IQRA NATIONAL UNIVERSITY

Subject

Corporate Governance

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Question # 1

A company which applies fairness, accountability, responsibility and transparency in its operations, will usually outperform other companies and will be able to attract investors, whose support can help to finance further growth. How concept corporate governance helps companies to achieve their basic objective while their operations. What are the basic reasons of agency issue that an any company could exposed for? Support your arguments with valid justified discussion.

Answer # 1

Corporate governance

Corporate governance is the system of rules, practices, and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

Corporate governance is about enabling organizations to achieve their goals, control risks and assuring compliance. Good Corporate governance incorporates a set of rules that define the relationship between stockholders, management and the board of directors of a company and influence how the company is operating.

Good corporate governance is about having the correct policies and procedures in place. It is also about maintaining a culture where good relationships between stakeholders provide positive contributions to the long-term goals of the organization.

Directors, company secretaries and managers can all make a significant contribution to good corporate governance, Compliance training as part of a learning management system is an excellent way to instill such a culture of cooperation at every level of the organization.
There are several key areas which contribute to good corporate governance.

These include:

- **The board** – having a board with the necessary skills, independence and commitment to make the right decisions.
- **Shareholders** – keeping them informed and encouraging their participation through general meetings.
- **Other stakeholders** – recognizing the organization’s obligations to non-shareholder stakeholders such as employees, suppliers and customers.
- **The community** – maintaining a policy of transparency and disclosure in every aspect of the organization from finances to personnel.

A vital element of good corporate governance is goal setting. Having clear, attainable objectives, which everyone in the organization is aware of and is committed to achieving, will increase the likelihood of those objectives being met, or even exceeded. Strategies should be regularly reviewed and adjustments made to allow for changing circumstances.

Sound budgeting is another factor in good corporate governance. Goals cannot be achieved without the financial resources to make them happen. Budgets can be set as much as five years in advance, although regular review and adjustment will obviously be necessary.

Effective risk management is also an important part of good governance. Minimizing risks and identifying opportunities should be an ongoing procedure, backed by sound policies and clear delineation of responsibilities. Risk can come from both internal and external sources and all members of the organization need to be made risk aware through compliance training.

Another key ingredient in good corporate governance is human resources. Hiring and retaining good employees with the necessary skills, attitude and experience is vital to an organization's success. Ongoing human resource management needs to focus on performance management, professional development and succession planning to ensure that vital expertise is retained within the organization.

An essential element of good governance is consultation with key stakeholders. Fostering relationships of trust and mutual respect with stakeholders is vital if organizational objectives are to be met. Key stakeholders can include government agencies, suppliers, employees and customers.

Finally, upper management performs an important role in good governance by providing leadership. If directors and managers are seen to behave ethically and always in the best interests of the organization, this example will inevitably be followed by others and will contribute to the evolution of a corporate culture that values ethical decision-making.

As can be seen, good corporate governance is a combination of many different things. At the end of the day, having all these measures in place will not guarantee success, as risk is an inherent part of any business venture.

Achieving good corporate governance will, however, reduce the risks considerably and increase the likelihood of long-term success. It should therefore be the ultimate goal of every organization.

Agency issue

1. **Defining Agency Conflicts**

Agency conflicts can occur when the incentives of the agent do not align with those of the principal.

> The agency view of the corporation posits that the decision rights (control) of the corporation are entrusted to the manager to act in shareholders' interests. Control systems in corporate governance can help align managers' incentives with those of shareholders and other stakeholders.
>
> The principal – agent problem concerns the difficulties in motivating one party (the "agent"), to act on behalf of another (the "principal"). The two parties have different interests and asymmetric information. Moral hazard and conflict of interest may thus arise.

The deviation from the principal's interest by the agent is called "agency costs." Agency costs mainly arise due to contracting costs and the divergence of control, separation of ownership and control, and the different objectives (rather than shareholder maximization) of the managers.

Much recent interest in corporate governance is concerned with mitigation of the conflicts of interests between stakeholders. These occur when an individual or organization is involved in multiple interests that may lead to conflicts in their ability to act in the best interest of one party.

2. Managers, Shareholders, and Bondholders

Three parties key to the corporation's functioning are managers, shareholders, and bondholders, each of which can have different interests.

Three parties key to the functioning of the corporation are the managers, shareholders, and bondholders. While managers control the corporation and make strategic decisions, shareholders are owners, and bondholders are creditors.

While all three parties have an interest, whether direct or indirect, in the financial performance of the corporation, each of the three parties has different rights and rewards, for example voting rights and forms of financial return.

Shareholders, managers, and bondholders have different objectives. For example, shareholders have an incentive to take riskier projects than bondholders do and may prefer that the company pay more out in dividends. Managers may also be shareholders or prefer risk-averse, empire-building projects.

