, hence, the owners' wealth.[11] Research shows that national models of corporate governance influence firms' decisions to invest and operate in different countries.[12]

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In the first section of this chapter, we describe the relationship that is the foundation on which the modern corporation is built: the relationship between owners and managers. The majority of this chapter is used to explain various mechanisms owners use to govern managers and to ensure that they comply with their responsibility to maximize shareholder value.

Three internal governance mechanisms and a single external one are used in the modern corporation. The three internal governance mechanisms we describe in this chapter are (1) ownership concentration, represented by types of shareholders and their different incentives to monitor managers; (2) the board of directors; and (3) executive compensation. We then consider the market for corporate control, an external corporate governance mechanism. Essentially, this market is a set of potential owners seeking to acquire undervalued firms and earn above-average returns on their investments by replacing ineffective top-level management teams.[13] The chapter's focus then shifts to the issue of international corporate governance. We briefly describe governance approaches used in German, Japanese, and Chinese firms whose traditional governance structures are being affected by the realities of global competition. In part, this discussion suggests that the structures used to govern global companies in many different countries, including Germany, Japan, the United Kingdom, and the United States, as well as emerging economies such as China and India, are becoming more, rather than less, similar. Closing our analysis of corporate governance is a consideration of the need for these control mechanisms to encourage and support ethical behavior in organizations.

Importantly, the mechanisms discussed in this chapter can positively influence the governance of the modern corporation, which has placed significant responsibility and authority in the hands of top-level managers. With multiple governance mechanisms operating simultaneously, however, it is also possible for some of the governance mechanisms to be in conflict.[14] Later, we review how these conflicts can occur.

Separation of Ownership and Managerial Control

Historically, U.S. firms were managed by the founder-owners and their descendants. In these cases, corporate ownership and control resided in the same persons. As firms grew larger, "the managerial revolution led to a separation of ownership and control in most large corporations, where control of the firm shifted from entrepreneurs to professional managers while ownership became dispersed among thousands of unorganized stockholders who were removed from the day-to-day management of the firm."[15] These changes created the modern public corporation, which is based on the efficient separation of ownership and managerial control. Supporting the separation is a basic legal premise suggesting that the primary objective of a firm's activities is to increase the corporation's profit and, thereby, the financial gains of the owners (the shareholders).[16]

The separation of ownership and managerial control allows shareholders to purchase stock, which entitles them to income (residual returns) from the firm's operations after paying expenses. This right, however, requires that they also take a risk that the firm's expenses may exceed its revenues. In order to manage this investment risk, shareholders maintain a diversified portfolio by investing in several companies to reduce their overall risk.[17] The poor performance or failure of any one firm in which they invest has less overall effect on the value of the entire portfolio of investments. Thus, shareholders specialize in managing their investment risk.

In small firms, managers often are high percentage owners, which means less separation between ownership and managerial control. In fact, in a large number of family-owned firms, ownership and managerial control are not separated. In the United States, at least one-third of the S&P 500 firms have substantial family ownership, holding on average about 18 percent of the outstanding equity. And family-owned firms perform better when a member of the family is the CEO than when the CEO is an outsider.[18] In many countries outside the United States, such as in Latin America, Asia, and some European countries, family-owned firms represent the dominant form.[19] The primary purpose of most of these firms is to increase the family's wealth, which explains why a family CEO often is better than an outside CEO.

Family-controlled firms face at least two critical issues. First, as they grow, they may not have access to all of the skills needed to effectively manage the firm and maximize its returns for the family. Thus, they may need outsiders. Also, as they grow, they may need to seek outside capital and thus give up some of the ownership. In these cases, protection of the minority owners' rights becomes important.[20] To avoid these potential problems, when these firms grow and become more complex, their owner-managers may contract with managerial specialists. These managers make major decisions in the owners' firm and are compensated on the basis of their decision-making skills. As such, recent research suggests that firms in which families own enough equity to have influence without major control tend to make the best strategic decisions.[21]

Without owner (shareholder) specialization in risk bearing and management specialization in decision making, a firm may be limited by the abilities of its owners to manage and make effective strategic decisions. Thus, the separation and specialization of ownership (risk bearing) and managerial control (decision making) should produce the highest returns for the firm's owners.

Shareholder value is reflected by the price of the firm's stock. As stated earlier, corporate governance mechanisms, such as the board of directors, or compensation based on the performance of a firm is the reason that CEOs show general concern about the firm's stock price.

Agency Relationships

The separation between owners and managers creates an agency relationship. An **agency relationship** exists when one or more persons (the principal or principals) hire another person or persons (the agent or agents) as decision-making specialists to perform a service.[22] Thus, an agency relationship exists when one party delegates decision-making responsibility to a second party for compensation (see Figure 10.1).[23] In addition to shareholders and top-level managers, other examples of agency relationships are consultants and clients and insured and insurer. Moreover, within organizations, an agency relationship exists between managers and their employees, as well as between top level managers and the firm's owners.[24] However, in this chapter we focus on the agency relationship between the firm's owners (the principals) and top-level managers (the principals' agents) because these managers formulate and implement the firm's strategies, which have major effects on firm performance.[25]

The separation between ownership and managerial control can be problematic. Research evidence documents a variety of agency problems in the modern corporation.[26] Problems can surface because the principal and the agent have different interests and goals, or because shareholders lack direct control of large publicly traded corporations. Problems also arise when an agent makes decisions that result in the pursuit of goals that conflict with those of the principals. Thus, the separation of ownership and control potentially allows divergent interests (between principals and agents) to surface, which can lead to managerial opportunism.

Managerial opportunism is the seeking of self-interest with guile (i.e., cunning or deceit).[27] Opportunism is both an attitude (e.g., an inclination) and a set of behaviors (i.e., specific acts of self-interest).[28] It is not possible for principals to know beforehand which agents will or will not act opportunistically. The reputations of top level managers are an imperfect predictor, and opportunistic behavior cannot be observed until it has occurred. Thus, principals establish governance and control mechanisms to prevent agents from acting opportunistically, even though only a few are likely to do so. Interestingly, research suggests that when CEOs feel constrained by governance mechanisms, they are more likely to seek external advice that in turn helps them to make better strategic decisions.[29] Any time that principals delegate decision-making responsibilities to agents, the opportunity for conflicts of interest exists. Top-level managers, for example, may make strategic decisions that maximize their personal welfare and minimize

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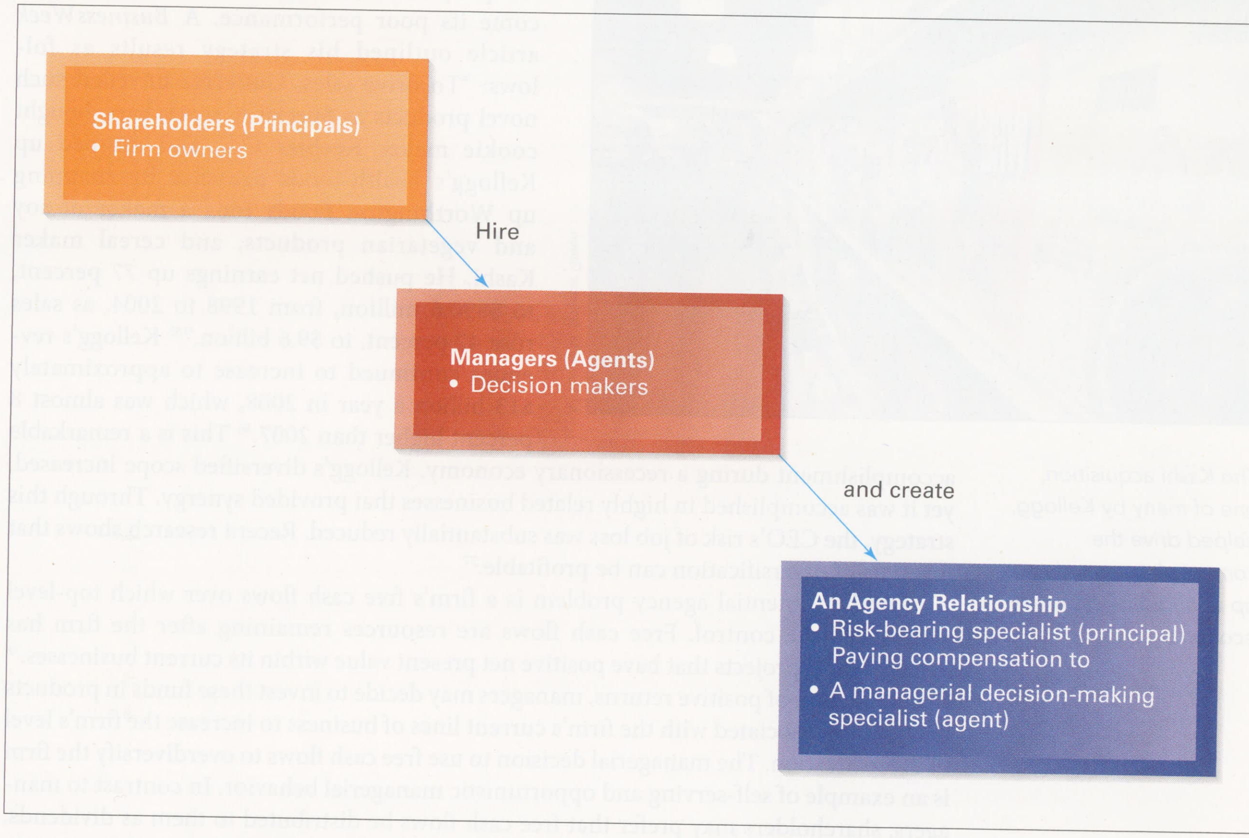
Figure 10.1 An Agency Relationship



their personal risk.[30] Decisions such as these prevent the maximization of shareholder wealth. Decisions regarding product diversification demonstrate this alternative.

