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"THE MORDERN CORPORATION" A THEORETICAL REVIEW OF THE MODERN CORPORATION IN ZIMBABWE AND THE USE OF SHARE OPTION SCHEMES AS A WAY OF REDUCING THE AGENCY PROBLEM IN STOCK-MARKET LISTED COMPANIES

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ABSTRACT

The main objective of this paper was to discuss the structure of the modern corporation, the nature of agency problem and the use of employee share option schemes in reducing the agency problem. The paper was done on a discussion basis, making use of the existing literature and existing evidence from media reports and company news. It was noted that design of executive compensation should align the interests of management with the shareholders and thereby induce managers to exert efforts to increase the firm's value. An optimally designed scheme would seek to provide risk-averse managers with cost-effective incentives to exert effort and make value-maximizing decisions. The ideal exercise price with respect to such a scheme should depend on a various situations that are likely to vary from executive to executive, from company to company, from industry to industry, and from time to time.

Key Words: Agency relationship, corporation, Employee share options, principal

INTRODUCTION

As noted from a report by the Reserve bank of Zimbabwe of 2006, the Zimbabwean corporate world had been replete with worrying corporate governance structures characterized by improperly constituted boards of directors, poor board oversight, dominance by a few shareholders exercising their undue influence and inexperienced management and undue. Today's increased focus on corporate governance means that those involved in the day to day running or control of the organisation need advice in the development and evaluation of governance structures and processes. Such services had been driven by the need to align interest of stakeholders especially managers and boards, with respect to shareholders and regulators. The structure of the modern corporation calls for a well co-ordinated system of corporate governance to ensure goal congruence between various stakeholders. The media in the country had been blowing the whistle about corporate initiatives, reforms and scandals that surface as a result of the structure of the modern day corporation. Issues like the agency conflict between shareholders and the board, board squabbles, executive remuneration; board restructuring and employee share options are making headlines in the country. The main objective of this paper is to discuss the structure of the modern corporation, the nature of agency problem and the use of employee share option schemes in reducing the agency problem.

1.1 Background to the Study

As the country is coming from economic meltdown and try to restore lost fortunes, one should rethink paradigms linked to maximising the welfare of shareholders. According to the Classical view, there is general agreement, at least among corporate finance practitioners that the objective when making decisions in a business is to maximize value. Value maximization is usually taken to be the goal of the firm. Such a strategy maximizes shareholders' wealth, thereby enabling shareholders to pursue their personal goals. It is against this background of value maximisation that Zimbabwe's corporate sector had been awash with corporate governance issues.

The Zimbabwean economy had been packed with corporate initiatives, reforms and scandals that surface as a result of the structure of the modern day corporation. Issues like the agency conflict between shareholders and the board, board squabbles, executive remuneration; board restructuring and employee share options are making headlines in the country reported in the financial gazette of june 28 2012 was a case where major shareholders in banking group, zb financial holdings limited (zbfhl), demanded a dividend from the financial services firm arguing that a resolution sought by directors for the company to buy its own shares indicated that it had the resources (nyakuzeya 2012). (lack of goal congruency). In another case the major shareholders of the hospitality group rtg were reported in the bid of axing the entire board (business herald 31 december 2011). The good news of the story was reported in form of employee share option schemes. (nyakuzeya 2013) reported a case where africa first renaissance corporation (afre) shareholders have approved the establishment of a share option scheme for the benefit of employees, agents and directors. (mpofu 2012) reported a case on delta beverages zimbabwe seeking shareholders' approval to ratify a share option scheme, and a case where ok zimbabwe limited directors were seeking shareholder approval at an annual general meeting to establish a new share option scheme that would see executives and senior managers controlling about 5 per cent equity in the retail giant. The local bourse itself (zimbabwe stock exchange) was also involved in an exercise to introduce new measures to rationalise share option schemes amid criticism from shareholders that company executives have since the dollarization of the economy pocketed millions of dollars from such schemes.

However, value maximization does not imply a disregard for ethical decision making, in part because the firm's reputation as an employer and business partner depends on its past actions. The main goal of the paper is to review and discuss the nature of agency problem and the extent to which share option schemes can be effective in reducing the agency problem in modern corporations of zimbabwe.

METHODOLOGY

The paper was done on a discussion basis, making use of the existing literature and existing evidence from media reports and company news.

