LM03 · CORPORATE ISSUERS · CFA LEVEL I

Corporate Governance: Conflicts, Mechanisms, Risks & Benefits

How checks, balances, and incentives manage conflicts between owners, managers, boards, creditors, and other stakeholders.

What This Reading Covers

Corporate governance is **the arrangement of checks, balances, and incentives that exists to manage conflicting interests** among a company's management, board, shareholders, creditors, and other stakeholders. This module walks through the conflicts that make governance necessary, the internal and external mechanisms that address those conflicts, and the tangible risks of weak governance versus benefits of strong governance.

Learning Outcome Statements

LOS a Describe the principal-agent relationship and conflicts that may arise between stakeholder groups

LOS b Describe corporate governance and mechanisms to manage stakeholder relationships and mitigate associated risks

LOS c Describe potential risks of poor corporate governance & stakeholder management and benefits of effective governance

Exam Tip: Governance questions typically test whether you can (1) identify the conflict at stake, (2) match the right mechanism to the right stakeholder, and (3) recognize that weak governance raises the firm's cost of capital while strong governance lowers it.

LOS A · THE PRINCIPAL-AGENT PROBLEM

Principal-Agent Relationship

A **principal-agent relationship** exists when one party (the principal) hires another (the agent) to perform a task or service on their behalf — with or without a contract. In a corporation, **shareholders are the principals**; **managers and directors are the agents**.

Two Structural Problems

1. **Information asymmetry** — the agent possesses more information about the firm's operations and strategy than the principal. This weakens the shareholder's (or non-executive director's) ability to monitor whether management is acting in their interest.
2. **Divergent interests & risk appetites** — the agent is *expected* to act in the principal's best interest, but conflicts arise when personal interests diverge. Shareholders, with diversified portfolios, generally have higher risk tolerance than managers whose wealth and careers are concentrated in the firm.

Agency Costs

Direct Costs

Out-of-pocket costs incurred to monitor or constrain the agent.

Example: hiring employees/auditors to monitor the agent; implementing internal-control systems.

Indirect Costs

Opportunity costs from missed business or suboptimal decisions.

Example: foregone profits because the agent failed to pursue a value-adding project.

Key relationship: As information asymmetry increases, the return demanded by shareholders and lenders rises — because investors price in the risk that the agent will not act in their interest. Good governance reduces asymmetry and thereby *lowers the firm's cost of capital*.

Exam Tip: The three classic principal-agent conflicts on the L1 exam are: (1) shareholder vs. manager/director, (2) controlling vs. minority shareholder, and (3) shareholder vs. creditor. We cover each next.

CONFLICT #1 · SHAREHOLDERS VS. DIRECTORS & MANAGEMENT

Shareholder-Manager Conflict

Information asymmetry reduces shareholders' ability to assess performance. Asymmetry grows when **institutional ownership is lower** and when **free float is smaller**. The principal tool to align interests is **compensation** — but even with incentive pay, interests can diverge in five recurring ways.

FIVE WAYS MANAGER INTERESTS DIVERGE FROM SHAREHOLDERS

1. Insufficient Effort
Unwilling to invest, manage costs, or make hard decisions; weak oversight → litigation

2. Inappropriate Risk
Stock grants/options → excessive risk-taking. No grants → overly risk-averse decisions

3. Empire Building
Compensation tied to business size → too many value-destroying acquisitions

4. Entrenchment
Play it safe → copy competitors, avoid risks, avoid speaking out, protect own position

5. Self-Dealing
Exploit firm resources → perquisites (private planes, memberships). Small stakes, low cost

Why diversified shareholders tolerate MORE risk than managers
Managers' wealth & careers are concentrated in one firm; shareholders diversify across many firms.

Exam Tip: Compensation is the **primary** alignment tool — but it is not a complete fix. Exam questions often show compensation tied to the wrong metric (e.g., revenue rather than return on capital) causing empire-building behavior.

CONFLICT #2 · CONTROLLING VS. MINORITY SHAREHOLDERS

Conflicts Between Groups of Shareholders

Dispersed Ownership

Many shareholders, **none** with enough votes to exercise control. Classic public-company model.

Concentrated Ownership

One shareholder (or a cohesive group) holds enough votes to exercise control — a **controlling shareholder**. Can be a family, another company, or the government.