Product Diversification as an Example of an Agency Problem

As explained in Chapter 6, a corporate-level strategy to diversify the firm's product lines can enhance a firm's strategic competitiveness and increase its returns, both of which serve the interests of shareholders and the top-level managers. However, product diversification can result in two benefits to managers that shareholders do not enjoy, so top level managers may prefer product diversification more than shareholders do.[31]

First, diversification usually increases the size of a firm, and size is positively related to executive compensation. Also, diversification increases the complexity of managing a firm and its network of businesses, possibly requiring more pay because of this complexity.[32] Thus, increased product diversification provides an opportunity for top-level managers to increase their compensation.[33]

Second, product diversification and the resulting diversification of the firm's portfolio of businesses can reduce top-level managers' employment risk. Managerial employment risk is the risk of job loss, loss of compensation, and loss of managerial reputation.[34] These risks are reduced with increased diversification, because a firm and its upper-level managers are less vulnerable to the reduction in demand associated with a single or limited number of product lines or businesses. For example, Kellogg Co. was almost entirely focused on breakfast cereal in 2001 when it suffered its first-ever market share leadership loss to perennial number two, General Mills, Inc. Upon appointing Carlos Gutierrez, a longtime manager at Kellogg, to the CEO position, the

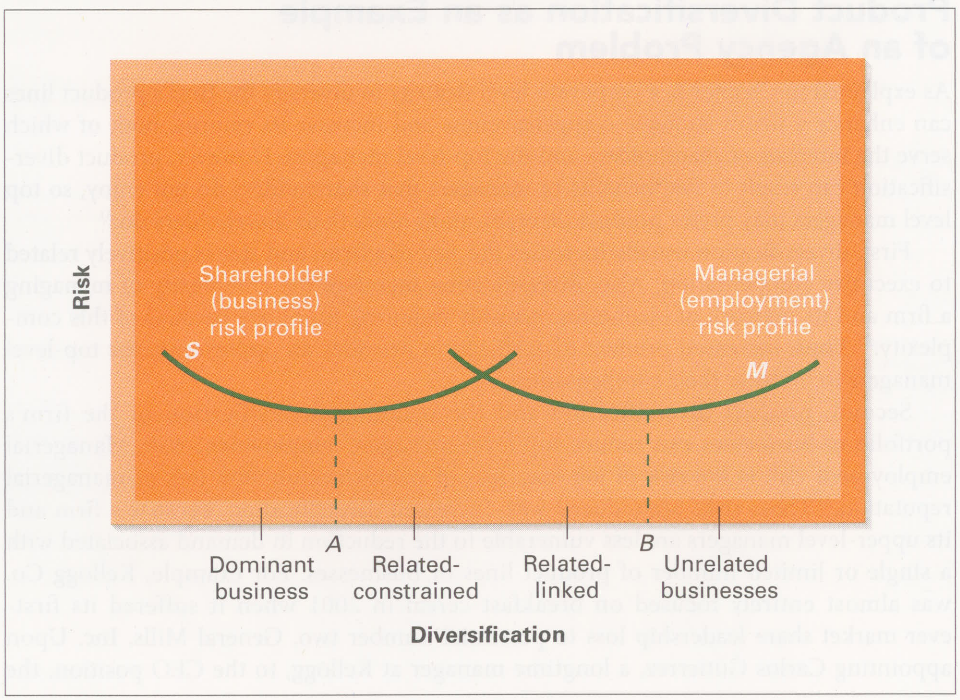
AP Photo/M. Spencer Green

The Kashi acquisition, one of many by Kellogg, helped drive the company's net earnings up during a recessionary economy.

company embarked on a new strategy to overcome its poor performance. A *BusinessWeek* article outlined his strategy results as follows: "To drive sales, Gutierrez unveiled such novel products as Special K snack bars, bought cookie maker Keebler Co., and ramped up Kellogg's health-foods presence by snapping up Worthington Foods Inc., a maker of soy and vegetarian products, and cereal maker Kashi. He pushed net earnings up 77 percent, to $890.6 million, from 1998 to 2004, as sales rose 42 percent, to $9.6 billion."[35] Kellogg's revenues continued to increase to approximately $13 billion a year in 2008, which was almost 8 percent higher than 2007.[36] This is a remarkable accomplishment during a recessionary economy. Kellogg's diversified scope increased, yet it was accomplished in highly related businesses that provided synergy. Through this strategy, the CEO's risk of job loss was substantially reduced. Recent research shows that this type of diversification can be profitable.[37]

Another potential agency problem is a firm's free cash flows over which top-level managers have control. Free cash flows are resources remaining after the firm has invested in all projects that have positive net present value within its current businesses.[38] In anticipation of positive returns, managers may decide to invest these funds in products that are not associated with the firm's current lines of business to increase the firm's level of diversification. The managerial decision to use free cash flows to overdiversify the firm is an example of self-serving and opportunistic managerial behavior. In contrast to managers, shareholders may prefer that free cash flows be distributed to them as dividends, so they can control how the cash is invested.[39]

Figure 10.2 Manager and Shareholder Risk and Diversification



Curve *S* in Figure 10.2 depicts the shareholders' optimal level of diversification. Owners seek the level of diversification that reduces the risk of the firm's total failure while simultaneously increasing the company's value through the development of economies of scale and scope (see Chapter 6). Of the four corporate-level diversification strategies shown in Figure 10.2, shareholders likely prefer the diversified position noted by point *A* on curve *S*—a position that is located between the dominant business and related-constrained diversification strategies. Of course, the optimum level of diversification owners seek varies from firm to firm.[40] Factors that affect shareholders' preferences include the firm's primary industry, the intensity of rivalry among competitors in that industry, and the top management team's experience with implementing diversification strategies and its effects on other firm strategies, such as its entry into international markets (see Chapter 8).[41]

As do principals, top level managers—as agents—also seek an optimal level of diversification. Declining performance resulting from too much product diversification increases the probability that corporate control of the firm will be acquired in the market. After a firm is acquired, the employment risk for the firm's top-level managers increases substantially. Furthermore, a manager's employment opportunities in the external managerial labor market (discussed in Chapter 12) are affected negatively by a firm's poor performance. Therefore, top level managers prefer diversification, but not to a point that it increases their employment risk and reduces their employment opportunities.[42] Curve *M* in Figure 10.2 shows that top level managers prefer higher levels of product diversification than do shareholders. Top-level managers might prefer the level of diversification shown by point *B* on curve *M*.

In general, shareholders prefer riskier strategies and more focused diversification. They reduce their risk through holding a diversified portfolio of equity investments. Alternatively, managers cannot balance their employment risk by working for a diverse portfolio of firms, and therefore, may prefer a level of diversification that maximizes firm size and their compensation while also reducing their employment risk. Product diversification, therefore, is a potential agency problem that could result in principals incurring costs to control their agents' behaviors.

Agency Costs and Governance Mechanisms

The potential conflict illustrated by Figure 10.2, coupled with the fact that principals cannot easily predict which managers might act opportunistically, demonstrates why principals establish governance mechanisms. However, the firm incurs costs when it uses one or more governance mechanisms. **Agency costs** are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent. If a firm is diversified, governance costs increase because it is more difficult to monitor what is going on inside the firm.[43]

In general, managerial interests may prevail when governance mechanisms are weak; this is exemplified in situations where managers have a significant amount of autonomy to make strategic decisions. If, however, the board of directors controls managerial autonomy, or if other strong governance mechanisms are used, the firm's strategies should better reflect the interests of the shareholders. More recently, governance observers have been concerned about more egregious behavior beyond inefficient corporate strategy.

Due to fraudulent behavior such as that found at Enron and WorldCom, concerns regarding corporate governance continue to grow. In 2002, the U.S. Congress enacted the Sarbanes-Oxley (SOX) Act, which increased the intensity of corporate governance mechanisms.[44] Furthermore, the serious problems experienced in the financial services industry are likely the result of poor governance and top-level managers making very bad strategic decisions. In fact, the bonuses paid to Merrill Lynch executives after extremely poor performance (described in the Opening Case) likely reflect managerial opportunism.

Agency costs are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent.

While the implementation of the Sarbanes-Oxley Act in 2002 has been controversial to some, most believe that the results of it have been generally positive. Section 404 of SOX, which prescribes significant transparency improvement on internal controls associated with accounting and auditing, has arguably improved the internal auditing scrutiny and thereby trust in such financial reporting. A recent study indicated that internal controls associated with Section 404 increased shareholder value.[45] However, some argue that the Act, especially Section 404, creates excessive costs for firms. In addition, a decrease in foreign firms listing on U.S. stock exchanges occurred at the same time as listing on foreign exchanges increased. In part, this shift may be due to the costs associated with listing on U.S. exchanges associated with requirements of SOX.

More intensive application of governance mechanisms may produce significant changes in strategies. For example, because of more intense governance, firms may take on fewer risky projects and thus decrease potential shareholder wealth. Next, we explain the effects of different governance mechanisms on the decisions managers make about the choice and the use of the firm's strategies.

