Agency theory and corporate governance: a review of the literature from a UK perspective

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Abstract

This paper attempts to provide an overview of the major literature which has developed in the area of agency theory and corporate governance in the 25 years since Jensen and Meckling's (1976) groundbreaking article proposing their theory of the firm. A discussion is provided as to why such problems arise within the 'nexus of contracts' that Jensen and Meckling describe as characterising the modern corporation and how managers and shareholders may act to control these costs to maximise firm value. The major articles covering areas where manager's interests are likely to diverge from those of the shareholders who employ them are also reviewed. Papers which have both proposed and empirically tested means by which such conflicts can be resolved are also surveyed. This section also attempts to incorporate international comparisons, with particular reference to several recent published and unpublished academic research in the UK. Finally, some concluding remarks are offered along with some suggestions for future research in the area of corporate governance.

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Agency theory and corporate governance:
A UK perspective 25 years after Jensen and Meckling

1. Introduction

Since the seminal work of Jensen and Meckling (1976) in proposing a theory of the firm based upon conflicts of interest between various contracting parties – namely shareholders, corporate managers and debt holders – a vast literature has developed in explaining both the nature of these conflicts, and means by which they may be resolved.

Finance theory has developed both theoretically and empirically to allow a fuller investigation of the problems caused by divergences of interest between shareholders and corporate managers.

To fully summarise all of the research that has been conducted in this field would be almost impossible. What is attempted, is to provide a summary of the major research that has taken place on the key topics which have emerged in terms of both the causes of agency conflicts, and the means by which they can be resolved.

Additionally, an attempt is also made to incorporate some of the more recent empirical studies, published and unpublished, in the area – with particular reference to that carried out in the United Kingdom. At the same time, cultural differences between various markets, which may have implications for the prevalence of these conflicts and how they can be controlled, are discussed to some extent.

Section two of this paper examines the nature of the agency relationship which exists between managers and shareholders and the agency costs which arise from them.[1] In section three, a discussion of the main divergences between managers and

[1] In the context of this paper the terms 'manager' and 'executive' are used interchangeably.

shareholders which result in these agency costs is provided. Section four provides a discussion of the various mechanisms that have been discussed as means of reducing agency conflicts between shareholders and managers and section five concludes these findings.

2. Agency Costs

Jensen and Meckling (1976) define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this, the principal will delegate some decision-making authority to the agent.

These agency problems arise because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal, Brennan (1995b). Arising from this problem is how to induce the agent to act in the best interests of the principal.

Managers bear the entire cost of failing to pursue their own goals, but capture only a fraction of the benefits. Jensen and Meckling (1976) argue that this inefficiency is reduced as managerial incentives to take value maximising decisions are increased.

As with any other costs, agency problems will be captured by financial markets and reflected in a company's share price. Agency costs are can be seen as the value loss to shareholders, arising from divergences of interests between shareholders and corporate managers. Jensen and Meckling (1976) defined agency costs as the sum of monitoring costs, bonding costs, and residual loss.

2.1. Monitoring Costs

Monitoring costs are expenditures paid by the principal to measure, observe and control an agent's behaviour. They may include the cost of audits, writing executive compensation contracts and ultimately the cost of firing managers. Initially these costs are paid by the principal, but Fama and Jensen (1983) argue that they will ultimately be borne by an agent as their compensation will be adjusted to cover these costs.

Certain aspects of monitoring may also be imposed by legislative practices. In the UK companies are required to provide statements of compliance with the Cadbury (1992) and Greenbury (1995) reports on corporate governance. Non-compliance must be disclosed and explained, and the attention brought by statements of non-compliance represent an additional source of monitoring.

Denis, Denis and Sarin (1997) contend that effective monitoring will be restricted to certain groups or individuals. Such monitors must have the necessary expertise and incentives to fully monitor management, in addition such monitors must provide a credible threat to management's control of the company.

Burkart, Gromb and Panunzi (1997) provide a contradictory view of monitoring, arguing that too much will constrain managerial initiative. Optimal levels of monitoring managerial policies are specific to an individual firm's contracting environment, Himmelberg, Hubbard and Palia (1999). Critics of Cadbury (1992) have felt that this increased level of monitoring may act as a deterrent to managerial entrepreneurship.

2.2. Bonding Costs

Given that agents ultimately bear monitoring costs, they are likely to set up structures that will see them act in shareholder's best interests, or compensate them accordingly if they don't. The cost of establishing and adhering to these systems are known as bonding costs.

They are borne by the agent, but are not always financial. They may include the cost of additional information disclosures to shareholders, but management will obviously have the benefit of preparing these themselves. Agents will stop incurring bonding costs when the marginal reduction in monitoring equals the marginal increase in bonding costs.

