

PERSPECTIVES ON CORPORATE GOVERNANCE AND FIRM VALUATION IN AFRICA

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Abstract

This paper reviews aspects of corporate governance as it impacts on the valuation and performance of firms. We consider the theoretical framework for corporate governance as an internal regulation mechanism, on the basis of principal agent problems, incentive contracts, and asymmetric information. We also discuss present various corporate governance practices around world. The paper discusses the empirical evidence on how the quality of corporate governance practices impact on the valuation of a firm and its general performance. Stylized facts on corporate governance practices in Africa and also presented.

Keywords: Corporate governance; Firm valuation; Anti-takeover; Internal and external governance

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1. Introduction

The importance of Corporate Governance has recently received much attention due to high profile corporate collapses and scandals such as Enron and WorldCom. The enactment of the Sarbanes-Oxley Act of 2002 in the US, the most sweeping corporate governance regulation in the US in the last 70 years (Byrnes et al., 2003), has its roots in the collapse of corporate governance practices. Furthermore, Jensen (1989) and Jensen (1993) have argued that the internal mechanisms of corporate governance in the US corporations have not been effective. This has resulted in arguments a move from the current corporate form to a much more highly levered organization, similar to a leveraged buyout (LBO). On the other hand, legal scholars, including Easterbrook and Fischel (1991) and Romano (1993), view the US mechanisms and the legal system in a favorable light. There is also issue about the relative efficacy of the corporate governance systems in the US and UK where shareholding is dispersed and the secondary market trading of shares is prominent, versus the corporate governance systems in Japan and Germany which are typified by more concentrated shareholdings and a prominent role for the banking institutions.

Several empirical studies have found that the quality of governance has an impact on the value of the firm as measured by such indicators as Tobin's Q (Gompers et al., 2003, Bebchuk and Cohen, 2005, Bebchuk et al., 2005 and Cremers and Nair, 2005).

The literature identifies key governance measures that underpin the link with firm value as board members being elected annually; company either has no poison pill or one approved by shareholders; option re-pricing, average options

granted recently as a percentage of basic shares outstanding did not exceed 3%; attendance by directors at least 75% of board meetings or had a valid excuse for non-attendance; and directors' stock ownership is governed by clear guidelines. The first two factors represent external governance while the remainder are internal governance factors.

Why is corporate governance necessary? Corporate governance exists as a mechanism for dealing with the separation of ownership and control, and the agency problems it creates. In this paper we discuss the various types of agency problems caused by the separation of ownership and control. The agency problems and conflicts of interest differ with different stakeholders in a company and are closely defined with the capital contribution and pay-off for each shareholder.

In a firm, corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (Senbet and John, 1998) Stakeholders of a corporation include equity-holders, creditors and other claimants who supply capital, as well as other stakeholders such as employees, consumers, suppliers, and the government, and society at large. The professional managers, and other corporate insiders, control the key day-to-day decisions of the corporation. Given the separation of ownership and control, how the stakeholders control management is the subject of corporate governance.

The monitoring role of the board of directors is an important component of corporate governance Board effectiveness in its monitoring function is determined by its *independence*, *size*, and *composition*. The board of directors is presumed to

carry out the monitoring function on behalf of shareholders, because the shareholders themselves would find it difficult to exercise control due to wide dispersion of ownership of common stock. This problem in monitoring is endemic to most large corporations with diffuse ownership, because an individual (atomistic) shareholder lacks sufficient stake in the firm to justify spending resources to closely monitor managers. This leads to a free rider problem, as shareholders, individually, attempt to free ride on others to monitor managers.

This paper reviews the theoretical underpinnings of corporate governance, corporate governance guidelines, and the impact of corporate governance on firm valuation and performance.

The rest of paper is organised as follows, section 2 presents the theoretical underpinnings of corporate governance. Section 3 presents the board of directors and its functions. Section 4 presents international guidelines on corporate governance. Section 5 surveys the empirical literature on corporate governance. Section 6 presents stylized facts on corporate governance practices in Africa, while section 7 concludes.