Typical Conflict Patterns

CONTROLLING SHAREHOLDER WANTS	MINORITY SHAREHOLDERS WANT
Founding family seeking to **diversify** into different businesses to reduce personal risk	Already hold diversified portfolios — focus on **maximizing firm value**, not corporate diversification
Long-term perspective: preserve legacy, multi-decade horizon	Seek **quick gains** via asset sales, cost cutting, or restructuring
Related-party transactions that benefit insiders/family	Arm's-length transactions that maximize residual value

Dual-Class Share Structures

A dual-class structure lets one group hold effective control with much less than 50% economic ownership.

CLASS A	CLASS B
One vote per share	**Several votes per share**
Publicly held and traded	Held by company insiders/founders

Result: a single group can have personal interest > will of the economic majority.

Exam Tip: When a company has concentrated ownership or dual-class stock, minority protections (independent directors, related-party transaction policies, cumulative voting) become *more* important, not less.

CONFLICT #3 · SHAREHOLDERS VS. CREDITORS

Creditor-Shareholder Conflict

Lenders have a **legal claim** to interest and principal — priority over owners — but **capped upside**. The best they can receive is their promised interest and principal. Owners have a **residual** claim with **unlimited upside** if the firm succeeds. As a result, shareholders may favor actions that increase potential growth but also increase risk. Lenders oppose those actions because they raise default risk without raising the lender's payoff.

Actions That Favor Shareholders at Creditors' Expense

1. **Issuing new debt** that increases the default risk faced by *existing* debtholders (asset substitution / leverage increase).
2. **Increasing dividends** at the cost of decreasing company assets available as collateral, raising default risk.
3. **Risky expansion or acquisitions** where the upside flows to equity and the downside is borne partly by debtholders.

This conflict is a greater risk for **long-term debtholders**, whose claims are exposed for longer.

Stakeholder Impact Matrix — Increase in Leverage

STAKEHOLDER	DIRECTION OF IMPACT	WHY
Existing bondholders	Negative	Higher default risk, no increase in promised payoff
Shareholders	Positive (expected)	Leverage amplifies ROE if ROA > cost of debt
Senior managers	Mixed	Option-style compensation gains upside; but wealth concentrated in firm
Employees, suppliers, customers	Indirect / limited	Affected only if distress materially threatens ongoing operations

Exam Tip: On the exam, the group *most negatively affected* by an unexpected leverage increase is almost always the **existing bondholders / creditors**. Employees, dealers, and suppliers have only indirect exposure through firm viability.

QUIZ 1 · CONFLICTS

Test Your Understanding: Principal-Agent & Conflicts

Q1. In a principal-agent relationship, *information asymmetry* refers to the fact that:

Q2. A CEO whose bonus is tied to total company revenue is *most likely* exhibiting which agency problem when she pursues multiple low-return acquisitions?

Q3. A dual-class share structure with Class A (1 vote) and Class B (10 votes) *most likely* creates conflict between:

Q4. A company announces a sharp increase in debt financing to fund an aggressive expansion. Which stakeholder is *most likely* negatively affected?

LOS B · MECHANISMS · REPORTING & TRANSPARENCY

Corporate Reporting and Transparency

External stakeholders rely on corporate reporting for information on performance and position. Investors use corporate reports to assess performance, make valuation and investment decisions, vote on corporate matters, and ensure compliance with debt covenants (via trustees).

PUBLIC COMPANIES	PRIVATE COMPANIES
Annual reports, proxy statements, disclosures, investor relations	Information disclosed only to the extent required by regulation (or voluntarily)
Must disclose: operations, objectives, **audited F/S**, governance structure, ownership structure, remuneration policies, **related-party transactions**, risk factors	Confidential information shared with investors as negotiated (not standardized)
Most jurisdictions & stock exchanges require audited financial statements	Most jurisdictions **do not** require audits

Why Transparency Matters for Governance

Transparent disclosure of **related-party transactions**, **remuneration policies**, **ownership structure**, and **risk factors** is the mechanism by which shareholders can detect self-dealing, misaligned incentives, and hidden conflicts. Without this visibility, the monitoring function collapses.

Exam Tip: Disclosure of related-party transactions is the single most commonly tested "assessment factor" for governance quality. If a firm transacts materially with the CEO's spouse or the chair's private company, investors need to see it.

LOS B · SHAREHOLDER MECHANISMS

Shareholder Mechanisms

No global standard set of shareholder rights exists — these are the common examples tested on the CFA.

1. Shareholder Meetings

Annual General Meeting (AGM)

Routine annual business:

- Board elections
- Auditor appointment
- Approval of financial statements
- Dividend declarations
- Director and auditor compensation
- Equity-based compensation plans
- "Say-on-pay" non-binding votes

Extraordinary General Meeting (EGM)

Called when a resolution requires shareholder approval between AGMs, or when a minimum number/% of shareholders request one. Examples:

- Special elections
- Mergers & acquisitions approval
- Voluntary liquidation
- **Amendment to corporate bylaws**

Shareholders unable to attend vote by **proxy**.