Denis (2001) argues that the optimal bonding contract should aim to entice managers into making all decisions that are in the shareholder's best interests. However, since managers cannot be made to do everything that shareholders would wish, bonding provides a means of making managers do some of the things that shareholders would like by writing a less than perfect contract.

Within the UK one interesting bonding structure imposed upon management is the requirement of closely held companies to distribute all income after allowing for business requirements. To the extent that earnings retention (to be discussed later) is a problem for UK companies, this bonding mechanism may serve to reduce the scope of this problem.[2]

2.3. Residual Loss

[2] However, the effectiveness of this mechanism is at best questionable since investment policies are at the discretion of company management.

Despite monitoring and bonding, the interest of managers and shareholders are still unlikely to be fully aligned. Therefore, there are still agency losses arising from conflicts of interest. These are known as residual loss.

They arise because the cost of fully enforcing principal-agent contracts would far outweigh the benefits derived from doing so. Since managerial actions are unobservable ex ante, to fully contract for every state of nature is impractical. The result of this is an optimal level or residual loss, which may represent a trade-off between overly constraining management and enforcing contractual mechanisms designed to reduce agency problems.

3. Where Agency Conflicts Arise

Agency problems arise from conflicts of interest between two parties to a contract, and as such, are almost limitless in nature. However, both theoretical and empirical research has developed in four key problematic areas – moral hazard, earnings retention, risk aversion, and time-horizon. The next section aims to provide a discussion of these major themes and empirical research that has been conducted in these areas.

3.1. Moral-Hazard Agency Conflicts

Jensen and Meckling (1976) first proposed a moral-hazard explanation of agency conflicts. Assuming a situation where a single manager owns the firm, they develop a model whereby his incentive to consume private perquisites, rather than investing in positive net present value (NPV) projects, increases as his ownership stake in the company declines.

This framework is easily applied in companies where ownership structure is diverse and the majority of the company's shares are not controlled by corporate managers. This is more often than not the case in most market based contracting economies such as the UK.

Shleifer and Vishny (1989) argue that rather than not investing, managers may choose investments best suited to their own personal skills. Such investments increase the value to the firm of the individual manager and increase the cost of replacing him, allowing managers to extract higher levels of remuneration from the company.

Moral-hazard problems are likely to be more paramount in larger companies, Jensen (1993). While larger firms attract more external monitoring, increasing firm size expands the complexity of the firm's contracting nexus exponentially. This will have the effect of increasing the difficulty of monitoring, and therefore, increase these costs.

In comparison to US companies, their UK counterparts may not suffer to the same extent from the problems of moral hazard. Conyon and Murphy (2000) argue that UK companies tend to be smaller than their US rivals, and this could explain their finding of pay-performance sensitivities[3] of UK CEO's being roughly one sixth of those of their US counterparts. A key issue of performance related pay is to resolve the moral-hazard problem, and as such, if the problem is less paramount within UK companies, then there is less of a need to provide executives with high levels of compensation.

Furthermore, Jensen (1986) argues that in larger, maturer, companies, free cash flow problems will heighten the difficulties created by moral hazard. Where managers have such funds at their disposal, without any strong requirements for investment, the

[3] Where, pay-performance sensitivities capture how much of an increase in shareholder's wealth is captured by changes in the total compensation of a company's chief executive officer (CEO).

scope for private perquisite consumption is vastly increased, as it becomes more difficult to monitor how corporate funds are utilised.

Moral-hazard problems are also related to a lack of managerial effort. As managers own smaller equity stakes in their companies, their incentive to work may diminish.

It is difficult to directly measure such shirking of responsibilities by directors. However, Rosenstein and Wyatt (1994) find that company stock prices decline upon the announcement of the appointment of an executive director to the board of another company. This would be consistent with diminishing managerial effort being damaging to company value.

3.2. Earnings Retention Agency Conflicts

Brennan (1995b) contends that moral hazard based theories over-simplify the agency problem as one of effort aversion. Grandiose managerial visions and cash distribution to shareholders may be of more concern. Here, the problem of over-investing may be more paramount than that of perquisite consumption and under-investment.

Studies of compensation structure have generally found that director remuneration is an increasing function of company size,[4] providing management with a direct incentive to focus on size growth, rather than growth in shareholder returns. Jensen (1986) furthers this, arguing that managers prefer to retain earnings, whereas shareholders prefer higher

[4] See for example Jensen and Murphy (1990) and Conyon and Murphy (2000).

levels of cash distributions, especially where the company has few internal positive NPV investment opportunities.[5]

Managers benefit from retained earnings as size growth grants a larger power base, greater prestige, and an ability to dominate the board and award themselves higher levels of remuneration, Jensen (1986, 1993). This reduces the amount of firm specific risk within the company, and therefore, strengthens executive job security. However, finance theory dictates that investors will already hold diversified portfolios. Therefore, further corporate diversification may be incompatible with their interests.