The Morden Corporation: a Theoretical Review

A corporation is a legal entity created by a state, and it is separate and distinct from its owners and managers (Brigham and Houston 1992). It is therefore widely believed in corporate finance that the value of any business other than a very small one will probably be maximized if it is organized as a corporation for the following three reasons (Brigham and Houston 1992):

- Limited liability reduces the risks borne by investors, and, ceteris paribus, the lower the firm's risk, the higher its value
- A firm's value depends on its growth opportunities, which, in turn, depend on the firm's ability to attract capital. Since corporations can attract capital more easily than unincorporated businesses, they are better able to take advantage of growth opportunities.in other words a corporation enjoys economies of scale and good reputation or credit rating when accessing capital
- The value of an asset also depends on its liquidity, which means the ease of selling the asset and converting it to cash at a "fair market value." Because the stock of a corporation is much more liquid than a similar investment in a proprietorship or partnership, this too enhances the value of a corporation.

In the Morden day corporation set up, the question still remains as to who owns the corporation. In the corporate form of ownership, the shareholders are the own company. The owner (shareholders) elect the directors of the corporation, directors in turn appoint the management of the organisation. This separation of ownership from control in the corporate form of organization is what causes agency problems to exist. Management may act in its own or someone else's best interests, rather than those of the shareholders. If such events occur, they may contradict the goal of maximizing the share price of the equity of the firm. The following diagram below shows the structure of a modern corporation

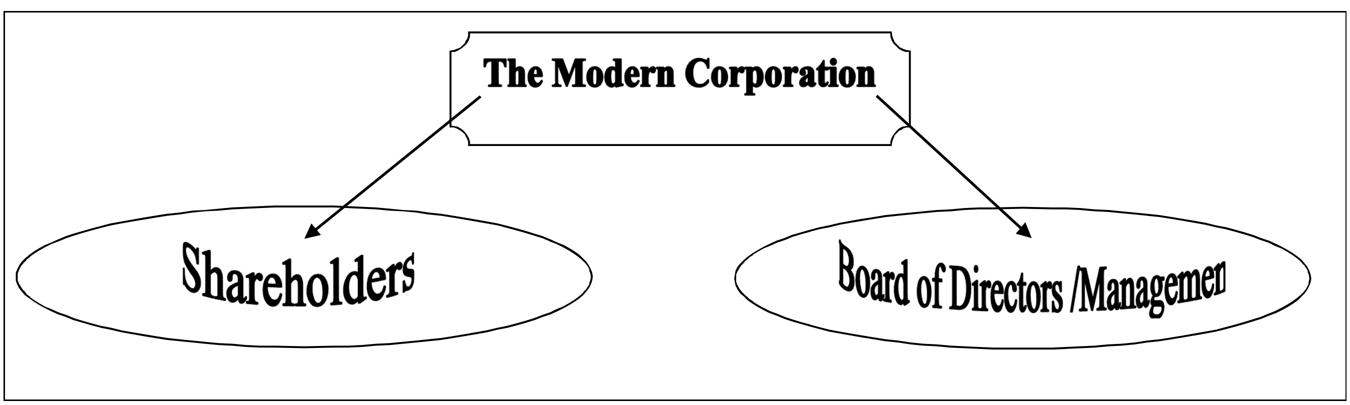


Figure 1: Structure of the modern corporation

There exists a SEPARATION between owners and managers. That is there is a divorce of ownership and control of the modern corporation. Jensen and Meckling (1976) develop the concern of ownership-control separation into a fully-fledged agency problem comprised within the economic 'theory of the firm'. In their paper, Jensen and Meckling identify the costs of the agency problem and trace who bears the costs and why. (Jerzemowska, 1999) contents that it must be remembered, that present day companies do not have owners in the traditional sense. Shareholders are typically dispersed and are unable to manage the entities that they own they have to hire agents (managers) to manage the firm on their behalf. In practice, shareholders act as investors not owners. The difference is subtle, but important. Owners focus on the business performance of the firm and investors focus on the risk and return of their stock portfolios.

1.1 Agency Problem

The primary financial management objective of a company is usually taken to be the maximization of shareholder wealth. In practice, the managers of a company acting as agents for the principals (the shareholders) may act in ways which do not lead to shareholder wealth maximization. The failure of managers to maximize shareholder wealth is referred to as the agency problem.

Shareholder wealth increases through payment of dividends and through appreciation of share prices. Since share prices reflect the value placed by buyers on the right to receive future dividends, analysis of changes in shareholder wealth focuses on changes in share prices. The objective of maximizing share prices is commonly used as a substitute objective for that of maximizing shareholder wealth.