Ownership Concentration

Both the number of large-block shareholders and the total percentage of shares they own define **ownership concentration. Large-block shareholders** typically own at least 5 percent of a corporation's issued shares. Ownership concentration as a governance mechanism has received considerable interest because large-block shareholders are increasingly active in their demands that corporations adopt effective governance mechanisms to control managerial decisions.[46]

In general, diffuse ownership (a large number of shareholders with small holdings and few, if any, large-block shareholders) produces weak monitoring of managers' decisions. For example, diffuse ownership makes it difficult for owners to effectively coordinate their actions. Diversification of the firm's product lines beyond the shareholders' optimum level can result from ineffective monitoring of managers' decisions. Higher levels of monitoring could encourage managers to avoid strategic decisions that harm shareholder value. In fact, research evidence shows that ownership concentration is associated with lower levels of firm product diversification.[47] Thus, with high degrees of ownership concentration, the probability is greater that managers' strategic decisions will be designed to maximize shareholder value.[48]

As noted, such concentration of ownership has an influence on strategies and firm value, mostly positive but perhaps not in all cases. For example, when large shareholders have a high degree of wealth, they have power relative to minority shareholders in extracting wealth from the firm, especially when they are in managerial positions. The importance of boards of directors in mitigating expropriation of minority shareholder value has been found in firms with strong family ownership wherein family members have incentive to appropriate shareholder wealth, especially in the second generation after the founder has departed.[49] Such expropriation is often found in countries such as Korea where minority shareholder rights are not as protected as they are in the United States.[50] However, in the United States much of the ownership concentration has come from increasing equity ownership by institutional investors.

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The Growing Influence of Institutional Owners

A classic work published in the 1930s argued that the "modern" corporation was characterized by a separation of ownership and control.[51] The change occurred primarily because growth prevented founders-owners from maintaining their dual positions in their increasingly complex companies. More recently, another shift has occurred: Ownership of many modern corporations is now concentrated in the hands of institutional investors rather than individual shareholders.[52]

Institutional owners are financial institutions such as stock mutual funds and pension funds that control large-block shareholder positions. Because of their prominent ownership positions, institutional owners, as large-block shareholders, are a powerful governance mechanism. Institutions of these types now own more than 60 percent of the stock in large U.S. corporations. Pension funds alone control at least one-half of corporate equity.[53]

These ownership percentages suggest that as investors, institutional owners have both the size and the incentive to discipline ineffective top-level managers and can significantly influence a firm's choice of strategies and overall strategic decisions.[54] Research evidence indicates that institutional and other large-block shareholders are becoming more active in their efforts to influence a corporation's strategic decisions, unless they have a business relationship with the firm. Initially, these shareholder activists and institutional investors concentrated on the performance and accountability of CEOs and contributed to the dismissal of a number of them. They often target the actions of boards more directly via proxy vote proposals that are intended to give shareholders more decision rights because they believe board processes have been ineffective.[55] In fact, a new rule recently proposed and approved by the U.S. Securities and Exchange Commission allows large shareholders (owning 1 to 5 percent of a company's stock) to nominate up to 25 percent of a company's board of directors.[56]

For example, CalPERS provides retirement and health coverage to more than 1.3 million current and retired public employees. At the end of 2008, it was the largest public employee pension fund in the United States, but the economic crisis caused its total assets to decrease by approximately 30 percent.[57] Still, CalPERS is respected and even feared in some companies' boardrooms. It is generally thought to act aggressively to promote governance decisions and actions that it believes will enhance shareholder value in companies in which it invests. For instance, CalPERS places five or so companies on its "Focus List" each year. This type of public acknowledgement may influence the board of directors and top-level managers to take action, which in turn often increases the firm's shareholder value. For example, the CalPERS focus list for 2009 had four firms on it led by Eli Lilly.[58] The largest institutional investor, TIAA-CREF, has taken actions similar to those of CalPERS, but with a less publicly aggressive stance. To date, research suggests that institutional activism may not have a strong effect on firm performance, but that its influence may be indirect through its effects on important strategic decisions, such as those concerned with international diversification and innovation.[59] With the increased intensity of governance associated with the passage of the SOX Act and the latest economic crisis largely created by poor strategic decisions in the financial services industry, institutional investors and other groups have been emboldened in their activism.

Board of Directors

Typically, shareholders monitor the managerial decisions and actions of a firm through the board of directors. Shareholders elect members to their firm's board. Those who are elected are expected to oversee managers and to ensure that the corporation is operated in ways that will maximize its shareholders' wealth. Even with large institutional investors having major equity ownership in U.S. firms, diffuse ownership continues to exist in most firms, which means that in large corporations, monitoring and control of managers by individual shareholders is limited. Furthermore, large financial institutions, such as banks, are prevented from directly owning stock in firms and from having representatives on companies' boards of directors, although this restriction is not the case in Europe and elsewhere.[60] These conditions highlight the importance of the board of directors for corporate governance. Unfortunately, over time, boards of directors have not been highly effective in monitoring and controlling top management's actions.[61]

Institutional owners are financial institutions such as stock mutual funds and pension funds that control large-block shareholder positions.

Given the recent problems with top-level managers making less than ethical decisions, boards are experiencing increasing pressure from shareholders, lawmakers, and regulators to become more forceful in their oversight role to prevent inappropriate actions by top-level managers. Furthermore, boards not only serve a monitoring role, but they also provide resources to firms. These resources include their personal knowledge and expertise as well as their access to resources of other firms through their external contacts and relationships.[62]

The **board of directors** is a group of elected individuals whose primary responsibility is to act in the owners' best interests by formally monitoring and controlling the corporation's top-level managers.[63] Boards have the power to direct the affairs of the organization, punish and reward managers, and protect shareholders' rights and interests. Thus, an appropriately structured and effective board of directors protects owners from managerial opportunism such as that found at Enron and WorldCom and at financial services firms including AIG and Merrill Lynch, where shareholders and employees encountered significant losses. Board members are seen as stewards of their company's resources, and the way they carry out these responsibilities affects the society in which their firm operates. For instance, research suggests that better governance produces more effective strategic decisions, which lead to higher firm performance.[64]

Generally, board members (often called directors) are classified into one of three groups (see Table 10.1). *Insiders* are active top-level managers in the corporation who are elected to the board because they are a source of information about the firm's day-to-day operations.[65] *Related outsiders* have some relationship with the firm, contractual or otherwise, that may create questions about their independence, but these individuals are not involved with the corporation's day-to-day activities. *Outsiders* provide independent counsel to the firm and may hold top-level managerial positions in other companies or may have been elected to the board prior to the beginning of the current CEO's tenure.[66]

Historically, boards of directors were primarily dominated by inside managers. A widely accepted view is that a board with a significant percentage of its membership from the firm's top-level managers provides relatively weak monitoring and control of managerial decisions.[67] Managers have sometimes used their power to select and compensate directors and exploit their personal ties with them. In response to the SEC's proposal to require audit committees to be composed of outside directors, in 1984, the New York Stock Exchange implemented a rule requiring outside directors to head the audit committee. Subsequently, other rules required important committees such as the compensation committee and the nomination committee to be headed by independent outside directors.[68] These other requirements were instituted after the Sarbanes-Oxley Act was passed, and policies of the New York Stock Exchange now require companies to maintain boards of directors that are composed of a majority of outside independent directors and to maintain full independent audit committees. Thus, corporate governance is becoming more intense especially with the oversight of the board of directors.

Table 10.1 Classifications of Board of Director Members

Insiders
• The firm's CEO and other top-level managers
Related outsiders
• Individuals not involved with the firm's day-to-day operations, but who have a relationship with the company
Outsiders
• Individuals who are independent of the firm in terms of day-to-day operations and other relationships

The **board of directors** is a group of elected individuals whose primary responsibility is to act in the owners' interests by formally monitoring and controlling the corporation's top-level managers.

Critics advocate reforms to ensure that independent outside directors represent a significant majority of the total membership of a board, which research suggests has been accomplished.[69] On the other hand, others argue that having outside directors is not enough to resolve the problems; it depends on the power of the CEO. One proposal to reduce the power of the CEO is to separate the chairperson's role and the CEO's role on the board so that the same person does not hold both positions.[70] Yet, having a board that actively monitors top executive decisions and actions does not ensure high performance. The value that the directors bring to the company also influences the outcomes. For example, boards with members having significant relevant experience and knowledge are the most likely to help the firm formulate effective strategies and to implement them successfully.[71]

Alternatively, having a large number of outside board members can also create some problems. Outsiders do not have contact with the firm's day-to-day operations and typically do not have easy access to the level of information about managers and their skills that is required to effectively evaluate managerial decisions and initiatives.[72] Outsiders can, however, obtain valuable information through frequent interactions with inside board members, during board meetings, and otherwise. Insiders possess such information by virtue of their organizational positions. Thus, boards with a critical mass of insiders typically are better informed about intended strategic initiatives, the reasons for the initiatives, and the outcomes expected from them.[73] Without this type of information, outsider-dominated boards may emphasize the use of financial, as opposed to strategic, controls to gather performance information to evaluate managers' and business units' performances. A virtually exclusive reliance on financial evaluations shifts risk to top-level managers, who, in turn, may make decisions to maximize their interests and reduce their employment risk. Reductions in R&D investments, additional diversification of the firm, and the pursuit of greater levels of compensation are some of the results of managers' actions to achieve financial goals set by outsider-dominated boards.[74] Additionally, boards can make mistakes in CEO succession decisions because of the lack of important information about candidates as well as specific needs of the firm. As you would expect, knowledgeable and balanced boards are likely to be the most effective over time.[75]

Enhancing the Effectiveness of the Board of Directors

As explained in the Strategic Focus, because of the importance of boards of directors in corporate governance and as a result of increased scrutiny from shareholders—in particular, large institutional investors—the performances of individual board members and of entire boards are being evaluated more formally and with greater intensity.[76] Given the demand for greater accountability and improved performance, many boards have initiated voluntary changes (e.g., those described at Borders and EasyJet). Among these changes are (1) increases in the diversity of the backgrounds of board members (e.g., a greater number of directors from public service, academic, and scientific settings; a greater percentage of ethnic minorities and women; and members from different countries on boards of U.S. firms), (2) the strengthening of internal management and accounting control systems, and (3) the establishment and consistent use of formal processes to evaluate the board's performance.[77] Additional changes include (4) the creation of a "lead director" role that has strong powers with regard to the board agenda and oversight of non-management board member activities, and (5) modification of the compensation of directors, especially reducing or eliminating stock options as a part of the package.