Empirical evidence suggests that such a strategy is ultimately damaging to shareholder wealth. Lang and Stulz (1994) find that returns to shareholders in undiversified firms are greater than for those who had attempted to reduce their exposure to risk through this diversification. Also, they found that the value of these firms is reduced as they diversified further.

Such earnings retentions reduce the need for outside financing when managers require funds for investment projects. However, despite the potential costs of raising new capital,[6] external markets provide a useful monitoring function in constraining grandiose managerial investment policies, Easterbrook (1984). Earnings retention reduces the likelihood of this external monitoring encouraging management to undertake value maximising decisions.

3.3. Time Horizon Agency Conflicts

[5] Internal investment opportunities generally refer to projects within the firm's existing business operations. External investment opportunities would refer to the company making a non-related takeover as an investment decision, potentially with the main purpose of diversifying operations.
[6] See Myers (1984) for a discussion of such costs.

Conflicts of interest may also arise between shareholders and managers with respect to the timing of cash flows. Shareholders will be concerned with all future cash flows of the company into the indefinite future. However, management may only be concerned with company cash flows for their term of employment, leading to a bias in favour of short-term high accounting returns projects at the expense of long-term positive NPV projects.

The extent of this problem is heightened as top executives approach their retirement, or has made plans to leave the company. Dechow and Sloan (1991) examine research and development (R&D) expenditures as top executives approach retirement and find that these tend to decline. R&D expenditures reduce executive compensation in the short-term, and since retiring executives won't be around to reap the benefits of such investments, this could explain the above findings.

Such a problem may also lead to management using subjective accounting practices to manipulate earnings prior to leaving their office in an attempt to maximise performance-based bonuses, Healy (1985). Weisbach (1988) finds that accounting earnings tend to be significantly higher in the year prior to a Chief Executive Officer (CEO) leaving their position, and attributes such findings to the problem of earnings manipulations.

3.4. Managerial Risk Aversion Agency Conflicts

Conflicts relating to managerial risk aversion arise because of portfolio diversification constraints with respect to managerial income. Should private investors wish to diversify their holdings they can do so at little cost with. However, company managers are more akin to individuals holdings a single, or very small number of stocks. Denis (2001)

comments that the majority a company director's human capital is tied to the firm they work for, and therefore, their income is largely dependent upon the performance of their company. As such, they may seek to minimise the risk of their company's stock. Therefore, they may seek to avoid investment decisions which increase the risk of their company, and pursue diversifying investments which will reduce risk, Jensen (1986).

Demsetz and Lehn (1985) document an inverse relation between the risk of a firm's stock and levels of ownership concentration. Executives in high-risk companies prefer to place a smaller fraction of their personal wealth in the company.

This problem may be heightened when executive compensation is composed largely of a fixed salary, or where their specific skills are difficult to transfer from one company to another. In addition, risk increasing investment decisions may also increase the likelihood of bankruptcy. Such a corporate event will severely damage a manager's reputation, making it difficult to find alternative employment.

Managerial risk aversion will also affect the financial policy of the firm. Higher debt is expected to reduce agency conflicts, Jensen (1986), and also carries potentially valuable tax shields, Haugen and Sendbet (1986). However, Brennan (1995b) contends that risk averse managers will prefer equity financing because debt increases the risk of bankruptcy and default.

3.5. Summary of Agency Conflicts

Within the agency framework agency conflicts arise from divergences of interest between any two parties to a contract within an organisation. As a result, they are almost limitless in nature. For this paper to attempt to fully cover these conflicts would be impossible,

however, what is dealt with is some of the main research which has been conducted into the area of agency conflicts. A summary of the results discussed in this section is provided in table 1.

Differing researchers have argued over the severity of each of the different types of conflicts described above. Research by Jensen (1986) and Himmelberg et al. (1999) amongst others stress the importance of a firm's contracting environment, as vitally important in determining the importance of such problems. For example, while perquisite consumption may be a major problem in larger companies, this may not be the case in smaller firms, where assets can be more easily monitored.

4. Controls on Agency Problems

Despite the existence of the problems discussed above, the modern corporation, with the diffused share ownership which leads to such conflicts, has continued to popular amongst both corporate managers and outside investors alike.[7] This could be attributed largely to the evolution of internal and external monitoring devices which are aimed at controlling such problems. What is aimed at here is to again summarise the main literature which has developed on the topic. It should be noted that there does tend to be a degree of interaction between each type of mechanism within firms.[8]

Himmelberg et al. (1999) argue that firms will tend to substitute various mechanisms depending on unobservable (to the economitrician) characteristics of the firm's contracting environment. Since this contracting nexus varies dramatically from one firm to the next, what is optimal for one, need not be optimal for another. Within this context, Agrawal and Knoeber (1996) argue that if one specific mechanism is utilised to a lesser degree, others may be used more, resulting in equally good decision making and performance.