2. Shareholder Activism

Investor strategies to compel a company to act in a desired manner. The **primary aim is to rapidly increase shareholder value** (sometimes also social/political/environmental goals).

Hedge funds are among the predominant shareholder activists — their fees are based on returns and they can fund large positions with leverage, unlike regulated investment entities. Typical actions: encourage focus on core business, push for restructuring, replace management.

3. Shareholder Litigation

Activists may pursue **shareholder derivative lawsuits** — shareholders act on behalf of the company against directors/management who have failed to act for the company's benefit. Some jurisdictions restrict such suits via minimum share-ownership thresholds or outright prohibition.

4. Corporate Takeovers (Market for Corporate Control)

MECHANISM	DEFINITION
Proxy Contest/Fight	A group seeking a controlling position persuades other shareholders to vote with them
Tender Offer	Invitation to existing shareholders to sell shares to the acquiring group — gain control of board, then management
Hostile Takeover	Attempt to acquire a company *without* the consent of its management

Anti-Takeover Measures

Preservation of employment should incentivize the board to maximize shareholder wealth; but threat of removal may have a negative impact on governance. Examples:

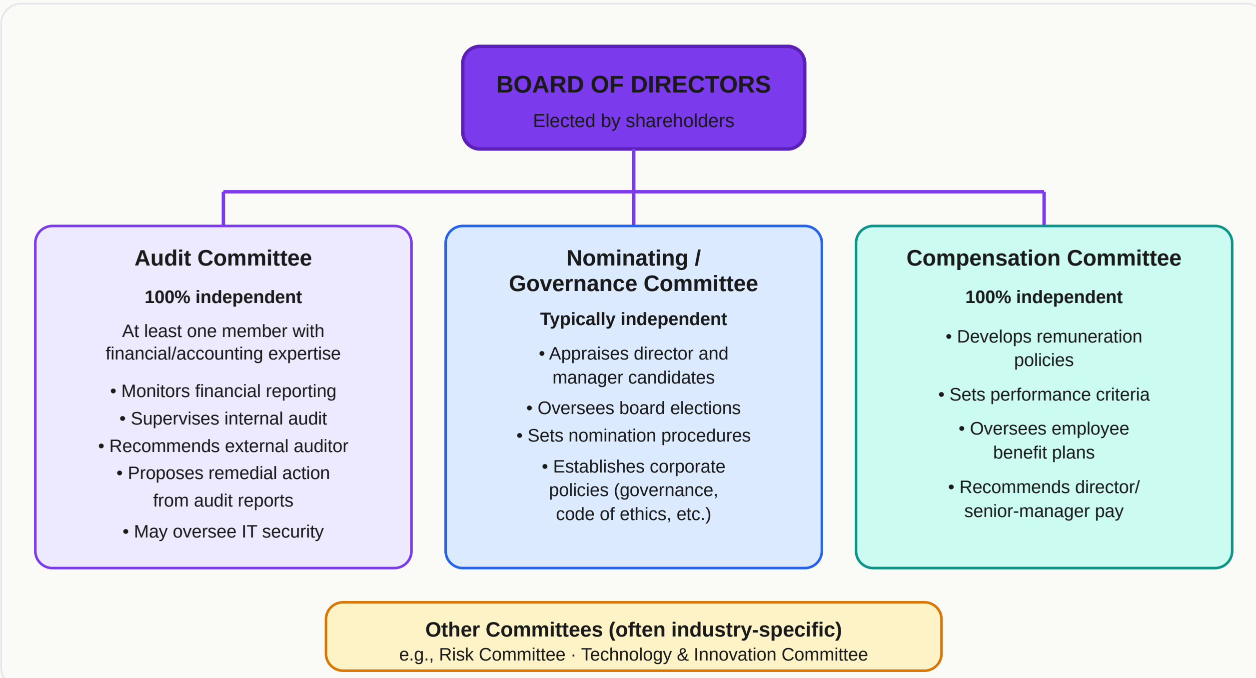
- **Staggered board elections** — prevent replacement of the entire board in a single year
- **Poison Pill** (shareholder rights plan) — if one shareholder purchases a given percentage of shares, other shareholders gain the right to buy more shares at a discount

LOS B · BOARD MECHANISMS

Board of Directors & Committees

Specific functions are delegated to committees, but **responsibility is not delegated** — the board remains accountable. Board members include inside directors (executives, founders) and **independent directors** who have no material relationship with the company.