2. Agency Conflicts and Corporate Governance

Corporate governance exists as a mechanism for dealing with the separation of ownership and control, and the potential agency conflicts that this separation engenders. Berle and Means (1932) argued that such a separation exists. Any firm can be viewed as an interlocking network of contracts (Jensen and Meckling, 1976), among various stakeholders, such as shareholders (equity-holders), bondholders, employees, and the society at large. The agency conflicts differ with different stakeholders in a company. The nature of the conflicts is also related to the capital contribution and pay-off for each stakeholder in the company. In a firm, corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (Senbet and John, 1998). Stakeholders of a corporation include equity-holders, creditors and other claimants who supply capital, as well as other stakeholders such as employees, consumers, suppliers, and the government, and society at large. The professional managers, and other corporate insiders, control the key day-to-day decisions of the corporation. Given the separation of ownership and control, how the stakeholders control management is the subject of corporate governance.

Left alone, each type of stakeholders is selfish and pursues their own interest in a way that may be detrimental to the welfare of other stakeholders. Conflicts are classified as *managerialism* (between stockholders (principals) and management(agent)), *debt agency* (between stockholders (agents) and debt-holders), *social agency* (between the private sector

(agent) and the public sector), and *political agency* (between the agents of the public sector (e.g., regulators) and the rest of the society or taxpayers, say) (see Barnea et al. (1985)), John and Senbet (1996, 1998). Such agency conflicts detract from efficient operation of a company.

Managerialism here refers to self-serving behavior by managers. Under separation of ownership and control, the actual operations of the firm are in the hands of a CEO and managers who may not be significant shareholders in the company. The self-serving nature of managers may lead to poorly performing investments being chosen for “empire-building” reasons, and in “runaway managerial compensation” which is not linked to performance. The corollary is destruction of shareholder value.

Debt agency is a conflict that arise due to the fact that debt contract may encourage managers to make investment and financing decisions that are sub-optimal to the principle of shareholder-value maximization. Debt-holders are always the first to be paid before equity holders in the hierarchy of claims from the cash-flows of the company. Should the firm go bankrupt debt-holders receive their claims ahead of stockholders, thus creating grounds for potential conflict.

Corporate governance is aimed at reducing the extent of friction between the various stakeholders, due the presence of these network of contracts, and separation of ownership and control.

3. The Board of Directors and its Functions

The Role of the Board

A board of directors is key to the well-functioning of corporate governance processes in company. The board is the primary means through which shareholders exercise control over management in a company. In the literature these are various empirical studies that seek to link and test various aspects of a board to company performance. Central to these tests is the effectiveness of a board in monitoring the process of shareholder-value maximization. The size of the board, its composition, and number of independent directors in board are among the characteristics of the board that have been tested in the literature, as determinants of firm valuation and performance.

Monitoring role of Boards and CEO Turnover: One way in which the effectiveness of the board is measured is through CEO turnover. CEO turnover signals the ability of a board to discipline top management and subject it to strict performance criteria on the basis of which they are removed from their positions if they do not meet those targets.

Board Composition and Board Independence: In the literature there is widely held view that board composition influences board independence. The

more independent a board the more effective it becomes and company performance also improves. The degree of independence of a board is often associated with the proportion of board members that are independent and do not represent any specific shareholder. In certain cases a Senior independent director is recommended and their presence is associated with greater board independence.

Board size: *Ab initio*, it seems like a bigger board is likely to exhibit a good spread of monitoring skills of the board and enhance its effectiveness. On the other hand, the board may be too big and compromise the quality of communication within the board. It does seem then that there is an optimal size of a board beyond which effectiveness is not improved and may indeed begin to decline. The literature often points to figure of 10 board members being the optimal board size. Indeed some of the studies point towards smaller boards being more effective than large boards. Furthermore, the separation of the CEO role from that of the chairman adds another non-executive director to which the CEO reports to and this seems to add the better form performance and valuation.