Denis (2001) argues that two conditions must ensue for an effective governance mechanism. Firstly, does the device serve to narrow the gap between managers' and shareholders' interests. Secondly, does the mechanism then have a significant impact on corporate performance and value. She also comments that where firms are all in equilibrium with respect to their governance mechanisms, then no meaningful relationship between any individual mechanism and performance will be seen to exist.

[7] Jensen (1993) appears to question the future of such corporations, favoring more closely held buy-out type companies for their ability to minimise the agency conflicts described above.

[8] A classic example of this is the Management Buy-Out Company as described by Kaplan (1989). Such companies achieve their efficiencies through a combination of large managerial incentives through higher

4.1. The Managerial Labor Market

Fama (1980) argues that corporate managers will be compensated in accordance with the market's estimation of how well they are aligned to shareholder's interests, based on prior performance with other companies.

4.1.1. Conditions for External Monitoring from Labor Markets

Three conditions are given for the managerial labor market to operate efficiently in setting executive compensation. Firstly, the manager's talents and tastes for private consumption on the job aren't known with certainty, are likely to change through time and can be determined by the managerial labor market from information on past and present performance.

The original analysis focuses mainly on Jensen and Meckling (1976)'s moral-hazard agency problem. However, Fama's (1980) analysis can easily be extended to impute managerial preferences for firm size maximisation (earnings retention problems), their age and the amount of time they are likely to spend with the firm (time horizon), and private wealth and preferences for diversification (risk aversion).

The second condition is that the managerial labor market can efficiently process information into its valuation of management. However, information gathering costs will likely result in an equilibrium level in markets, where different parties hold different amounts of information.

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insider ownership, and the monitoring constraints placed by higher levels of debt financing. Both of these devices will be discussed further in this section.

Finally, Fama argues that the weight of the wage revision process must be sufficient to resolve any problems with managerial incentives. Fama accepts that, due to market imperfections, this model won't result in full ex-post settling up, where managers will always be rewarded for the level of alignment they achieve with the interests of the shareholders. Jensen and Murphy (1990) also suggest that equilibrium in the managerial labor market is likely to prevent large penalties for poor performance.

Despite its limitations, the market for managerial labor can be an important factor in reducing the agency costs of the separation of share ownership and decision control in corporate forms. Where it is efficient in disciplining managers for decisions not in the best interests of company shareholders, it provides a useful incentive in encouraging management to take decisions in the shareholder's best interests.

4.1.2. *Empirical Evidence*

Regardless of the data examined, one of the most consistent empirical results in the corporate governance literature is that directors are more likely to lose their jobs if they are poor performers. However, Weisbach (1988) and Warner et al. (1988) amongst others find that it is only the very poorest performing management who lose their jobs and that it generally takes a prolonged period of poor performance to result in forced top executive turnover.

In addition, Gilson (1989) finds that external labor markets use evidence on past performance in defining job opportunities and compensation levels for company executives. Kaplan and Reishus (1990) also find that managers in company's who have

cut dividends were less likely to receive roles as outside directors in other companies as they are perceived as poor managers.

4.1.3. How Effective is Labor Market Discipline?

Such studies tend to indicate that managerial labor markets do help to force managers into shareholder value maximising decisions. However, the arguments of Jensen and Murphy (1990) and the findings of Kaplan and Reishus (1990) suggest that perhaps it may only be effective in disciplining the poorest performing managers.

Given their apparent similarity to US markets, it is likely that labour markets within the UK may indeed discipline poorly performance management. Skapinker (2000) documents that the average tenure of chief executives in both the UK and US is roughly equal. Top managers in both countries are expected to hold their positions for an average of four years. Table 2 summarises the major findings of the articles reviewed in this section.

4.2. Corporate Boards

In theory, the board of directors is directly elected by shareholders at the company's annual general meeting (AGM). If these directors wish to stay in their jobs they should take decisions which maximise the wealth of their shareholders.

In their literature review, Hermalin and Weisbach (2001) contend that company boards have evolved as part of the market solution to the problem of contracting within organisations.

4.2.1. Board Composition and Monitoring

Fama and Jensen (1983) argued that effective corporate boards would be composed largely of outside independent directors holding managerial positions in other companies. They argued that effective boards had to separate the problems of decision management and decision control. However, if the CEO was able to dominate the board, separation of these functions would be more difficult, and shareholders would suffer as a result. Outside directors, they contend, are able to separate these functions and exercise decision control, since reputational concerns, and perhaps any equity stakes, provide them with sufficient incentive to do so.