Boards are increasingly involved in the strategic decision-making process, so they must work collaboratively. Some argue that improving the processes used by boards to make decisions and monitor managers and firm outcomes is important for board effectiveness.[78] Moreover, because of the increased pressure from owners and the potential

STRATEGIC FOCUS

WHERE HAVE ALL THE GOOD DIRECTORS GONE?

The global economic crisis, largely the result of extremely poor strategic decisions made by top-level managers in the financial services industry, laid bare the holes in the U.S. corporate governance system. In particular, the crisis showed that many boards of directors were very weak. In the early 2000s, boards of directors suffered significant criticism for the failures in monitoring executive actions at Enron, Tyco, WorldCom, and other companies. With more recent failures, boards are now experiencing substantial public animosity. Many people do not understand how top-level managers were allowed to take the extreme risks that have melted away corporate value when the debt became too heavy for most of the firms.

The weakness of corporate boards is exemplified by the fact that the President of the United States had to fire a highly ineffective CEO because the board of General Motors had failed to act in recent years.

As a result of the economic meltdown, the obviously poor strategic decisions leading to it, and the inability of previous boards to prevent the problems, many boards are now changing. Old board members are resigning or being replaced and many new members are joining boards. For example, in 2009, Citigroup, one of the major contributors to the problems in the financial services industry, nominated four new independent directors. Boardroom shakeups are also occurring outside of the financial services industry. For example, EasyJet announced that it had appointed a new chairman of its board to replace the current chairman, Colin Chandler. The new chairman, Michael Rake, formerly headed the BT Group.

William Thomas Cain/Getty Image News/Getty Images

Rick Wagoner is the former CEO of GM, who was asked to resign by President Obama.

In an industry challenged by technology developments and the recession, Borders has suffered the most. Its poor financial results are the outcome of its inability to keep pace. Thus, in 2009, Borders made major changes in the top management team and announced that seven of its ten directors were departing. Only five of them will be replaced, thereby shrinking the number of members on the board to eight. The former executive team and board tried unsuccessfully to sell the firm. The new team will focus on restructuring the firm.

Interestingly, research suggests that smaller boards are more effective in governing companies than are larger boards. Thus, Borders' decision to downsize its board may be a good one. Changes are being made in the processes used by many boards in order to improve their monitoring function. These changes extend to the balance of independent and inside members, renewed emphasis on audit and compensation committees, and ensuring that outside board members spend an adequate amount of time on board business so that they can make informed decisions. Furthermore, there are other moves afoot to change the governance practices in firms. These include new rules and a renewed scrutiny by the U.S. Securities and Exchange Commission and other governmental agencies. In addition, the chairman of the Financial Reporting Council in the United Kingdom announced a complete review of the Combined Code, a template of corporate governance used by investors and listed companies. In fact, the code is commonly used by institutional investors to evaluate the boards of companies. In addition, the Institute of Company Secretaries announced plans to strengthen the norms for corporate governance practices in India.

Sources: J. A. Trachtenberg, 2009, Borders plans to install new board, *Wall Street Journal*, http://www.wsj.com, April 16; K. Shwiff, 2009, Egan-Jones urges vote against Citi directors, *Wall Street Journal*, http://www.wsj.com, April 13; J. Espinoza, 2009, EasyJet shakes up boardroom, *Forbes*, http://www.forbes.com, April 6; 2009, ICSI plans governance norms, *Business Standard*, http://www.business-standard.com, April 5; D. Serchuk, 2009, Where are Wall Street's directors? *Forbes*, http://www.forbes.com, March 31; M. Costello, 2009, New boardroom code to "draw on lessons" from bank crisis, *The Times*, http://www.business.timesonline.co.uk, March 18; 2009, Directors under fire, *Stuff*, http://www.stuff.co.nz, March 10.

conflict among board members, procedures are necessary to help boards function effectively in facilitating the strategic decision-making process.

Increasingly, outside directors are being required to own significant equity stakes as a prerequisite to holding a board seat. In fact, some research suggests that firms perform better if outside directors have such a stake; the trend is toward higher pay for directors with more stock ownership, but with fewer stock options.[79] However, other research suggests that too much ownership can lead to lower independence for board members.[80] In addition, other research suggests that diverse boards help firms make more effective strategic decisions and perform better over time.[81] Although questions remain about whether more independent and diverse boards enhance board effectiveness, the trends for greater independence and increasing diversity among board members are likely to continue. Clearly, the corporate failures in the first decade of the 21st century suggest the need for more effective boards.

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Executive Compensation

As the Opening Case illustrates, the compensation of top-level managers, and especially of CEOs, generates a great deal of interest and strongly held opinions. One reason for this widespread interest can be traced to a natural curiosity about extremes and excesses. For example, the *Los Angeles Times* reported that "CEO compensation tripled from 1990 to 2004, rising at more than three times the rate of corporate earnings. CEOs at 11 of the largest U.S. companies received $865 million in a five-year period while presiding over losses in shareholder value."[82] As stated in the Opening Case, the ten highest-paid executives in 2008, during a strong recession, earned an average of $47.22 million. Some consider this excessive pay, especially for those whose firms suffered net losses during this year, because most firms lost market value in 2008. Another stems from a more substantive view that CEO pay is tied in an indirect but tangible way to the fundamental governance processes in large corporations. Some believe that while highly paid, CEOs are not overpaid.[83] Others argue that not only are they highly paid, they are overpaid. These critics are especially concerned that compensation is not as strongly related to performance as some believe.[84]

Executive compensation is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long-term incentive compensation, such as stock awards and options.[85] Long-term incentive plans have become a critical part of compensation packages in U.S. firms. The use of longer-term pay theoretically helps firms cope with or avoid potential agency problems by linking managerial wealth to the wealth of common shareholders.[86]

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Sometimes the use of a long-term incentive plan prevents major stockholders (e.g., institutional investors) from pressing for changes in the composition of the board of directors, because they assume the long-term incentives will ensure that top executives will act in shareholders' best interests. Alternatively, stockholders largely assume that top-executive pay and the performance of a firm are more closely aligned when firms have boards that are dominated by outside members. However, research shows that fraudulent behavior can be associated with stock option incentives, such as earnings manipulation.[87]

Effectively using executive compensation as a governance mechanism is particularly challenging to firms implementing international strategies. For example, the interests of owners of multinational corporations may be best served by less uniformity among the firm's foreign subsidiaries' compensation plans.[88] Developing an array of unique compensation plans requires additional monitoring and increases the firm's potential agency costs. Importantly, levels of pay vary by regions of the world. For example, managerial pay is highest in the United States and much lower in Asia. Compensation is lower in India partly because many of the largest firms have strong family ownership and control.[89] As corporations acquire firms in other countries, the managerial compensation puzzle for boards becomes more complex and may cause additional governance problems.[90]

The Effectiveness of Executive Compensation

Executive compensation—especially long-term incentive compensation—is complicated for several reasons. First, the strategic decisions made by top-level managers are typically complex and nonroutine, so direct supervision of executives is inappropriate for judging the quality of their decisions. The result is a tendency to link the compensation of top-level managers to measurable outcomes, such as the firm's financial performance. Second, an executive's decision often affects a firm's financial outcomes over an extended period, making it difficult to assess the effect of current decisions on the corporation's performance. In fact, strategic decisions are more likely to have long-term, rather than short-term, effects on a company's strategic outcomes. Third, a number of other factors affect a firm's performance besides top-level managerial decisions and behavior. Unpredictable economic, social, or legal changes (see Chapter 2) make it difficult to identify the effects of strategic decisions. Thus, although performance-based compensation may provide incentives to top management teams to make decisions that best serve shareholders' interests, such compensation plans alone cannot fully control managers. Still, incentive compensation represents a significant portion of many executives' total pay.

Although incentive compensation plans may increase the value of a firm in line with shareholder expectations, such plans are subject to managerial manipulation.[91] Additionally, annual bonuses may provide incentives to pursue short-run objectives at the expense of the firm's long-term interests. Although long-term, performance-based incentives may reduce the temptation to under-invest in the short run, they increase executive exposure to risks associated with uncontrollable events, such as market fluctuations and industry decline. The longer term the focus of incentive compensation, the greater are the long-term risks borne by top-level managers. Also, because long-term incentives tie a manager's overall wealth to the firm in a way that is inflexible, such incentives and ownership may not be valued as highly by a manager as by outside investors who have the opportunity to diversify their wealth in a number of other financial investments.[92] Thus, firms may have to overcompensate for managers using long-term incentives.

Even though some stock option–based compensation plans are well designed with option strike prices substantially higher than current stock prices, some have been designed with the primary purpose of giving executives more compensation. Research of stock option repricing where the strike price value of the option has been lowered from its original position suggests that action is taken more frequently in high-risk situations.[93] However, repricing also happens when firm performance is poor, to restore the incentive effect for the option. Evidence also suggests that politics are often involved, which has resulted in "option backdating."[94] While this evidence shows that no internal governance mechanism is perfect, some compensation plans accomplish their purpose. For example, recent research suggests that long-term pay designed to encourage managers to be environmentally friendly has been linked to higher success in preventing pollution.[95]

Stock options became highly popular as a means of compensating top executives and linking pay with performance, but they also have become controversial of late as indicated in the Opening Case. Because all internal governance mechanisms are imperfect, external mechanisms are also needed. One such governance device is the market for corporate control.