The agency problem arises because the objectives of managers differ from those of shareholders; because there is a divorce or separation of ownership from control in modern companies; and because there is an asymmetry of information between shareholders and managers which prevents shareholders being aware of most managerial decisions. In larger companies, the ordinary shares are likely to be diversely held, and so the actions of shareholders are likely to be restricted in practical terms. This is due to the fact that the responsibility of running the company will be with the board of directors, who may only own a small percentage of the shares in issue. The managers of an organization are essentially agents for the shareholders, being tasked with running the organization in the shareholders' best interests. The shareholders, however, have little opportunity to assess whether the managers are acting in the shareholders' best interests.

When suppliers of capital invest in a business venture, they of course want to be sure that managers will be working in their interests and providing adequate returns. In a simple world, financiers could be assured of such outcomes by signing a straightforward contract stipulating what managers should do with the invested funds and how the returns are to be divided between both parties. But in the real world it is hard to describe and foresee all future contingencies, thereby creating what can be called an "incomplete contract" between financiers and managers. On an international perspective, in 2002, the proposed merger between HP and Compaq triggered one of the most widely followed, bitterly contested, and expensive proxy fights and agency conflict in history over $100 million. The available theory and evidence are consistent with the view that stockholders control the firm and that stockholder wealth maximization is the relevant goal of the corporation. (CFA 2006) explained that agency relationship is created when decision-making authority is delegated to an agent without the agent being fully responsible for the decision that is made. An agency relationship occurs in two common corporate scenarios: (1) the company's stockholders delegate decision-making authority to the managers (agents), but the managers do not receive the full benefit or bear the full cost of their decisions; (2) the company's debt holders delegate authority to managers who act on behalf of the shareholders. Management acts as an agent for the owners (shareholders) of the firm. An agent is an individual authorized by another person, called the principal, to act in the latter's behalf. Principals must provide incentives so that management acts in the principals' best interests and then monitor results

1.2 Goal congruence

In a control system, the state which leads individuals or groups to take actions which are in their self-interest and also in the best interest of the entity is *Goal congruence (*Ogilvie and Parkinson CIMA 2000). It is evident that an important element within companies is the extent to which all members of the management team and their staff work together to achieve the strategic objectives of that company. An aspect of agency theory aims to demonstrate that while various kinds of contract exist, formal and informal (such as job descriptions, departmental responsibilities and office and factory rules), these can only be effective in helping to make a company successful if there is general acceptance of them in practice, and a concerted effort by all concerned to strive in the same direction, that is, to achieve genuine goal congruence. Salter (2003) argued that given the ambiguity of agency problems in organizations, matters of corporate governance deals with constraints that managers put on themselves, or that, investors put on managers to minimize these agency problems. To this end corporate boards and CEOs (via their delegated authority) must devise internal administrative practices that minimize self-interested behavior and personal opportunism and foster cooperative behavior and compliance with organizational objectives and policies. The diagram below shows the nature of agency theory in modern corporations.