Corporate boards should act as monitors in disagreements amongst internal managers and carry out tasks involving serious agency problems, such as setting executive compensation and hiring and firing managers. Indeed, in the UK, the Greenbury (1995) report recommends that remuneration committees be comprised only of independent directors in order to increase their neutrality in this task. Effective corporate governance by company boards requires both good information (provided by insiders?) and the will to act on negative information (provided by outsiders?).

The positive role of outside directors on company boards with respect to particular discrete tasks has been explored with respect to disciplining poorly performing top management, Weisbach (1988), reducing top management's ability to block a takeover bid, Cotter et al. (1997), the proportion of managerial compensation that is equity based, Mehran (1995), and reducing managerial opportunism in granting executive stock options, Yermack (1997), amongst others.

However, Warner, Watts and Wruck (1987) find that only prolonged poor performance leads to top management having shorter tenures within their positions. Denis and Denis (1995) find modest performance increases following top management turnover, but find that such changes are precipitated by external control events rather than the composition of the company's board.

Agrawal and Knoeber (1996) examine a range of governance variables within a simultaneous regressions framework and find that the proportion of outside directors on company boards is the only governance mechanism which consistently affects corporate value. However, the relationship is negative, suggesting the US firms have destroyed shareholder wealth by employing these directors. However, Hermalin and Weisbach (1991) find no relationship between board composition and firm value.

Perhaps most significantly, Denis (2001) discusses the important role of outsiders in 'crisis' situations such as those that would necessitate top management turnover. However, the role of such directors in the day to day running of a business is unlikely to be significant.

Similarly, Hermalin and Weisbach (2001) present a model of the importance of outside directors, whereby their power is determined the performance of the incumbent CEO. If this director is a 'star performer' then outside directors have very little power in controlling their actions, since shareholders perceive the top officer as being high quality. Outsiders are reliant on the CEO providing observable signals of poor quality to shareholders before they are able to intervene and appropriately discipline such managers.

4.2.2. The Market Reaction to Director Appointments

Rosenstein and Wyatt (1990) find that a company's stock price rises significantly upon the announcement of an outside director to the company board. However, upon further examination, they find that the greatest increases arise in their sub-sample of smaller firms, with insignificant increases for their sample of larger firms. Lin, Pope, and Young (2000) attribute these findings to higher information asymmetries and fewer existing outside board members in smaller companies.

Lin et al. (2000) conduct a similar analysis in the UK. However, they find no evidence of significant share price reactions for their whole sample. They also seek to examine the backgrounds of the directors being appointed and find that small firms with low ownership tend to appoint outsiders with no other board seats, product or technology relevant expertise, or affiliated directors with strong monitoring incentives,[9] which gave rise to significantly positive market reactions. In contrast, they find that appointments to large companies with low ownership generally tended to have no sector experience and already had roles on other boards, perhaps contributing to the negative market reaction.

In conclusion they argue that the market reaction to the appointment of outside directors generally depends upon the extent of the agency problems within companies and the characteristics of the appointee. The market tends to react in a relatively sophisticated manner to the appointment of outside directors.

However, Hermalin and Weisbach (2001) and Demsetz and Villalonga (2001) comment that such studies must be taken with a caveat. The positive market reaction to the appointment of an outside director is likely to reflect the correction of a disequilbrium

within the individual firm. Such results do not imply that continuously appointing non-executives to company boards is a 'sure fire' way to increase share prices.

4.2.3. CEO Control and Board Size

However, Mace (1986) argues that the CEO tends to dominate the director nomination process, and will choose directors most in line with their own preferences.

Jensen (1993) argues that corporate boards are less effective as they grow in size. Larger boards may be slower to react to decisions that require an immediate course of action. Also, he argues that as more directors are added, boards lose their ability to be direct and decisive in their operation. Directors also become less candid in their ability to be critical of one another, thus making for less efficient decision making.

Yermack (1996) and Eisenberg, Sundgren and Wells (1998) find empirical confirmation of this, where they document an inverse relationship between board size and corporate value for large and small companies respectively. This is partly contested in the UK by Faccio and Lasfer (1999) who find higher corporate value in firms with above the median level of board size.

Core, Holthausen and Larcker (1999) find that CEO compensation is an increasing function of board size, the percentage of outside directors appointed by the CEO, and the percentage of outside directors serving on three of more boards. In addition, they find that CEO compensation is a decreasing function of the percentage of

[9] Contrary to Weisbach (1988), Lin et al.'s original definition of outsiders is simply non-executives. Affiliated directors are outsiders with connections to the board. Affiliated outsiders with strong monitoring incentives included appointees from blockholders and the company's bank.

insiders on the board. This is in contrast to the UK study of Conyon and Peck (1998) who find no relation between compensation and board structure.[10]

Furthermore, Core et al. (1999) find a stronger relation between accounting returns and board composition, as opposed to stock returns. However, they do find a strong cross-sectional variation between board characteristics, which is perhaps consistent with Himmelberg et al.'s (1999) argument that unobservable aspects of the company's contracting environment will define which agency reducing mechanisms will be optimal for different companies.