Market for Corporate Control

The **market for corporate control** is an external governance mechanism that becomes active when a firm's internal controls fail.[96] The market for corporate control is composed of individuals and firms that buy ownership positions in or take over potentially undervalued corporations so they can form new divisions in established diversified companies or merge two previously separate firms. Because the undervalued firm's top-level managers are assumed to be responsible for formulating and implementing the strategy that led to poor performance, they are usually replaced. Thus, when the market for corporate control operates effectively, it ensures that managers who are ineffective or act opportunistically are disciplined.[97]

The takeover market as a source of external discipline is used only when internal governance mechanisms are relatively weak and have proven to be ineffective. Alternatively, other research suggests that the rationale for takeovers as a corporate governance strategy is not as strong as the rationale for takeovers as an ownership investment in target candidates where the firm is performing well and does not need discipline.[98] A study of active corporate raiders in the 1980s showed that takeover attempts often were focused on above-average performance firms in an industry.[99] Taken together, this research suggests that takeover targets are not always low performers with weak governance. As such, the market for corporate control may not be as efficient as a governance device as theory suggests.[100] At the very least, internal governance controls are much more precise relative to this external control mechanism.

Hedge funds have become a source of activist investors as noted in Chapter 7. An enormous amount of money has been invested in hedge funds, and because it is significantly more difficult to gain high returns in the market, hedge funds turned to activism. Likewise in a competitive environment characterized by a greater willingness on part of investors to hold underperforming managers accountable, hedge funds have been given license for increased activity.[101] Traditionally, hedge funds are a portfolio of stocks or bonds, or both, managed by an individual or a team on behalf of a large number of investors. Activism allows them to influence the market by taking a large position in seeking to drive the stock price up in a short period of time and then sell. Most hedge funds have been unregulated relative to the Securities and Exchange Commission because they represent a set of private investors. However, the recent economic crisis has increased the scrutiny of hedge funds' actions by government regulatory bodies.

Although the market for corporate control may be a blunt instrument for corporate governance, the takeover market continues to be active even in the economic crisis. In fact, the more intense governance environment has fostered an increasingly active takeover market. Certainly, the government has played a highly active role in the acquisitions of major U.S. financial institutions (e.g., Merrill Lynch's acquisition by Bank of America). Target firms earn a substantial premium over the acquiring firm.[102] At the same time, managers who have ownership positions or stock options are likely to gain in making a transaction with an acquiring firm. Even more evidence indicates that this type of gain may be the case, given the increasing number of firms that have golden parachutes that allow up to three years of additional compensation plus other incentives if a firm is taken over. These compensation contracts reduce the risk for managers if a firm is taken over. Private equity firms often seek to obtain a lower price in the market through initiating friendly takeover deals. The target firm's top-level managers may be amenable to such

The **market for corporate control** is an external governance mechanism that becomes active when a firm's internal controls fail.

"friendly" deals because not only do they get the payout through a golden parachute, but at their next firm they may get a "golden hello" as a signing bonus to work for the new firm.[103] Golden parachutes help them leave, but "golden hellos are increasingly needed to get them in the door" of the next firm.[104] Although the 1980s had more defenses put up against hostile takeovers, the more recent environment has been much friendlier. However, the recent economic crisis has led to significant criticism of golden parachutes, especially for executives of poorly performing firms. For example, there was significant criticism of the large bonuses paid to Merrill Lynch managers after the acquisition by Bank of America. This is because of the huge loss suffered by Merrill Lynch because of poor strategic decisions executed by these managers. Furthermore, there were issues with AIG, which received billions of dollars in government support to stay afloat yet paid huge managerial bonuses. As a result of the criticism, the firm cancelled its $10 million golden parachute for its departing CFO, Steven Bensinger.[105]

The market for corporate control governance mechanisms should be triggered by a firm's poor performance relative to industry competitors. A firm's poor performance, often demonstrated by the firm's below-average returns, is an indicator that internal governance mechanisms have failed; that is, their use did not result in managerial decisions that maximized shareholder value. Yet, although these acquisitions often involve highly underperforming firms and the changes needed may appear obvious, there are no guarantees of success. The acquired firm's assets still must be integrated effectively into the acquiring firm's operation to earn positive returns from the takeover. Also, integration is an exceedingly complex challenge.[106] Even active acquirers often fail to earn positive returns from some of their acquisitions, but some acquirers are successful and earn significant returns from the assets they acquire.[107]

Target firm managers and members of the boards of directors are commonly sensitive about hostile takeover bids. It frequently means that they have not done an effective job in managing the company. If they accept the offer, they are likely to lose their jobs; the acquiring firm will insert its own management. If they reject the offer and fend off the takeover attempt, they must improve the performance of the firm or risk losing their jobs as well.[108]

Merrill Lynch's acquisition by Bank of America has not been without controversy, including the awarding of large bonuses to Merrill Lynch managers after the acquisition despite enormous losses.

Managerial Defense Tactics

Hostile takeovers are the major activity in the market for corporate control governance mechanism. Not all hostile takeovers are prompted by poorly performing targets, and firms targeted for hostile takeovers may use multiple defense tactics to fend off the takeover attempt. Historically, the increased use of the market for corporate control has enhanced the sophistication and variety of managerial defense tactics that are used in takeovers. The market for corporate control tends to increase risk for managers. As a result, managerial pay is often augmented indirectly through golden parachutes (wherein, a CEO can receive up to three years' salary if his or her firm is taken over). Golden parachutes, similar to most other defense tactics, are controversial.

James Leynse/Documentary Value/CORBIS

Among other outcomes, takeover defenses increase the costs of mounting a takeover, causing the incumbent management to become entrenched while reducing the chances of introducing a new management team.[109] One takeover defense is traditionally known as a "poison pill." This defense mechanism usually allows shareholders (other than the acquirer) to convert "shareholders' rights" into a large number of common shares if anyone acquires more than a set amount of the target's stock (typically 10 to 20 percent). This move dilutes the percentage of shares that the acquiring firm must purchase at a premium and in effect raises the cost of the deal for the acquiring firm.

Table 10.2 lists a number of additional takeover defense strategies. Some defense tactics necessitate only changes in the financial structure of the firm, such as repurchasing shares of the firm's outstanding stock.[110] Some tactics (e.g., reincorporation of the firm in another state) require shareholder approval, but the greenmail tactic, wherein money is used to repurchase stock from a corporate raider to avoid the takeover of the firm, does not. Some firms use rotating board member elections as a defense tactic where only one third of members are up for reelection each year. Research shows that this results in managerial entrenchment and reduced vulnerability to hostile takeovers.[111]

Most institutional investors oppose the use of defense tactics. TIAA-CREF and CalPERS have taken actions to have several firms' poison pills eliminated. Many institutional investors also oppose severance packages (golden parachutes), and the opposition is growing significantly in Europe as well.[112] However, as previously noted, an advantage to severance packages is that they may encourage top level managers to accept takeover bids that are attractive to shareholders.[113] Alternatively, recent research has shown that the use of takeover defenses reduces pressure experienced by managers for short-term performance gains. As such, managers engage in longer-term strategies and pay more

Table 10.2 Hostile Takeover Defense Strategies

Defense strategy	Category	Popularity among firms	Effectiveness as a defense	Stockholder wealth effects
Poison pill Preferred stock in the merged firm offered to shareholders at a highly attractive rate of exchange.	Preventive	High	High	Positive
Corporate charter amendment An amendment to stagger the elections of members to the board of directors of the attacked firm so that all are not elected during the same year, which prevents a bidder from installing a completely new board in the same year.	Preventive	Medium	Very low	Negative
Golden parachute Lump-sum payments of cash that are distributed to a select group of senior executives when the firm is acquired in a takeover bid.	Preventive	Medium	Low	Negligible
Litigation Lawsuits that help a target company stall hostile attacks; areas may include antitrust, fraud, inadequate disclosure.	Reactive	Medium	Low	Positive
Greenmail The repurchase of shares of stock that have been acquired by the aggressor at a premium in exchange for an agreement that the aggressor will no longer target the company for takeover.	Reactive	Very low	Medium	Negative
Standstill agreement Contract between the parties in which the pursuer agrees not to acquire any more stock of the target firm for a specified period of time in exchange for the firm paying the pursuer a fee.	Reactive	Low	Low	Negative
Capital structure change Dilution of stock, making it more costly for a bidder to acquire; may include employee stock option plans (ESOPs), recapitalization, new debt, stock selling, share buybacks.	Reactive	Medium	Medium	Inconclusive

Source: J. A. Pearce II & R. B. Robinson, Jr., 2004, Hostile takeover defenses that maximize shareholder wealth, *Business Horizons*, 47(5): 15–24.

attention to the firm's stakeholders. When they do this, the firm's market value increases, which rewards the shareholders.[114]

A potential problem with the market for corporate control is that it may not be totally efficient. A study of several of the most active corporate raiders in the 1980s showed that approximately 50 percent of their takeover attempts targeted firms with above-average performance in their industry—corporations that were neither undervalued nor poorly managed.[115] The targeting of high-performance businesses may lead to acquisitions at premium prices and to decisions by managers of the targeted firm to establish what may prove to be costly takeover defense tactics to protect their corporate positions.[116]

Although the market for corporate control lacks the precision of internal governance mechanisms, the fear of acquisition and influence by corporate raiders is an effective constraint on the managerial-growth motive. The market for corporate control has been responsible for significant changes in many firms' strategies and, when used appropriately, has served shareholders' interests. But this market and other means of corporate governance vary by region of the world and by country. Accordingly, we next address the topic of international corporate governance.