3. Conflicts between Managers and Shareholders

Agency costs mainly occur when ownership is separated, or when managers have objectives other than shareholder value maximization.

The agency view of the corporation suggests that the decision rights of the corporation should be entrusted to a manager to act in shareholders 'interests. Agency costs mainly occur when ownership is separated, or when managers have objectives other than shareholder value maximization.

Typically, the CEO and other top executives are responsible for making decisions about high-level policy and strategy. Shareholders, on the other hand, are individuals or institutions that legally own shares of corporation stock. Shareholders typically concede control rights to managers.

There are various conflicts of interest that can impact manager's decisions to act in shareholders' interests. Management may, for example, buy other companies to expand power. Venturing onto fraud, they may even manipulate financial figures to optimize bonuses and stock-price-related options.

Contemporary discussions of corporate governance argue that corporations should respect the rights of shareholders and help shareholders to exercise those rights. Disclosure and transparency are intimately intertwined with these goals.

4. **Conflicts of Interest between Shareholders and Bondholders**

The shareholders and bondholders have different rights and returns, leading to potential conflicts of interest.

The shareholders are individuals or institutions that legally own shares of stock in the corporation, while the bondholders are the firm's creditors. The two parties have different relationships to the company, accompanied by different rights and financial returns.

Stockholders have an incentive to take riskier projects than bondholders do. Other conflicts of interest can stem from the fact that bonds often have a defined term, or maturity, after which the bond is redeemed, whereas stocks may be outstanding indefinitely but can also be sold at any point.

Bondholders may put contracts in place prohibiting management from taking on very risky projects or may raise the interest rate demanded, increasing the cost of capital for the company. Conversely, shareholder preferences–for example for riskier growth strategies –can adversely impact bondholders.

Question # 2

Corporate governance" first came into vogue in the 1970s in the United States. Within 25 years corporate governance had become the subject of debate worldwide by academics, regulators, executives and investors. In changing paradigm, 4Ps (People, Purpose, Process and Performance) have become critical for corporate sustainability. Please provide valid argument for the above statement's accordance with the great economic desperation of 1930s and great economic recession of 2007-2009.

Answer # 2

Great economic desperation of 1930s

The Great Depression was the greatest and longest economic recession in modern world history. It began with the U.S. stock market crash of 1929 and did not end until 1946 after World War II. Economists and historians often cite the Great Depression as the most catastrophic economic event of the 20th century.

The Great Depression was a severe worldwide economic depression that took place mostly during the 1930s, beginning in the United States. The timing of the Great Depression varied across the world; in most countries, it started in 1929 and lasted until the late 1930s. It was the longest, deepest, and most widespread depression of the 20th century. The Great Depression is commonly used as an example of how intensely the global economy can decline.

The Great Depression started in the United States after a major fall in stock prices that began around September 4, 1929, and became worldwide news with the stock market crash of October 29, 1929, (known as Black Tuesday). Between 1929 and 1932, worldwide gross domestic product (GDP) fell by an estimated 15%. By comparison, worldwide GDP fell by less than 1% from 2008 to 2009 during the Great Recession. Some economies started to recover by the mid-1930s. However, in many countries, the negative effects of the Great Depression lasted until the beginning of World War II.

The Great Depression had devastating effects in both rich and poor countries. Personal income, tax revenue, profits and prices dropped, while international trade fell by more than 50%. Unemployment in the U.S. rose to 23% and in some countries rose as high as 33%.

Cities around the world were hit hard, especially those dependent on heavy industry. Construction was virtually halted in many countries. Farming communities and rural areas suffered as crop prices fell by about 60%. Facing plummeting demand with few alternative sources of jobs, areas dependent on primary sector industries such as mining and logging suffered the most.

The Stock Market Crash

During the short depression that lasted from 1920 to 1921, known as the Forgotten Depression, the U.S. stock market fell by nearly 50%, and corporate profits declined over 90%. However, the U.S. economy enjoyed robust growth during the rest of the decade. The Roaring Twenties, as the era came to be known, was a period when the American public discovered the stock market and dove in head first.

Causes of the Great Depression

The two classic competing economic theories of the Great Depression are the Keynesian (demand-driven) and the monetarist explanation. There are also various heterodox theories that downplay or reject the explanations of the Keynesians and monetarists. The consensus among demand-driven theories is that a large-scale loss of confidence led to a sudden reduction in consumption and investment spending. Once panic and deflation set in, many people believed they could avoid further losses by keeping clear of the markets. Holding money became profitable as prices dropped lower and a given amount of money bought ever more goods, exacerbating the drop in demand. Monetarists believe that the Great Depression started as an ordinary recession, but the shrinking of the money supply greatly exacerbated the economic situation, causing a recession to descend into the Great Depression.