Board Committees: The internal administrative structure of a board is crucial to its effectiveness. The internal structure boils down to the presence of board committees that are chaired by independent directors. At a minimum there should be two committees in any board namely, an Audit and Remuneration Committees. The audit committee acts as the internal auditors for the board for the company's operations, management systems, and general financial control and reporting. The remuneration committee deals with setting and regulating remuneration packages for management and some human- resource issues.

Compensation of Boards: There is a fine balance between incentivizing directors sitting on boards and overpaying them to appoint where they feel they are close to receiving managerial compensation. In certain cases, board members have been known to receive share options just like full-time management. While such compensation may seem to be working at aligning the interests of board members to those of shareholders, they may be counter productive and cause seemingly independent directors to support risky investments that are likely to push up share prices in the short-term. The optimal design of board compensation is challenging.

Role of Market for Takeovers: Williamson (1983) argued that the importance of board as corporate control mechanism, will be greater in companies operating in markets where takeovers are difficult, such as in Africa. Therefore, there may be a substitution effect such that when the market for takeovers is weak (an external mechanism), there is greater role for internal control mechanisms such as boards. There may also be causality between the two mechanisms where weak boards leak to poor

company performance and an increase in the likelihood of a takeover. Bhimani and Ncube (2005) develop a model and framework where the market for takeovers is determined by the type of managers and quality of governance.

Role of Debt in Corporate Governance: While debt possible tax-deductibility advantages, which are sometimes an important consideration in the design of financial structures, debt is often viewed as a disciplining mechanism, especially if its maturity is relatively short and is risky (eg variable interest rates). Debt forces the firm to disgorge cash flow. By taking cash out of the firm, to service debt, this prevents managers from "consuming" it unnecessarily. It reduces the ability of managers to turn their "free cash flow" into lavish perks or futile negative net present value investments, also limits "runaway compensation". The presence of debt could also act as an incentive for the company's managers to manage better as they plan to generate cash-flows to service short-term debt.

Lack of discipline and poor management may eventually bankruptcy of the company, leading to loss of employment and reputation risk. Therefore the presence of debt in the capital structure of the company enhances the effectiveness of corporate governance

4. Corporate Governance Guidelines

Various corporate governance guidelines have been developed around the world in response to the corporate governance challenge. Such guidelines include the King Report II (South Africa), Cadbury Report (UK), Commonwealth Corporate Governance guidelines, among others. The guidelines recognize the fact that corporate governance is not merely compliance, as it works best when it is flexible. The market is the ultimate compliance officer. Table 1 below shows a summary of the various guidelines.

In all the codes in table 1, it is recognized that directors should treat the company as if it is an "incapacitated entity" or "bed-ridden" that needs to be cared for. Who are the stake-holders in the corporate? Directors should act in good faith, exercise due care, possess some skills, and exercise due diligence. This is quite lucid in King (2006).

A good director should always ask themselves silent questions, such as

- Is there a conflict of interest?
- Do I have all the facts to make a decision?
- Is the decision based on all the facts?
- Is the communication to stakeholders transparent?
- I am acting as a good steward of the entity's assets?
- How does the entity make its money?

Table 1. Examples of Corporate Governance Guidelines

	Independent directors?	Separation of chairman-CEO roles?	Rotation of external auditor?	Frequency of financial reporting?	'Comply or explain' requirement?	Selected country-specific governance issues
Brazil CVM Code (2002)	As many as possible	Clear preference for split	Not covered	Quarterly	No	Adoption of IAS/U.S. GAAP Fiscal boards Tag-along rights
France Bouton Report (2002)	At least one-half of board	No recommendation	Regularly, for lead auditors	No recommendation given	No	Dual statutory auditors
Russia CG Code (2002)	At least one-quarter of board	Split required by law	Not covered	Quarterly	No	Managerial boards
Singapore CG Committee (2001)	At least one-third of board	Recommended	Not covered	Quarterly	Yes	Disclosure of pay for family members of directors/CEOs
United Kingdom Cadbury Code (1992)	Majority of nonexecutive directors	Recommended	Periodically, for lead auditors	Semiannually	Yes	
Combined Code (2003)	At least one-half of board	Clear preference for split	Not covered	Semiannually, per listing rules	Yes	
United States Conference Board (2003)	Substantial majority of board	Separation is one of three acceptable options	Recommended for audit firm	Quarterly, as required by law	No	
South Africa (King II Report) 2004	As many as possible	Recommended	Recommended	Semiannually	No	