In their UK analysis, Dahya et al. (2002) find a negative relationship between performance related top-management turnover and board size, which perhaps confirms Jensen's (1993) suggestion that smaller boards allow more candid discussion and quicker decision making.

4.2.4. UK Boards and the Governance Reform

The nature of the board of directors in the UK is largely influenced by the Cadbury Committee's Code of Best Practice (1992). This committee was set up in 1991 following several high profile 'disasters' to strike the business community in the UK.[11] Part of these failing were attributed to the failings of corporate governance systems within these companies. In comparison to their US counterparts, UK firms have historically been more likely to split the positions of Chairman and Chief Executive Officer, but have been less likely to employ outside directors, Short and Keasey (1999).

[10] Due to a lack of previous disclosure requirements in the UK, their study does not account for any form of equity based compensation.
[11] These included the Maxwell scandal, and the case of Pollypeck.

The final report of the committee produced two major recommendations with respect to the structure of UK corporate boards. Firstly, boards should consist of at least three non-executive directors, two of whom should be independent of management. Also, the positions of the chairman and the CEO (or equivalent) should not be held by the same individual.[12] The rationale for this was to ensure a higher level of monitoring by company boards by introducing more independence and to prevent any one individual from dominating the board. The report of the Hampel Committee (1998) event went so far as to suggest that non-executive directors have greater levels of equity based compensation to ensure even greater monitoring incentives.

These proposals aren't legally binding. However, Dahya, McConnell and Travlos (2002) report how the code does provide warning that its proposals would likely become law if firms failed to adopt its proposals voluntarily. Further to this, since 1993 the London Stock Exchange (LSE) requires disclosure from member firms' in their financial statements as to whether they comply with the code, and any reasons for their failure to do so. This provides some backbone to the committee's proposals and Dahya et al. report that by 1998, 90% of LSE companies were in compliance with the code.

Franks et al. (2001) contend that non-executive directors in UK companies are still less likely to monitor management than their US counterparts. They argue that since there have been very few cases of UK directors being sued for failing to act upon their fiduciary duties then a strong incentive for such directors to exercise decision control is removed.

[12] In addition to this the code suggests that companies should provide full disclosure of the pay of the chairman and the highest paid director obtain shareholder's approval on any executive director's service contract exceeding three years. Companies should also appoint board subcommittees consisting mainly of outside directors to set director's pay and report on the effectiveness of internal control systems.

In an examination of Cadbury compliance, Young (2000) finds that companies were more likely to adopt the recommendations of Cadbury (1992) if they had been poor past performance, had relatively low levels of managerial ownership, or were larger firms. Companies which had already separated the top officer position were also more likely to appoint the necessary non-executive directors to comply with the code. The result the poorly performing firms were more likely to adopt Cadbury is in contrast to Dahya et al. (2002) who find insignificantly positive returns for firms which subsequently adopted the two main recommendations of the committee's report.

Short, Keasey, Wright and Hall (1999) contend that the Hampel committee's report represented an important departure from the narrow Cadbury view of corporate governance. Unlike Cadbury, Hampel recognises that enterprise should not be sacrificed in the name of accountability.

In addition, Brickley, Coles and Jarrell (1997) are critical of the need for policy setters to emphasise separating the position of CEO and chairman of the board. They contend that such a move would bring costs and disruption to the natural CEO succession process, and potentially reduce the incentive for a new CEO to perform. They find no evidence of sub-standard performance amongst firms who fail to split these roles. This is in contrast to Mehran (1995) who finds some evidence that splitting these positions is associated with higher corporate value.

Dahya et al. (2002) find that corporate boards were comprised of 35.3% non-executive directors pre-Cadbury, and that this figure had risen to 46% post Cadbury. Additionally, they find that the median board size increases by 2, suggesting that firms added non-executives to the board, rather than substituting inside directors for them.

This contrasts with Young (2000) who finds that firms typically did substitute inside directors for outsiders following Cadbury. Additionally, Dahya et al. (2002) find that 84.6% of firms split the position of CEO and COB post Cadbury, an increase of over 20% from the pre-Cadbury period. This evidence on board characteristics is supplemented by Faccio and Lasfer (1999), who find that during a period spanning June 1996 to 1997 that 88% of non-financial UK companies had split the position of their top officer, 43% of directors were non-executives, and finally, the median board size is 7.