BOARD STRUCTURE & CORE COMMITTEES



Board Structures

One-Tier Board

Inside directors and independent directors serve on a **single** board.

Two-Tier Board

Independent directors serve on a **supervisory** board that oversees a **management** board of inside directors.

In a **staggered board**, only a fraction of the board is elected each year — an anti-takeover feature that can also insulate weak boards.

Exam Tip: Audit and compensation committees are **100% independent** on the CFA answer key. The nominating/governance committee is *typically* independent but not always 100%. If a stem asks which committee recommends the external auditor or recommends remedial action based on audit reports — it's the audit committee.

LOS B · CREDITOR & OTHER STAKEHOLDER MECHANISMS

Creditor, Employee, Customer/Supplier, & Government Mechanisms

Creditor Mechanisms

The rights of creditors are established by **law** and by **contracts** with the company.

Bond Indenture — Legal contract describing the structure of the bond, the obligations of the company, and the rights of bondholders. Terms & conditions may **require** certain actions, **prohibit** certain actions, or **require** assets to be pledged as collateral.

Creditor Committees — Established when a company files for bankruptcy (in some jurisdictions). **Ad hoc committees** may be formed by bondholder groups when a company is struggling — even before formal distress.

Employee Mechanisms

Labor Laws — Country-specific; define standard rights and responsibilities.

Unions — Employees have the right to form unions. In some countries, employees may have **board representation**.

ESOP — Employee Stock Ownership Plan — aligns employee interests with shareholders.

Customer & Supplier Mechanisms

Contracts — Specify prices, rights, and responsibilities.

Social Media — A virtually cost-free channel to compete with management for influence over public sentiment.

Government Mechanisms

Laws & Regulations — Protect and enforce property and contract rights, and rights of specific groups. Industries that affect public or stakeholder interests most heavily are more heavily regulated — e.g., **Financial Services, Health Care**.

Corporate Governance Codes — Guiding principles for publicly traded companies — typically **"comply or explain"**. Stock exchanges may impose governance requirements as listing conditions.

Internal vs. External Governance Mechanisms

Internal

- Board of directors & committees
- Independent directors
- Shareholder voting & meetings
- Transparency & disclosure
- Related-party policies, code of ethics

External

- Regulators & government
- External auditors
- Credit-rating agencies
- Market for corporate control (takeovers)
- Bond indentures & creditor committees

QUIZ 2 · MECHANISMS

Test Your Understanding: Governance Mechanisms

Q5. Which shareholder meeting would *most likely* be called to approve an amendment to a corporation's bylaws?

Q6. Which governance mechanism *most directly* protects creditors' interests?

Q7. Which is a responsibility of the *audit committee*?

Q8. Which statement about shareholder activism is *most accurate*?

LOS B / C · ASSESSMENT FACTORS

Assessing Corporate Governance

When analysts assess the quality of a company's governance, they focus on a consistent set of factors drawn from the mechanisms above.

Board & Committee Composition

- Proportion of **independent directors**
- One-tier vs. two-tier structure
- Staggered elections (pro/con)
- 100% independent audit & compensation committees
- At least one audit-committee member with financial/accounting expertise
- Board diversity & relevant expertise

Shareholder Rights

- Voting procedures (one-vote-per-share vs. dual-class)
- Proxy voting access
- Say-on-pay votes
- Ability to call EGMs / propose resolutions
- Legal standing for derivative lawsuits

Transparency & Disclosure

- Audited financial statements
- Ownership structure disclosure
- Remuneration policies (including equity-based)
- **Related-party transactions**
- Risk factors & material contingencies

ESG Factors

- **Environmental:** emissions, pollution, energy, waste, water, climate exposure
- **Social:** customer privacy, employee engagement, diversity/inclusion, labor & community relations
- **Governance:** board composition, audit committee, executive compensation, bribery/corruption, political contributions & lobbying

Who bears ESG risk? Equity investors bear the brunt of ESG risk because their residual claim absorbs first losses. Debt investors have less exposure *unless* adverse events result in losses large enough to bring about default.

Exam Tip: When a question asks which factor is *most relevant* to assessing governance — the highest-frequency correct answers are (1) board independence, (2) audit-committee composition, and (3) disclosure of related-party transactions.

LOS C · RISKS OF WEAK GOVERNANCE & BENEFITS OF STRONG GOVERNANCE

Consequences of Governance Quality

Weak corporate governance can lead to **competitive disadvantage**. Strong corporate governance can **increase competitiveness and efficiency**. The CFA curriculum groups the consequences into three buckets.