Source: Coombs and Wong (2004) and King II Report.

Corporate governance guidelines are merely guidelines which are recommended, and do not constitute compliance. Deviation is merely frowned upon rather than punished, except by the market mechanism. However, the Sarbanes-Oxley Act (2002) enacted in the US is an enforceable law on certain aspects of corporate governance and makes the board accountable for mis-reporting.

5. Empirical Literature linking Corporate Governance, Firm Valuation and Performance

Research in literature has linked corporate governance to firm valuation using Tobin's Q as a proxy for firm valuation. Early studies have found links between individual internal governance provisions and Tobin's Q (Hermalin and Weisbach, 1991, Bhagat and Black, 2002 and Yermack, 1996). Studies by Hermalin and Weisbach, 1991 and Bhagat and Black, 2002 found no relationship between the proportion of outside directors and Tobin's Q. Yermack (1996) found an inverse relation between board size and Tobin's Q. The study by Callahan et al. (2003) found a positive relationship between management participation in the director selection process and Tobin's Q.

Several studies have examined summary measures of corporate governance and their linkage to

firm valuation. Gompers et al. (2003) used Investor Responsibility Research Center (IRRC) data, and found that firms with fewer shareholder rights have lower firm valuations and lower stock returns. Gompers, et al, classified 24 governance factors into five groups (tactics for delaying hostile takeover, voting rights, director/officer protection, other takeover defenses, and state laws). They created a G-Index by summing 24 binary governance factors. This G-Index has been used in studies to represent governance even though it is more reflective of an anti-takeover protection index, rather than a corporate governance index (Cremers and Nair, 2005).

The study by Bebchuk and Cohen (2005) shows that staggered boards have a negative impact on the value of the firm. Bebchuk et al. (2005) show that a six-factor firm entrenchment index fully drives the relation between G-Index and firm value. Cremers and Nair (2005) show that a three-factor external governance index impedes firm valuation. Cremers and Nair (2005) argue that effective corporate governance requires both internal and external measures so they include shareholder activism, their proxy for internal governance.

Brown and Caylor (2005), add to this literature by re-examining the links between corporate governance and firm valuation, using a far more extensive database than the oft-used IRRC database.

They create simple summary governance index using 51 ISS data items. Similar to Gompers, et al, they show that their new Gov-Score increases in firm value. They also show that a small subset of factors fully drives the relation between ISS corporate governance data and firm value. Similar to Cremers and Nair (2005), they show that links between governance and firm value are not confined to anti-takeover measures.

Brown and Caylor regress Tobin's Q on Gov-Score and three control variables. The control variables based on prior research are log of assets and log of firm age (Shin and Stulz, 2000) and a dummy variable for firm is incorporated in Delaware (Daines, 2001). They show that Tobin's Q is positively related to Gov-Score. They use three econometric techniques to conduct this investigation. First, they regress Tobin's Q on all 51 firm-specific factors. Second, they regress Tobin's Q on each of the 51 factors plus the remaining 50, defined as Gov-Score minus the factor in question. Third, they use stepwise regression to identify which of the 51 factors enter the valuation model.