In a pre-Cadbury analysis of disciplinary mechanisms which are believed to discipline poorly performing management, Franks et al. (2001) find that non-executive directors have no affect on the relationship between top management turnover and firm performance.[13]

Dahya et al. (2002) find that performance related top management turnover increases following during their post-Cadbury period. In addition, both increases in forced and non-forced turnover are significant within the set of firms which adopted the recommendations of the Cadbury code during the period. Further analysis reveals that specifically firms that increased their use of non-executive directors over the period where those more likely to see the removal of their top executive, splitting the position of CEO and COB had no significant impact on the probability of top management turnover.

This is in contrast to earlier work by Dahya et al. (1998) find that the probability of top management turnover increases where firms have split the role of the CEO and COB.[14]

[13] The p-value of 0.16 was marginally short of statistical significance.
[14] However, one noteable difference between these studies is that Dahya et al. (1998) classify top executive turnover as that of either the CEO or the COB. The later study by Dahya et al. (2002) focuses only on a single top officer who is the CEO where these positions have been split.

4.2.5. Managerial Decision Making and the Nature of Company Boards

Bhagat and Black (1999) discuss how results from previous studies of board size and performance aren't robust to different measures of value. They contend that while outsider dominated boards may be better at certain corporate decisions (such as removing poorly performing CEO's) they may be less effective at other discrete tasks which are unobservable to the econometrician. Therefore, they examine the relationship between long-run performance and board structure in a study of large US firms and find that independent boards perform worse than more balanced boards.

Additionally, Hermalin and Weisbach (2001) hypothesise that corporate board structures are endogenously determined by amongst other factors, past performance and bargaining power between the CEO and independent directors.

The findings of Bhagat and Black (1999) and Core et al. (1999) suggest that it may not be appropriate to follow any strict guidelines in setting up corporate boards.

While the existence of truly independent outside directors on corporate boards may be important in separating the functions of decision making and decision control, what should be emphasised is a search for quality in the monitoring of managerial decision making, in whatever form this manifests itself. This section is summarised in table 3.

4.3. Corporate Financial Policy

The financial structure and policy of companies may also have strong implications for agency controls. Since the earnings retention problem discussed in section 3.2 essentially

arises from how managers deal with free cash flow, doing so effectively can reduce the severity of the problem.

4.3.1. Monitoring and Bonding from Debt Financing

Jensen and Meckling (1976) argue that the existence of debt reduces the amount of equity, and enables higher levels of insider ownership. Jensen (1986) also argues that the existence of debt in the firm's capital structure acts as a bonding mechanism for company managers. By issuing debt, rather than paying dividends, managers contractually bind themselves to pay out future cash flows in a way unachievable through dividends.

Easterbrook (1984) argues that external capital market monitoring brought to companies by debt financing forces managers in value maximising strategies, rather than personal utility maximisation.

The bankruptcy costs of debt and the personal embarrassment arising from bankruptcy act as effective incentive mechanisms in encouraging managers to be more efficient. This function is particularly important in firms with low internal growth prospects and high free cash flows.

Lang, Ofek and Stulz (1996) find an inverse relationship between growth and leverage for firms with low Tobin's Q. Firms with low Q's represent firms with low investment opportunities and poor performers, indicating that debt performs an important disciplinary function in such companies.

Brennan (1995b) argues that the role of a firm's capital structure should be to ensure it's socially optimal liquidation. Higher levels of debt improve the liquidation decision by making default more likely, Harris and Raviv (1991). Harris and Raviv

(1990) develop this argument from their finding that higher leverage is associated with higher corporate value, which is attributed to higher levels of default risk.

In the UK, Franks et al. (2001) find that companies with high leverage and low interest coverage on their debt are more likely to experience forced turnover of top management. Significantly, such turnover was also associated with poor past performance.

4.3.2. The Costs of Debt Financing

However, leverage also brings higher levels of debt-related agency costs and bankruptcy costs.[15] The optimal capital structure should be where the marginal costs of debt equal its marginal benefits.[16] This is the point where the value of the firm is maximised.

Nevertheless, issuing debt beyond optimal levels will increase its risk and reduce the value of the company. Stulz (1990) argues that, while debt may reduce the risk of over-investment, there will always be a danger that it could lead to under-investment due to the costs of raising new finance.

4.3.3. Using Dividend Policy to Reduce Agency Conflicts

Paying dividends also reduces the agency costs of free cash flow. However, they don't carry the same legally binding obligation to make payments as debt, making them a less efficient means of forcing managers to pay out cash-flows, Jensen (1986). However,

[15] Harris and Raviv (1991), Section 1B, discuss the potential agency costs associated with carrying debt. These deal with transfers of wealth from bondholders to shareholders and how bondholders will pay a lower price for corporate debt, since they anticipate this. Warner (1977) examines the bankruptcy costs of debt. These are likely to rise with the risk of the company's assets, amongst other things.