International Corporate Governance

Understanding the corporate governance structure of the United Kingdom and the United States is inadequate for a multinational firm in the current global economy.[117] The stability associated with German and Japanese governance structures has historically been viewed as an asset, but the governance systems in these countries are changing, similar to other parts of the world. The importance of these changes has been heightened by the global economic crisis.[118] These changes are partly the result of multinational firms operating in many different countries and attempting to develop a more global governance system.[119] Although the similarity among national governance systems is increasing, significant differences remain evident, and firms employing an international strategy must understand these differences in order to operate effectively in different international markets.[120]

Corporate Governance in Germany and Japan

In many private German firms, the owner and manager may still be the same individual. In these instances, agency problems are not present.[121] Even in publicly traded German corporations, a single shareholder is often dominant. Thus, the concentration of ownership is an important means of corporate governance in Germany, as it is in the United States.[122]

Historically, banks occupied the center of the German corporate governance structure, as is also the case in many other European countries, such as Italy and France. As lenders, banks become major shareholders when companies they financed earlier seek funding on the stock market or default on loans. Although the stakes are usually less than 10 percent, banks can hold a single ownership position up to but not exceeding 15 percent of the bank's capital. Shareholders can tell the banks how to vote their ownership position, they generally do not do so. The banks monitor and control managers, both as lenders and as shareholders, by electing representatives to supervisory boards.

German firms with more than 2,000 employees are required to have a two-tiered board structure that places the responsibility for monitoring and controlling managerial (or supervisory) decisions and actions in the hands of a separate group.[123] All the functions of strategy and management are the responsibility of the management board (the Vorstand), but appointment to the Vorstand is the responsibility of the supervisory tier (the Aufsichtsrat). Employees, union members, and shareholders appoint members to the Aufsichtsrat. Proponents of the German structure suggest that it helps prevent corporate wrongdoing and rash decisions by "dictatorial CEOs." However, critics maintain that it slows decision making and often ties a CEO's hands. The corporate governance framework in Germany has made it difficult to restructure companies as quickly as can be done in the United States when performance suffers. Because of the role of local government (through the board structure) and the power of banks in Germany's corporate governance structure, private shareholders rarely have major ownership positions in German firms. Large institutional investors, such as pension funds and insurance companies, are also relatively insignificant owners of corporate stock. Thus, at least historically, German executives generally have not been dedicated to the maximization of shareholder value that occurs in many countries.[124]

However, corporate governance in Germany is changing, at least partially, because of the increasing globalization of business. Many German firms are beginning to gravitate toward the U.S. system. Recent research suggests that the traditional system produced some agency costs because of a lack of external ownership power. Interestingly, German firms with listings on the U.S. stock exchange have increasingly adopted executive stock option compensation as a long-term incentive pay policy.[125]

Attitudes toward corporate governance in Japan are affected by the concepts of obligation, family, and consensus.[126] In Japan, an obligation "may be to return a service for one rendered or it may derive from a more general relationship, for example, to one's family or old alumni, or one's company (or Ministry), or the country. This sense of particular obligation is common elsewhere but it feels stronger in Japan."[127] As part of a company family, individuals are members of a unit that envelops their lives; families command the attention and allegiance of parties throughout corporations. Moreover, a *keiretsu* (a group of firms tied together by cross-shareholdings) is more than an economic concept; it, too, is a family. Consensus, an important influence in Japanese corporate governance, calls for the expenditure of significant amounts of energy to win the hearts and minds of people whenever possible, as opposed to top executives issuing edicts.[128] Consensus is highly valued, even when it results in a slow and cumbersome decision-making process.

As in Germany, banks in Japan play an important role in financing and monitoring large public firms.[129] The bank owning the largest share of stocks and the largest amount of debt—the main bank—has the closest relationship with the company's top executives. The main bank provides financial advice to the firm and also closely monitors managers. Thus, Japan has a bank-based financial and corporate governance structure, whereas the United States has a market-based financial and governance structure.[130]

Aside from lending money, a Japanese bank can hold up to 5 percent of a firm's total stock; a group of related financial institutions can hold up to 40 percent. In many cases, main-bank relationships are part of a horizontal keiretsu. A keiretsu firm usually owns less than 2 percent of any other member firm; however, each company typically has a stake of that size in every firm in the keiretsu. As a result, somewhere between 30 and 90 percent of a firm is owned by other members of the keiretsu. Thus, a keiretsu is a system of relationship investments.

As is the case in Germany, Japan's structure of corporate governance is changing. For example, because of Japanese banks' continuing development as economic organizations, their role in the monitoring and control of managerial behavior and firm outcomes is less significant than in the past.[131] Also, deregulation in the financial sector reduced the cost of mounting hostile takeovers.[132] As such, deregulation facilitated more activity in Japan's market for corporate control, which was nonexistent in past years.[133] Interestingly, however, recent research shows that CEOs of both public and private companies in Japan receive similar levels of compensation and their compensation is tied closely to observable performance goals.[134]

Corporate Governance in China

Corporate governance in China has changed dramatically in the past decade, as has the privatization of business and the development of the equity market. The stock markets in China are young. In their early years, these markets were weak because of significant insider trading. However, research has shown that they have improved with stronger governance in recent years.[135] The Chinese institutional environment is unique. While there has been a gradual decline in the equity held in state-owned enterprises and the number and percentage of private firms have grown, the state still dominates the strategies employed by most firms through direct or indirect controls.

Recent research shows that firms with higher state ownership tend to have lower market value and more volatility in those values over time. This is because of agency conflicts in the firms and because the executives do not seek to maximize shareholder returns. They also have social goals they must meet placed on them by the government.[136] This suggests a potential conflict between the principals, particularly the state owner and the private equity owners of the state-owned enterprises.[137]

The Chinese governance system has been moving toward the Western model in recent years. For example, China YCT International recently announced that it was strengthening its corporate governance, with the establishment of an audit committee within its board of directors, and appointing three new independent directors.[138] In addition, recent research shows that the compensation of top executives of Chinese companies is closely related to prior and current financial performance of the firm.[139] While state ownership and indirect controls complicate governance in Chinese companies, research in other countries suggests that some state ownership in recently privatized firms provides some benefits. It signals support and temporarily buoys stock prices, but over time continued state ownership and involvement tend to have negative effects on the stock price.[140] Thus, the corporate governance system in China and the heavy oversight of the Chinese government will need to be observed to determine the long-term effects.

Global Corporate Governance

As noted in the Strategic Focus, corporate governance is becoming an increasingly important issue in economies around the world, even in emerging economies. The problems with Satyam in India could be repeated in other parts of the world if diligence in governance is not exercised. This concern is stronger because of the globalization in trade, investments, and equity markets. Countries and major companies based in them want to attract foreign investment. To do so, the foreign investors must be confident of adequate corporate governance. Effective corporate governance is also required to attract domestic investors. Although many times domestic shareholders will vote with management, as activist foreign investors enter a country it gives domestic institutional investors the courage to become more active in shareholder proposals, which will increase shareholder welfare.

For example, Steel Partners, LLC, focused its attention on Korean cigarette maker KT&G. Warren Lichtenstein of Steel Partners and Carl Icahn pressured KT&G to increase its market value. Lichtenstein and Icahn began their activism in February 2006, by nominating a slate of board directors as well as pushing KT&G to sell off its lucrative Ginseng unit, which manufactures popular herbal products in Korea. They also demanded that the company sell off its real estate assets, raise its dividends, and buy back common shares. Lichtenstein and Icahn threatened a hostile tender offer if their demands were not met. Shareholders showed support for Steel Partners' activism such that they elected Lichtenstein to KT&G's board. In 2008, Lichtenstein resigned from the board with the election of four new independent directors. During his service on the board, KT&G's market value increased and its corporate governance improved.[141] Steel Partners recently targeted Aderans Holdings Company Limited in Japan for major changes. Steel Partners is Aderans's largest shareholder with about 27 percent of the outstanding stock. Steel Partners is unhappy with Aderans's efforts to turnaround its performance and has proposed replacing most of its board members and undergoing

STRATEGIC FOCUS

THE SATYAM TRUTH: CEO FRAUD AND CORPORATE GOVERNANCE FAILURE

In 2008, Satyam was India's fourth largest IT company with clients around the world. The firm provided IT services to more than one third of the *Fortune 500* companies. The company and its founder and CEO, Ramalinga Raju, were well known and respected. In September 2008, Raju was named the Ernst & Young Entrepreneur of the Year. On December 16, 2008, he was given the Golden Peacock Award for Corporate Governance and Compliance. But then his term as CEO started to unravel.

On December 17, 2008, Raju announced plans to acquire two companies, Maytas Infra and Maytas Properties, both owned by members of his family. The rationale was to diversify Satyam's business portfolio to avoid being so tied to the IT services market. However, the stockholders strongly protested these acquisitions. They believed that only Raju and his family would benefit from the acquisition but Satyam would not.

On December 23, 2008, the World Bank announced that Satyam was barred from doing business with the bank because of alleged malpractices in securing previous contracts (e.g., paying bribes). In turn, Satyam requested an apology from the World Bank. Shortly thereafter, the price of Satyam's stock declined to a four-year low. Then, on December 26 three major outside directors resigned from Satyam's board of directors.

Worst of all, on January 7, 2009, Raju sent a letter to the Satyam board of directors and India's Securities and Exchange Commission. In this letter, he admitted his involvement in overstating the amount of cash held by Satyam on its balance sheet. The overstatement was approximately $1 billion. Furthermore, Satyam had a liability for $253 million arranged for his personal use, and he overstated Satyam's September 2008 quarterly revenues by 76% and its quarterly profits by 97%. This announcement sent shockwaves through corporate India and through India's stock market. Not only did Satyam's stock price suffer greatly (78% decline) but the overall market decreased by 7.3% on the day of the announcement.