1. Operational Risks & Benefits

Benefits

- Mitigation, identification, control of risk factors including **fraud**
- Clear delineation of responsibilities
- Alignment of interests → improved decision making

Risks

- Adverse performance
- One stakeholder group benefits at the expense of others
- Management makes decisions solely for their own benefit

Case — Theranos. Health-care company. 2014 valuation: USD 10 billion. 2018: ceased operations. Board had very little knowledge of medical technology; no independent expert validation of the blood-testing product; no peer-reviewed publications; whistleblowers were ignored by the board and fired by the company.

2. Legal, Regulatory & Reputational Risks & Benefits

Benefits

- Stakeholders seek long-term relationships with firms that respect their rights
- Reputation enhances ability to **attract talent**, **secure capital**, improve sales
- Mitigation of conflicts of interest and agency problems

Risks

- Government/regulatory investigation for violation of laws
- Lawsuits from other stakeholders
- Loss of reputation from improperly managed conflicts of interest

Case — Volkswagen AG. 2014: diesel vehicles failed emissions testing; VW initially responded by questioning the testing process. 2015: VW admitted falsifying emissions data. To date: **USD 37.7 billion** in fines.

3. Financial Risks & Benefits

Benefits

- Increased investor confidence → **reduces required return**, higher valuation

Risks

- Weak management of creditor interests → **default**
- Weak control systems & ineffective decision making

- Increased likelihood of **credit rating upgrade** from speculative to investment grade
- Listed companies with experienced audit committees have shown stronger performance during crises
- Board diversity and independence appear to be **key factors in firm valuation**

- Default and bankruptcy risk
- Higher cost of capital

The Core Takeaway

Effective governance → **lower default risk** → **lower cost of capital** → higher firm value. That is the single mechanism through which governance quality translates into financial performance.

QUIZ 3 · RISKS, BENEFITS & ASSESSMENT

Test Your Understanding: Governance Quality

Q9. Which is *most likely* a benefit of effective corporate governance?

Q10. Which of the following is *least likely* a risk of poor corporate governance?

Q11. An analyst evaluating governance quality would view which of the following *most* favorably?

MODULE COMPLETE

Your Scorecard

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LM03 Key Takeaways — Exam-Ready Cheat Sheet

Principal-Agent & Conflicts

1. **Principal-agent:** one party hires another to act on its behalf; agent has more information (asymmetry); conflicts arise when interests diverge.
2. **Agency costs:** direct (e.g., monitoring) and indirect (e.g., foregone profits). As asymmetry rises, required return rises.
3. **Three classic conflicts:** shareholder vs. manager · controlling vs. minority shareholder · shareholder vs. creditor.
4. **Five manager pathologies:** insufficient effort · inappropriate risk · empire building · entrenchment · self-dealing.
5. **Dual-class structures** let insiders control with less than 50% economic ownership — amplifies controlling-vs-minority conflict.

Mechanisms

6. **Shareholder mechanisms:** reporting & transparency · AGM/EGM · activism · derivative lawsuits · corporate takeovers (proxy contest, tender offer, hostile takeover).
7. **Anti-takeover measures:** staggered boards, poison pills (shareholder-rights plans).
8. **Creditor mechanisms:** bond indentures · reporting · creditor committees (including ad hoc committees during distress).
9. **Board committees:** Audit (100% indep., financial expert) · Nominating/Governance (typ. indep.) · Compensation (100% indep.) · Risk / Tech (industry-specific).

10 **External mechanisms:** regulators · auditors · credit-rating agencies · market for corporate control · governance codes ("comply or explain").

Risks & Benefits

11 **Risks of weak governance:** weak controls · ineffective decisions · legal · regulatory · reputational · default & bankruptcy.

12 **Benefits of strong governance:** higher operational & financial performance · reputation benefits · credit-rating upgrades · **lower cost of capital**.

13 **Key assessment factors:** board independence & diversity · audit-committee composition · related-party transactions · remuneration policies · shareholder voting rights · ESG disclosures.

Last-Minute Exam Checklist

AGM vs EGM: AGM = routine annual business; EGM = special resolutions (bylaws, mergers, liquidation)

Audit committee: 100% indep · financial expertise · recommends external auditor

Comp committee: 100% indep · sets performance criteria

Takeover tools: proxy fight · tender offer · hostile takeover · poison pill · staggered board

Creditor tools: bond indenture · ad hoc committee · reporting

Bottom line: strong governance → lower default risk → lower cost of capital → higher firm value

Step 1 of 15