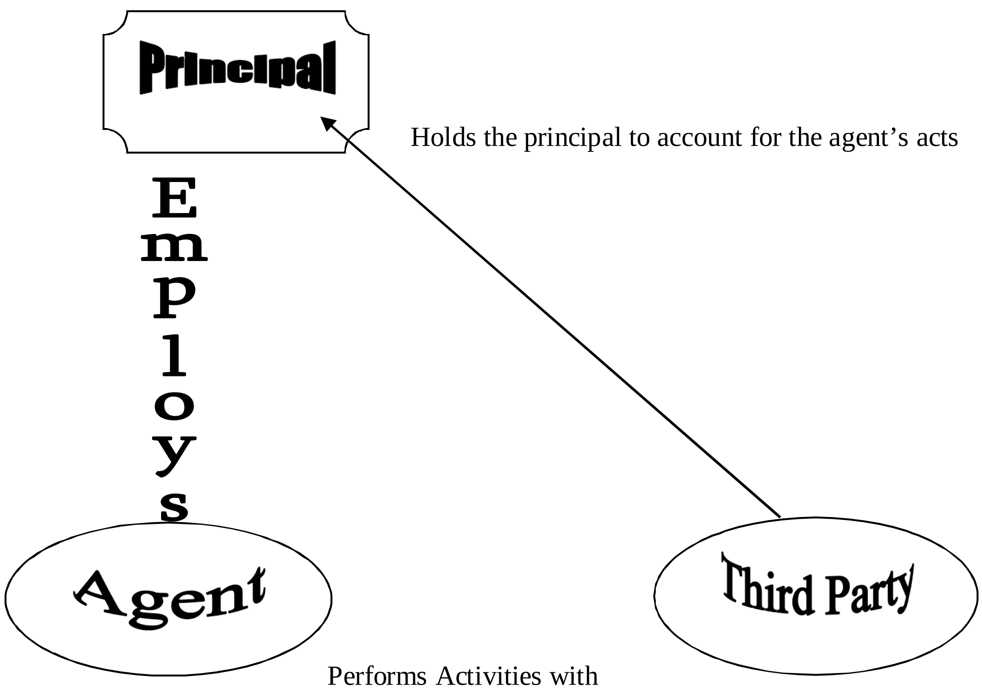


Figure 2. The Principal-Agent relationship

Managers are the agents of shareholders, and employees can be seen as agents of managers, managers and shareholders can be seen as agents of long-term and short term creditors. The problem lies in the fact that once the agent has been appointed he is able to act in his own selfish interest rather than pursuing the objectives.

1.3 Possible sources of Agency conflict and goal incongruence

Arnold et al 2003 noted that according to agency theory, principals and agents have conflicts because of differing risk preferences. According to Eisenhardt, (1989) principals may be risk neutral because they can diversify their risk across firms and other investments. In contrast, agents are said to have an aversion to risk, therefore differing goals to the principal. If left unchecked, the agent will manage the firm according to their own goals (Donaldson, 1990). In the Enron scandal of 2002, there appeared persistent information asymmetry and management appeared to escalate their risk taking efforts aware that this would enhance the perception of their performance with little chance of being exposed. These risks were ultimately taken on behalf of the owners and would have continued undetected as long as they produced acceptable returns (Thomas, 2002). The following are some of the possible sources of conflict between principles and agency.

1.3.1 Choice of Projects Appraisal Technique

In pursuit of their sell-interests, managers may prefer projects with short lives as against those with long lives. They may therefore, want to use Payback technique instead of the superior Net Present Value technique. Shareholders wealth will be maximised by investing in projects with positive net present values. Managers may be more interested in short-term payback than net present value as the investment criterion, in order to help further their own promotion prospects.

1.3.2 Appraisal of Risky Projects

Financial managers may not want to undertake projects which bring substantial benefits to the owners, but are highly risky, because of the negative impact of this risk on their own financial position. However, this risk has presumably been well diversified away by the shareholders. Shareholders can spread their risk by investing in a number of companies. Managers have personal and financial capital invested in the company and so may be averse to investing in a risky investment

1.3.3 Gearing

Financial managers may not want the company's debt to be unduly large in relation to equities so as to reduce the financial risk of the company. Financial managers may however, by doing this, not be taking advantage of tax-deductible interest cost, where interest is treated by the tax authorities as a charge against profits.

1.3.4 Diversification through acquisition.

This is where a company acquires the shares of another company for the reason that it wants to diversity its operations. However, since rational shareholders are expected to diversify their investments, financial managers will only be adding value if they can obtain greater return than what the shareholders themselves would have gotten.

1.3.5 Takeover bids

When a company is compulsorily taking over another company, the target company's directors may be resisting such action in order to protect their own jobs; even though it will bring greater wealth to the existing shareholders. Managers of companies that are subject to a takeover bid often put up a defence to repel the predator. While arguing this action is in the shareholders best interests, Shareholders of acquired companies often receive large gains in the value of their shares.

1.3.6 Leveraged Buy-Out.

In a leveraged buyout, the company's management borrows funds to purchase the outstanding shares of the company via a tender otter (an offer to buy the shares of a company directly from the shareholders). There is the possibility that managers might try to drive down the price of the company's share just before the tender offer, so that they can buy the shares at a bargain price.

1.3.7 Dividend Policy

This is where financial managers are pursuing an unduly conservative dividend policy: that is, trying to keep dividends at a level which is much lower than the normal level, given the industry norms. The question, however, is: can the funds not distributed be utilized better by the shareholders themselves, if received as dividends?