Economists and economic historians are almost evenly split as to whether the traditional monetary explanation that monetary forces were the primary cause of the Great Depression is right, or the traditional Keynesian explanation that a fall in autonomous spending, particularly investment, is the primary explanation for the onset of the Great Depression. Today the controversy is of lesser importance since there is mainstream support for the debt deflation theory and the expectations hypothesis that — building on the monetary explanation of Milton Friedman and Anna Schwartz — add non-monetary explanations.

There is a consensus that the Federal Reserve System should have cut short the process of monetary deflation and banking collapse. If they had done this, the economic downturn would have been far less severe and much shorter.

Great Recession

The Great Recession was a period of marked general decline (recession) observed in national economies globally during the late 2000s. The scale and timing of the recession varied from country to country (see map). The International Monetary Fund (IMF) formerly concluded that it was the most severe economic and financial meltdown since the Great Depression, although it was ultimately eclipsed by the Great Lockdown in 2020.

The causes of the Great Recession include a combination of vulnerabilities that developed in the financial system, along with a series of triggering events that began with the bursting of the United States housing bubble in 2005–2006. When housing prices fell and homeowners began to walk away from their mortgages, the value of mortgage-backed securities held by investment banks declined in 2007–2008, causing several to collapse or be bailed out in September 2008. This 2007–2008 phase was called the Subprime mortgage crisis. The combination of banks unable to provide funds to businesses, and homeowners paying down debt rather than borrowing and spending, resulted in the Great Recession that began in the U.S. officially in December 2007 and lasted until June 2009, thus extending over 19 months. As with most of other recessions, it appears that no known formal theoretical or empirical model was able to accurately predict the advance of this recession, except for minor signals in the sudden rise of forecasted probabilities, which were still well under 50%.

The recession was not felt equally around the world; whereas most of the world's developed economies, particularly in North America, South America and Europe, fell into a severe, sustained recession, many more recently developed economies suffered far less impact, particularly China, India and Poland, whose economies grew substantially during this period – similarly, the highly developed country of Australia was unaffected, having experienced uninterrupted growth since the early 1990s.

Causes of the Great Recession

According to a 2011 report by the Financial Crisis Inquiry Commission, the Great Recession was avoidable. The appointees, which included six Democrats and four Republicans, cited several key contributing factors that they claimed led to the downturn.

First, the report identified failure on the part of the government to regulate the financial industry. This failure to regulate included the Fed’s inability to curb toxic mortgage lending.

Next, there were too many financial firms taking on too much risk. The shadow banking system, which included investment firms, grew to rival the depository banking system but was not under the same scrutiny or regulation. When the shadow banking system failed, the outcome affected the flow of credit to consumers and businesses.

Other causes identified in the report included excessive borrowing by consumers and corporations and lawmakers who were not able to fully understand the collapsing financial system.

Great Recession Origins and Consequences

In the wake of the 2001 recession and the World Trade Center attacks of 9/11/2001, the U.S. Federal Reserve pushed interest rates to the lowest levels seen up to that time in the post-Bretton Woods era in an attempt to maintain economic stability. The Fed held low interest rates through mid-2004. Combined

with federal policy to encourage home ownership, these low interest rates helped spark a steep boom in real estate and financial markets. Financial innovations such as new types of subprime and adjustable mortgages allowed borrowers, who otherwise might not have qualified otherwise, to obtain generous home loans based on expectations that interest rates would remain low and home prices would continue to rise indefinitely.

However, from 2004 through 2006, the Federal Reserve steadily increased interest rates in an attempt to maintain stable rates of inflation in the economy. As market interest rates rose in response, the flow of new credit through traditional banking channels into real estate moderated. Perhaps more seriously, the rates on existing adjustable mortgages and even more exotic loans began to reset at much higher rates than many borrowers expected or were led to expect. The result was the bursting of what was later widely recognized to be a housing bubble.

During the American housing boom of the mid-2000s, financial institutions had begun marketing mortgage-backed securities and sophisticated derivative products at unprecedented levels. When the real estate market collapsed in 2007, these securities declined precipitously in value. The credit markets that had financed the housing bubble quickly followed housing prices into a downturn as a credit crisis began unfolding in 2007. The solvency of over-leveraged banks and financial institutions came to a breaking point beginning with the collapse of Bear Stearns in March 2008.

Things came to a head later that year with the bankruptcy of Lehman Brothers, the country's fourth-largest investment bank, in September 2008. The contagion quickly spread to other economies around the world, most notably in Europe. As a result of the Great Recession, the United States alone shed more than 8.7 million jobs, according to the U.S. Bureau of Labor Statistics, causing the unemployment rate to double. Further, American households lost roughly $19 trillion of net worth as a result of the stock market plunge, according to the U.S Department of the Treasury. The Great Recession's official end date was June 2009.

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