Subsequently, Brown and Caylor identify seven factors that are significant in determining firm valuation, and these include: (1) board members are elected annually; (2) company either has no poison pill or a pill that was shareholder approved; (3) option re-pricing did not occur within the last three years; (4) average options granted in the past three years as a percent of basic shares outstanding did not exceed 3%; (5) all directors attended at least 75% of board meetings or had a valid excuse for non-attendance; (6) board guidelines are in each proxy statement; and (7) directors are subject to stock ownership guidelines. They create a summary index based on these seven factors, and show that a small subset of ISS data (seven of 51 factors) fully drives the relation between Gov-Score and firm valuation.

6. Stylized Facts on Corporate Governance in Africa

6.1 Poor Monitoring Role of Financial Markets

African stock markets are small, illiquid and lack the manpower to monitor the quality of corporate governance, with the exception of the Johannesburg Stock Exchange (JSE).¹⁵ African finance systems are dominated by the banking sector which tends to advance loans on the basis of availability of collateral regardless of the quality of governance in the borrower company. The corollary is that such a bank dominated financial system where banks do not take equity, the quality of corporate governance can only be poor.

¹⁵ The JSE offers a course jointly with Wits Business School for new directors of publicly-listed companies, on how to be an effective director.

6.2 Weak takeover possibilities

The characteristics of African stock markets, being that of small and illiquid markets calls into question the efficiency of the markets and their ability to price stocks correctly. Such unreliable pricing of stocks creates barriers to the development of a market for takeovers, and mergers and acquisitions. Takeovers are one way through which poor corporate governance and management are punished by the market. If the market pricing mechanism is unable to correctly reflect the quality of governance then takeovers will be stifled.

6.3 CEO Turnover Ineffective

To an extent the effectiveness of corporate governance and boards is reflected in their ability to remove CEOs who are not behaving appropriately. CEO turnover then becomes a proxy for good governance practices. In Africa, family owned firms are quite prevalent and CEOs are typically entrepreneurs who have a large holding in the company they lead. It then becomes difficult for the remaining shareholders to fire CEO who is a significant shareholder. Besides, if the company is family-controlled then the board members are likely to be mainly from the family and minority shareholders are unable to fire a CEO who is a member of the family. Then CEO turnover can not be relied upon as an effective tool for ensuring compliance to good corporate governance.

6.3 Tension between Social Institutions and Corporate Governance

Age and seniority in society are often characteristics that are correlated with some form of professional experience. There is a spill-over of these characteristics into board rooms and determine who sit on boards. In most Africa societies older people are revered. If such people sit on boards it becomes difficult to challenge their decisions and positions on governance matters within the boards. Often younger directors would defer to older directors even when they may not have the necessary skill to make a contribution to a decision. As a result corporate governance practices are subjected to social behaviors and institutions. Indeed, this tension between social institutions and corporate governance practices may lead to a compromise on the quality of governance.

6.5 Poor Director Skills

It is important for members of the board of directors in any company to possess certain skills useful for understanding how a company works. A simple thing to know is how the company makes money; how is the CEO compensated; what is the business model of the company; the company's marketing strategy; knowledge of ethical business conduct; and indeed the strategic direction of the company. Such understanding of the company, albeit basic, will enable the director to grow to become an effective director. Some skill-acquisition in order to be able to

ask the right questions about the company is required. Directors in Africa are not trained in the acquisition of such skills and indeed there is reliance on the social institutions of things such as age being considered to be an embodiment of wisdom and eventually good corporate governance practices.

6.6 Tension between Corporate Governance and Political Governance

In African countries most successful business people almost end up being involved in active politics. This may then spill over into the existence of corporate boards that are geared towards advancing the CEOs political ambitions rather than shareholder value creation. On the other hand, some people who join active politics view it as a way of getting into business, especially business related to government contracts. This could result in the appointment of corporate boards and CEOs that advance business interests of politicians and promotion of general corruption. A good example, is the state of state-owned enterprises in Africa which often exhibit poor governance, ineffective management, corruption by politicians that supervise them, and have boards that are controlled by the supervising politicians. When government ministers are changed they in turn change the boards of companies that fall under their ministries. This tension between corporate governance and political governance, which erodes the development of good corporate governance, is quite glaring in most Africa countries.