1.3.8 Disclosure of Information in the Financial Statements

This is where financial managers 'paint' the financial condition of the company, via its balance sheet, rosier than what it really is. This is known as 'window dressing' or, in a mild form, 'creative accounting'. It is made possible by the open-ended nature of the choice of accounting policies, when directors prepare financial statements. For example, directors might want to defer certain type of expenditure (e.g. advertising) and capitalize it or put value on intangibles such as patents or off balance sheet financing. According ACCA F9 module (2013) to Directors are responsible for selecting the accounting policies to be used by their company subject to accounting standards and opinions of auditors. They still have the discretion to use accounting techniques to flatter their published accounts and perhaps artificially boost the share price

1.3.9 Ethics

Top management might display certain unethical practices when it makes some decisions on operations. Typical examples of such practices are the degradation of the environment through pollution and testing of products on human beings or trading with countries on dictatorship, testing products on animals and espionage against competitors. Unethical activities might not be prohibited by the companies Act, ZSE act or the Securities Exchange Commission Act but are believed by many to be undesirable to society as a whole. Recent events in some of Zimbabwe's listed companies , government-owned and even unlisted, in which the public invests – have called into question the effectiveness of our corporate governance frameworks in general, and specifically, the ability of our corporate governance systems to deal with the problem of company directors' self-dealing (Chikomwe 2012). Having discussed the nature of the modern corporation and the nature of agency problems, the question is 'how can shareholders motivate managers to work in their best interest?'

1.4 Use of Executive Share option schemes to reduce agency problem.

One way to ensure goal congruency is the use of executive share option schemes (ESOPS). (Laiho 2011) commented that Equity based compensation schemes are very common in stock listed companies, and derive their justification largely from agency theory. At the height of hyperinflation in 2008in Zimbabwe, shareholders of listed companies crafted enticing incentives in share option schemes for senior management in a bid to retain and motivate skilled personnel. Hale (1998) noted that Stock options can motivate employees to remain with the firm because employees in general are required to exercise their options before they leave the company.

All performance based compensation that aligns the management's and owners' incentives have potential to reduce agency costs, although most of the literature focuses on equity based compensation. Though not directly related to Jensen's and Meckling's model, there is a large optimal contracting literature on solving the problem of an optimal contract (in this case optimal compensation scheme) between principals and agents. For example, Holmstrom (1979) and Grossman and Hart (1983) have made important contributions in this field.

A stock option is a right but an obligation buy an underlying security at a pre specified price called the exercise price in at or before a specified future date (expiry date). At or before the expiry date, the buyer of a call option will exercise this right by paying the exercise price to and receiving the underlying asset from the seller of the option when price of underlying asset is greater than the exercise price, and vice versa for a put option. A call option gives the buyer the right but not the obligation to buy the underlying asset.

In, out of and at (or near) the money options are options (both call and put) that have positive intrinsic value, zero intrinsic value and where underlying asset price = exercise price respectively.

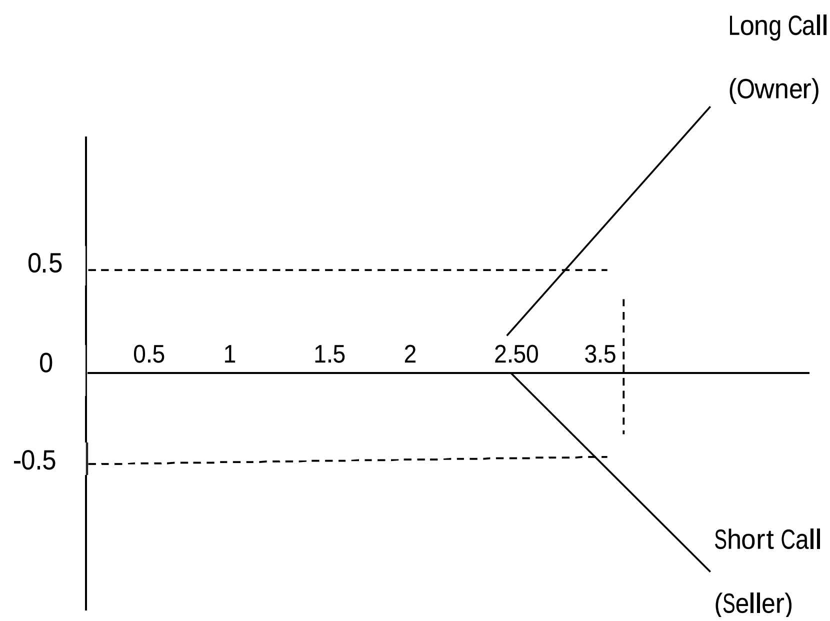
The following illustration shows the payoffs from an option

We assume the following information:

Exercise price	=	2.50
Face value of risk free debt	=	2.50
Cost of option	=	0

Suppose price of stock is 3.50 at expiry

<u>Value Profile of Call Option</u>



Suppose price of stock is 3.50 at expiry
Cash flows (Managers/Buyer)

Transaction		Cash flow
1	Buy call	-0
2	Exercise call to obtain stock	-2.50
3	Sell stock at market price	3.50
	Net	1

Below a price of 2.50, at expiry, the call option is valueless. That is managers will only exercise their right to buy when the option is in the money, when the Stock price expire date if greater than the exercise price. Share options will encourage managers to make decisions that are likely to lead to share price increases (such as investing in projects with positive net present values), since this will increase the rewards they receive from share options. The higher the share price in the market when the share options are exercised, the greater will be the capital gain that could be made by managers owning the options. (Kato et al., 2005) noted in their study in Japan that the use of stock options as a compensation for executives and employees has got a considerable attention with the inevitable reforms in the Japanese corporate governance structure, which was traditionally defined by; the group of companies, cross shareholdings and lifetime employment. Theoretical models suggest the use of option grants to provide an incentive for the managers, when the unobservable managerial efforts have a greater effect on the firm's value (Milgrom and Roberts, 1992). The scheme at the end of the day will benefit both managers and shareholders (agents and principals) and by so doing results in goal congruency. This is so because when an executive is awarded a share option, the theory is that it is in their best interests for the share price to rise, so they will do whatever possible to improve the share price. Their interest will be best served by working towards a goal that is also in the interest interests of the shareholders and by so doing reducing the agency problem. Share options therefore go some way towards reducing the differences between the objectives of shareholders and managers.

1.4.1 The bad news about Share options

However, it is possible that managers may be rewarded for poor performance if share prices in general are increasing. It is also possible that managers may not be rewarded for good performance if share prices in general are falling. Hassan & Hoshino commented that Stock options were banned in Japan before 1997. However, amendments in the Japan's commercial code in May, 1997 enabled companies to offer stock options as compensation. These amendments determined two means of granting options as compensation i.e., firms can buy their own stocks in advance of the transfer to employees or the firms can issue new stocks to option holders at the time of exercise. (Bebchuk & Fried 2003) highlighted that one major perpetual feature of stock option plans is that they fail to filter out stock price rises that are due to industry and general market trends and thus are completely unrelated to managers' own performance. With conventional options, when the market or sector rises substantially, even executives whose companies perform poorly relative to those of their peers can make large profits. Paying managers substantial compensation for stock price increases that have nothing to do with their own performance is difficult to explain under optimal contracting. The substantial amount currently spent on rewarding managers for market or sector rises could either be used to enhance incentives (for example, by giving managers a larger number of options linked more tightly to the managers' relative performance) or be saved with little weakening of incentives. In cases where the exercise price of an indexed option is tracks the market or sector averages, there is a substantial possibility that the manager will receive no payoff from the option plan. It is difficult to decide on a share option exercise price and a share option exercise date that will encourage managers to focus on increasing shareholder wealth while still remaining challenging, rather than being easily achievable. A problem might arise in the ownership structure if corporates issue large quantities of share options. This is because there is a possibility of some risk of excessive dilution of the equity interests of the existing shareholders. Mores when directors exercise their options, they tend to sell the shares almost immediately to cash in on their profit. Unless they are awarded more share options, their interest in the price ends when the option exercise date has passed. Scholtz (2009) highlighted that the wave of corporate scandals raised concerns regarding the design of executive remuneration and the extent to which share options truly align the interests of executive management and stakeholders.

Conclusion

According to Jensen (1993) equity incentives can resolve the agency problems when the separation of ownership and control cause the self-interested managers to act in the ways not beneficial to the shareholders. Therefore, design of executive compensation should align the interests of management with the shareholders and thereby induce managers to exert efforts to increase the firm's value. An optimally designed scheme would seek to provide risk-averse managers with cost-effective incentives to exert effort and make value-maximizing decisions. The optimal exercise price under share option schemes should depend on a couple of factors that are likely to vary from executive to executive, from company to company, from industry to industry, and from time to time (Bebchuk & Fried 2003). Such factors might include the degree of managerial risk aversion, which in turn might be affected by the manager's age and wealth, the project choices available to the company, the volatility of the company's stock, the expected rate of inflation, and the length of the executive's contract, among other things. Efficient managers may be penalised at times when share price in general are falling

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