AP Photo/Mahesh Kumar A

Ramalinga Raju, Satyam's chairman quit after admitting the company's profits had been doctored for several years, shaking faith in the country's corporate giants as shares of the software services provider plunged nearly 80 percent.

Sadly, Satyam means "truth" in Sanskrit. While the CEO has been arrested and charged, others are working hard to save the company—and it appears that Satyam will be saved. Tech Malindra outbid two other firms to acquire an eventual 51% of Satyam and thus will have controlling interest in the company. The sale was due partly to swift government intervention to arrange a sale and save the company. Even though Satyam has been saved, corporate governance in India has taken a big hit and its reputation has been tarnished.

Sources: P. G. Thakurta, 2009, Satyam scam questions corporate governance, IPS Inter Press Service, http://www.ipsnews.net. April 21; G. Anand, 2009, How Satyam was saved, *Wall Street Journal,* http://www.wsj.com, April 14; 2009, Satyam-chronology, Trading Markets, http://www.tradingmarkets.com, April 7; H. Timmons & B. Wassener, 2009, Satyam chief admits huge fraud, *New York Times,* http://nytimes.com, January 8; H. Arakali, 2009, Satyam chairman resigns after falsifying accounts, Bloomberg, http://bloomberg.com, January 7; M. Kripalani, 2009, India's Madoff? Satyam scandal rocks outsourcing industry, *BusinessWeek,* http://www.businessweek.com, January 7; J. Riberiro, 2008, Satyam demands apology from World Bank, Network World, http://www.networkworld.com, December 26.

a major restructuring.[142] Research suggests that foreign investors are likely to focus on critical strategic decisions and their input tends to increase a firm's movement into international markets.[143] Thus, foreign investors are playing major roles in the governance of firms in many countries.

Not only has the legislation that produced the Sarbanes-Oxley Act in 2002 increased the intensity of corporate governance in the United States,[144] but other governments around the world are seeking to increase the transparency and intensity of corporate governance to prevent the types of scandals found in the United States and other places around the world. For example, the British government in 2003 implemented the findings of the Derek Higgs report, which increased governance intensity mandated by the United Kingdom's Combined Code on Corporate Governance, a template of corporate governance used by investors and listed companies. Also, as reported in the earlier Strategic Focus, in 2009 the chairman of the Financial Reporting Council in the United Kingdom announced a complete review of the Combined Code. In addition, the European Union enacted what is known as the "Transparency Directive," which is aimed at enhancing reporting and the disclosure of financial reports by firms within the European capital markets. Another European Union initiative labeled "Modernizing Company Law and Enhancing Corporate Governance" is designed to improve the responsibility and liability of executive officers, board members, and others to important stakeholders such as shareholders, creditors, and members of the public at large.[145] Thus, governance is becoming more intense around the world.

Governance Mechanisms and Ethical Behavior

The governance mechanisms described in this chapter are designed to ensure that the agents of the firm's owners—the corporation's top-level managers—make strategic decisions that best serve the interests of the entire group of stakeholders, as described in Chapter 1. In the United States, shareholders are recognized as the company's most significant stakeholders. Thus, governance mechanisms focus on the control of managerial decisions to ensure that shareholders' interests will be served, but product market stakeholders (e.g., customers, suppliers, and host communities) and organizational stakeholders (e.g., managerial and nonmanagerial employees) are important as well.[146] Therefore, at least the minimal interests or needs of all stakeholders must be satisfied through the firm's actions. Otherwise, dissatisfied stakeholders will withdraw their support from one firm and provide it to another (e.g., customers will purchase products from a supplier offering an acceptable substitute).

The firm's strategic competitiveness is enhanced when its governance mechanisms take into consideration the interests of all stakeholders. Although the idea is subject to debate, some believe that ethically responsible companies design and use governance mechanisms that serve all stakeholders' interests. The more critical relationship, however, is found between ethical behavior and corporate governance mechanisms. The Enron disaster and the sad affair at Satyam (described in the Strategic Focus) illustrate the devastating effect of poor ethical behavior not only on a firm's stakeholders, but also on other firms. This issue is being taken seriously in other countries. The trend toward increased governance scrutiny continues to spread around the world.[147]

In addition to Enron, scandals at WorldCom, HealthSouth, Tyco, and Satyam along with the questionable behavior of top-level managers in several of the major U.S. financial services firms (Merrill Lynch, AIG) show that all corporate owners are vulnerable to unethical behavior and very poor judgments exercised by their employees, including top-level managers—the agents who have been hired to make decisions that are in shareholders' best interests. The decisions and actions of a corporation's board of directors can be an effective deterrent to these behaviors. In fact, some believe that the most effective boards participate actively to set boundaries for their firms' business ethics and values.[148] Once formulated, the board's expectations related to ethical decisions and actions of all of the firm's stakeholders must be clearly communicated to its top-level managers. Moreover, as shareholders' agents, these managers must understand that the board will hold them fully accountable for the development and support of an organizational culture that allows unethical decisions and behaviors. As will be explained in Chapter 12, CEOs can be positive role models for improved ethical behavior.

Only when the proper corporate governance is exercised can strategies be formulated and implemented that will help the firm achieve strategic competitiveness and earn above-average returns. While there are many examples of poor governance, Cummins Inc. is a positive example. In 2009 it was given the highest possible rating for its corporate governance by GovernanceMetrics International. The rating is based on careful evaluation of board accountability and financial disclosure, executive compensation, shareholder rights, ownership base, takeover provisions, corporate behavior, and overall responsibility exhibited by the company.[149] As the discussion in this chapter suggests, corporate governance mechanisms are a vital, yet imperfect, part of firms' efforts to select and successfully use strategies.

SUMMARY

- Corporate governance is a relationship among stakeholders that is used to determine a firm's direction and control its performance. How firms monitor and control top-level managers' decisions and actions affects the implementation of strategies. Effective governance that aligns managers' decisions with shareholders' interests can help produce a competitive advantage.
- Three internal governance mechanisms in the modern corporation include (1) ownership concentration, (2) the board of directors, and (3) executive compensation. The market for corporate control is the single external governance mechanism influencing managers' decisions and the outcomes resulting from them.
- Ownership is separated from control in the modern corporation. Owners (principals) hire managers (agents) to make decisions that maximize the firm's value. As risk-bearing specialists, owners diversify their risk by investing in multiple corporations with different risk profiles. As decision-making specialists, owners expect their agents (the firm's top-level managers) to make decisions that will help to maximize the value of their firm. Thus, modern corporations are characterized by an agency relationship that is created when one party (the firm's owners) hires and pays another party (top-level managers) to use its decision-making skills.
- Separation of ownership and control creates an agency problem when an agent pursues goals that conflict with principals' goals. Principals establish and use governance mechanisms to control this problem.
- Ownership concentration is based on the number of large-block shareholders and the percentage of shares they own. With significant ownership percentages, such as those held by large mutual funds and pension funds, institutional investors often are able to influence top-level managers' strategic decisions and actions. Thus, unlike diffuse ownership, which tends to result in relatively weak monitoring and control of managerial decisions, concentrated ownership produces more active and effective monitoring. Institutional investors are a powerful force in corporate America and actively use their positions of concentrated ownership to force managers and boards of directors to make decisions that maximize a firm's value.
- In the United States and the United Kingdom, a firm's board of directors, composed of insiders, related outsiders, and outsiders, is a governance mechanism expected to represent shareholders' collective interests. The percentage of outside directors on many boards now exceeds the percentage of inside directors. Through the implementation of the SOX Act, outsiders are expected to be more independent of a firm's top-level managers compared with directors selected from inside the firm. New rules imposed by the U.S. Securities and Exchange Commission to allow owners with large stakes to propose new directors are likely to change the balance even more in favor of outside and independent directors.
- Executive compensation is a highly visible and often criticized governance mechanism. Salary, bonuses, and long-term incentives are used to strengthen the alignment

between managers' and shareholders' interests. A firm's board of directors is responsible for determining the effectiveness of the firm's executive compensation system. An effective system elicits managerial decisions that are in shareholders' best interests.

- In general, evidence suggests that shareholders and boards of directors have become more vigilant in their control of managerial decisions. Nonetheless, these mechanisms are insufficient to govern managerial behavior in many large companies as shown in the latest economic crisis brought on by poor strategic decisions made by top-level managers in financial services firms. Therefore, the market for corporate control is an important governance mechanism. Although it, too, is imperfect, the market for corporate control has been effective in causing corporations to combat inefficient diversification and to implement more effective strategic decisions.
- Corporate governance structures used in Germany, Japan, and China differ from each other and from the structure used in the United States. Historically, the U.S. governance structure focused on maximizing shareholder value. In Germany, employees, as a stakeholder group, take a more prominent role in governance. By contrast, until recently, Japanese shareholders played virtually no role in the monitoring and control of top-level managers. However, now Japanese firms are being challenged by "activist" shareholders. China's governance system is the youngest and has a number of characteristics that mirror those in the United States. However, the central government still plays a major role in governance in China as well. Internationally, all these systems are becoming increasingly similar, as are many governance systems both in developed countries, such as France and Spain, and in transitional economies, such as Russia and India.
- Effective governance mechanisms ensure that the interests of all stakeholders are served. Thus, long-term strategic success results when firms are governed in ways that permit at least minimal satisfaction of capital market stakeholders (e.g., shareholders), product market stakeholders (e.g., customers and suppliers), and organizational stakeholders (managerial and nonmanagerial employees; see Chapter 2). Moreover, effective governance produces ethical behavior in the formulation and implementation of strategies.