6.7 Poor Role of Independent Directors

Outside or Independent directors, who do not represent any shareholder in the company, play an important role in ensuring good governance for the benefit of all shareholders who rank *pari passu*. In African countries, where there is poor remuneration for board members, it is difficult to attract professional independent directors. The corollary is the recruitment of seemingly independent directors who are in fact close to the CEO, and are unlikely to challenge the CEO on governance matters. Indeed, the CEO will recruit from the same class and social network as themselves. Members within the same social network are unlikely to criticize one another in public forums without feeling they may be damaging their own social network (*old-boys-network* problem). This phenomenon results on poor governance practices.

6.8 Large and ubiquitous shareholders and the “free-rider problem”

In most Africa countries, perhaps due to underdeveloped equity markets, there is an underdeveloped market for investment houses and fund management. As a result, one finds a handful of the same shareholders controlling majority shareholding in a wide variety of companies across the economy. Such shareholders include life-companies, insurance companies and

some powerful family-controlled investment vehicles. Some of these shareholders are state-provident funds. These large shareholders lack the manpower to police the quality of corporate governance across all the companies in which they possess a dominant shareholding. At the same time, small shareholders who invest alongside such large shareholders are too small to exert any influence on the company and one is faced with a serious but typical “free-rider problem”. The presence of such large shareholdings creates an impression of a presence of *shareholder-activism* but in fact stifle the development of such activism. This perverse situation is accentuated by management who are able to develop close relationships with such large shareholders.

6.9 Close relationship between External auditors and Boards

Generally, there is a debate about the role and effectiveness of external auditors in ensuring that the interests of shareholders are protected. Auditor decisions could be influenced by future business with the company. Indeed, this may drive the auditors close to board members of the company they audit as a way protecting future audit contracts with the company. In Africa, the market for audit contracts is small, and this may be a catalyst for the cultivation of a close relationship between boards of companies and auditors. Such close relationships, in an environment where the quality and independence of board members is in ready in question, compromises the external auditors role in monitoring and reporting on aspects of corporate governance in the company. In certain instances, external auditors may collude with management, thus making it difficult for even an independent board, to be critical of “auditor-endorsed” management practices. The problem of poor disclosure and “earnings-inflation” may be accentuated by poor external audit processes.

6.10 Poor Monitoring of Executive Pay

It is quite prevalent in Africa for the salaries and general remuneration of the CEO and senior management to be negotiated privately between senior management and the company Chairman. Such secrecy in the remuneration results in others members of the board not knowing the exact remuneration packages of senior managers. Often, the Remuneration committee of the board, if it exists at all, is relegated to deciding on the human resources and remuneration of junior employees within the company. The board is therefore unable to link the remuneration of senior management to company performance. This may lead to huge payments for executives, and general “runaway compensation”. Such circumvention of good corporate governance practices may lead to poor company performance.

6.11 Separation of Chairman and CEO's Positions

In order to enhance the monitoring of the CEO and senior management, a separation of the CEO and Chairman's positions is advised. A position for a non-executive chairman to whom the CEO is subject to is desirable as additional mechanism for monitoring the CEO. In most Africa countries, such separation of roles does not exist. In cases where there is separation, the CEO develops such a close relationship with the chairman, making it difficult for the board to monitor the CEO's behavior.

7. Conclusion

In the analysis above we have reviewed aspects of corporate governance as it impacts on the valuation and performance of firms. We consider the theoretical framework for corporate governance as an internal regulation mechanism, on the basis of principal agent problems, incentive contracts, and asymmetric information. These conflicts arise from the separation of ownership from control. Corporate governance then becomes the mechanism for bridging the gap in this separation. We also discussed present various corporate governance practices developed and being implemented around world. We also discussed the empirical evidence on how the quality of corporate governance practices impact on the valuation of a firm and its general performance. We also presented a standard framework for incentive-compatible behavior. Stylized facts on corporate governance practices in Africa were also presented, highlighting deficiencies.

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