REVIEW QUESTIONS

1. What is corporate governance? What factors account for the considerable amount of attention corporate governance receives from several parties, including shareholder activists, business press writers, and academic scholars? Why is governance necessary to control managers' decisions?
2. What is meant by the statement that ownership is separated from managerial control in the corporation? Why does this separation exist?
3. What is an agency relationship? What is managerial opportunism? What assumptions do owners of corporations make about managers as agents?
4. How is each of the three internal governance mechanisms—ownership concentration, boards of directors, and executive compensation—used to align the interests of managerial agents with those of the firm's owners?
5. What trends exist regarding executive compensation? What is the effect of the increased use of long-term incentives on executives' strategic decisions?
6. What is the market for corporate control? What conditions generally cause this external governance mechanism to become active? How does the mechanism constrain top-level managers' decisions and actions?
7. What is the nature of corporate governance in Germany, Japan, and China?
8. How can corporate governance foster ethical strategic decisions and behaviors on the part of managers as agents?

EXPERIENTIAL EXERCISES

EXERCISE 1: INTERNATIONAL GOVERNANCE CODES

As described in the chapter, passage of the Sarbanes-Oxley Act in 2002 has drawn attention to the importance of corporate governance. Similar legislation is pending in other nations as well. However, interest in improved governance predated SOX by a decade in the form of governance codes or guidelines. These codes established sets of "best practices" for both board composition and processes. The first such code was developed by the Cadbury Committee for the London Stock Exchange in 1992. The Australian Stock Exchange developed its guidelines in the Hilmer Report, released in 1993. The Toronto Stock Exchange developed its guidelines the following year in the Dey Report. Today, most major stock exchanges have governance codes.

Working in small groups, find the governance codes of two stock exchanges. Prepare a short (two to three pages, single-spaced) bullet-point comparison of the similarities and differences between the two codes. Be sure to include the following topics in your analysis:

- How are the guidelines structured? Do they consist of rules (i.e., required) or recommendations (i.e., suggestions)? What mechanism is included to monitor or enforce the guidelines?
- What board roles are addressed in the guidelines? For example, some codes may place most or all of their emphasis on functions derived from the importance of the agency relationship illustrated in Figure 10.1 on page 289, such as monitoring, oversight, and reporting. Codes might also mention the board's role in supporting strategy, or their contribution to firm performance and shareholder wealth.
- What aspects of board composition and structure are covered in the guidelines? For instance, items included in different codes include the balance of insiders and outsiders, committees, whether the CEO also serves as board chair, director education and/or evaluation, compensation of officers and directors, and ownership by board members.

EXERCISE 2: GOVERNANCE: DOES IT MATTER COMPETITIVELY?

Governance mechanisms are considered to be effective if they meet the needs of all stakeholders, including shareholders. Governance mechanisms are also an important way to ensure that strategic decisions are made effectively. As a potential employee, how would you go about investigating a firm's governance structure and would that investigation weigh in your decision to become an employee or not? Identify a firm that you would like to join or one that you just find interesting. Working individually, complete the following research on your target firm:

- Find a copy of the company's most recent proxy statement and 10-K. Proxy statements are mailed to shareholders prior to each year's annual meeting and contain detailed information about the company's governance and present issues on which a shareholder vote might be held. Proxy statements are typically available from a firm's Web site (look for an "Investors" submenu). You can also access proxy statements and other government filings such as the 10-K from the SEC's EDGAR database (http://www.sec.gov/edgar.shtml). Alongside the proxy you should also be able to access the firm's annual 10-K. Here you will find information on performance, governance, and the firm's outlook, among other things.
- Identify one of the company's main competitors for comparison purposes. You can find this information using company analysis tools such as Datamonitor.

Some of the topics that you should examine include:

- Compensation plans (for both the CEO and board members; be sure to look for any difference between fixed and incentive compensation)
- Board composition (e.g., board size, insiders and outsiders, interlocking directorates, functional experience, how many active CEOs, how many retired CEOs, what is the demographic makeup, age diversity, etc.)
- Committees (how many, composition, compensation)
- Stock ownership by officers and directors—identify beneficial ownership from stock owned (you will need to look through the notes sections of the ownership tables to comprehend this)
- Ownership concentration. How much of the firm's outstanding stock is owned by institutions, individuals, and insiders? How many large-block shareholders are there (owners of 5 percent or more of stock)?
- Does the firm utilize a duality structure for the CEO?
- Is there a lead director who is not an officer of the company?
- Activities by activist shareholders regarding corporate governance issues of concern
- Are there any managerial defense tactics employed by the firm? For example, what does it take for a shareholder proposal to come to a vote and be adopted?
- List the firm's code of conduct.

Prepare a double-spaced memo summarizing the results of your findings with a side-by-side comparison of your target and its competitor. Your memo should include the following topics:

- Summarize what you consider to be the key aspects of the firm's governance mechanisms.
- Attach to your memo a single graph covering the last 10-year historical stock performance for both companies. If applicable, find a representative index to compare both with, such as the S&P, NASDAQ, or other applicable industry index.
- Highlight key differences between your target firm and its competitor.
- Based on your review of the firm's governance, did you change your opinion of the firm's desirability as an employer? How does the competitor stack up, governance wise? Why or why not?

VIDEO CASE

EFFECTIVE CORPORATE GOVERNANCE

Paul Skinner/Former Chairman/Rio Tinto

Paul Skinner, former chairman of Rio Tinto Corporation, discusses how the firm went through some significant governance changes. Spend some time with the Rio Tinto Web site and familiarize yourself with its governance structure and philosophy.

Before you watch the video consider the following concepts and questions and be prepared to discuss them in class:

Concepts

- CEO duality
- Board of directors
- Director demographics
- Corporate governance

Questions

1. What do you think is meant by the term *good governance*?
2. Do you think separation of the chairman and CEO positions should be mandatory for every company?
3. In designing a firm for "good governance," what do you consider important structural arrangements? For example, how should the board be organized, what roles should nonexecutive members have, how many committees should there be, what types of board members, etc.?
4. What do you think of the way that Rio Tinto views governance?

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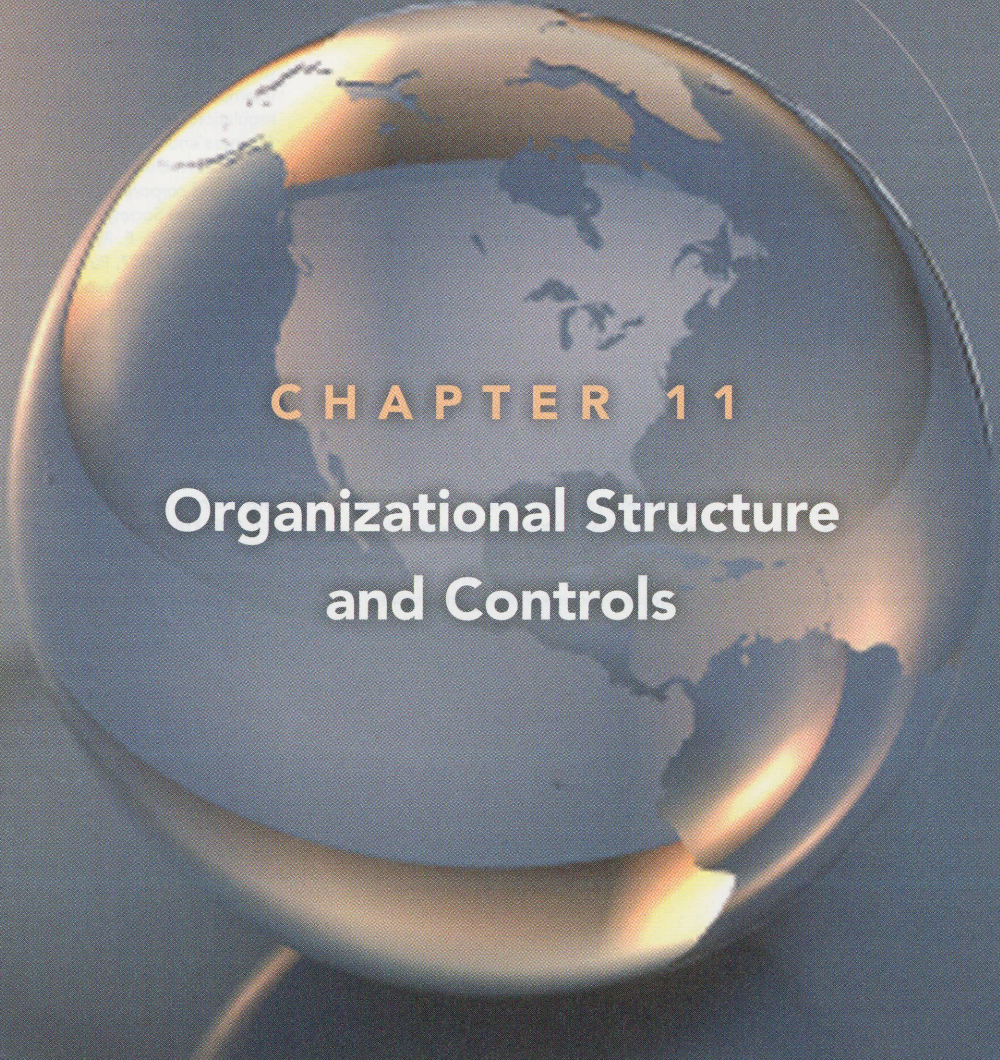

CHAPTER 11

Organizational Structure and Controls

Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define organizational structure and controls and discuss the difference between strategic and financial controls.
2. Describe the relationship between strategy and structure.
3. Discuss the functional structures used to implement business-level strategies.
4. Explain the use of three versions of the multidivisional (M-form) structure to implement different diversification strategies.
5. Discuss the organizational structures used to implement three international strategies.
6. Define strategic networks and discuss how strategic center firms implement such networks at the business, corporate, and international levels.