[16] Myers (1984) discusses an alternative to this agency model of capital structure. He suggests a 'pecking order' theory, where capital structure is determined by a desire to avoid diluting the wealth of existing shareholders.

such arguments may underestimate the pressures involved in maintaining dividends and the penalties for firms cutting them.[17]

4.3.4. Capital Market Discipline

Franks et al. (2001) find that equity issues by financially distressed companies provide the most significant means of disciplining management in a sample of poorly performing UK companies. These authors argue that the UK company law dictating that any equity issue of greater than 5% of share capital must be in the form of a rights issue, thus providing atomistic shareholders with greater ability to monitor managerial decision making in such situations, as compared to US shareholders.

4.3.5. Summary of Financial Policy

Nevertheless, overly distributing cash flows can always leave the problem of insufficient funds for investment opportunities and increase the need for further external financing, and the costs that come with this, Harris and Raviv (1991).[18] Table 4 summarises the main theoretical arguments and empirical findings discussed in the above section.

4.4. Blockholders and Institutional Investors[19]

Ordinary atomistic shareholders may not have the time, skill, or the interest to monitor managerial activities. Since they own a small portion of the total shares, there may be a

[17] For a discussion of the signaling potential of changes in dividend policy see Miller and Rock (1985).
[18] These authors also provide a discussion of the potential costs of having to resort to external financing.
[19] For the purposes of this discussion the term 'blockholder' refers to any party outside of company management with an equity stake greater than 3% in the UK or 5% in the US. The term 'institutional

free-rider problem, whereby it is not in their best interests to monitor management while others will also derive the benefits from this. The existence of large block investor(s) may overcome this problem, as they may have more skill, more time, and a greater financial incentive to overcome this free-rider problem and closely monitor management.

In addition, such large shareholders may be able to elect themselves onto company boards, increasing their ability to monitor management. CEO's may also tend to voluntarily disclose information to blockholders to reduce monitoring costs. In their analysis of UK market reactions to director appointments, Lin et al. (2000) find positive market reactions in smaller firms when affiliated directors (including appointees of blockholders) are appointed to the board.

Denis, Denis and Sarin (1997) contend that internal governance mechanisms such as company boards may act more efficiently in the presence of information provided by external control markets. The purchase of large share stakes by outside investors represents such a control threat to company management and can provide pressure for internal governance systems to operate more efficiently.

Blockholder pressure may also deter management from non-value adding diversification strategies. Since such investors already hold diversified portfolios, further risk-reductions aren't of interest to them.

4.4.1. The Benefits of Block Shareholdings

Mikkelson and Ruback (1985) report significantly positive market reactions to block purchases, but that these disappear quickly unless the acquirer initiates some form of

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investors' generally refers to financial investors, such as money managers and pension funds, with such a stake in the company.

corporate restructuring. McConnell and Servaes (1990) find a positive relationship between institutional ownership and corporate value, but no such relationship between blockholder ownership value.

Bethel, Liebskind and Opler (1998) find that all blockholders target poorly performing firms, but activist investors were particularly likely to purchase blocks in poorly performing diversified firms and such purchases were generally followed by corporate restructuring and performance improvements.

Denis and Denis (1995) find that top management turnover in poorly performing companies is generally precipitated by an external control event such as a block purchase. Additionally, Denis and Kruse (2000) find that block purchases partially substitute for takeovers in disciplining poorly performing management during periods of low takeover activity.

Also, in the UK Dahya et al. (1998) find that top management turnover is more likely in the presence of high levels of ownership by financial institutions. Furthermore, Faccio and Lasfer (1999) present evidence that companies with high levels of block ownership are associated with greater proportions of non-executive directors and are more likely to split the functions of the CEO and the COB. However, Faccio and Lasfer also find that block ownership is associated with lower corporate value.

4.4.2. Passiveness and Self-Serving Blockholders

Shleifer and Vishny (1997) argue that companies holding large blocks of shares in other companies may pursue their own interests at the expense other shareholders. This may include trying to acquire the firm for their own value-destroying diversification purposes.

Similarly, Denis (2001) contends that whilst blockholders seek to increase firm value, they may also attempt to enjoy benefits not available to other shareholders.

In addition, Holmstrom and Tirole (1993) find that such blocks can reduce the liquidity of a stock and the supply of company information to the market. Furthermore, Burkart (1995) finds that aggressive counter-bidding by large blockholders reduces the probability of a takeover, even when this is in the best interests of the company's shareholders.

Georgen and Renneboog (1998) also contend that financial institutions may not participate on individual firm corporate governance since their stake may represent only a tiny fraction of their overall portfolio. Passive investment strategies are typically less costly for fund managers. Also, these managers are aware that participating in governance may put them in the position of a company insider who is privy to price sensitive information, and such, they would be unable to trade immediately on the basis of any governance enhancements they had participated in.

4.4.3. Blockholders and the UK Institutional Framework

Denis (2001) argues that a country's legal system appears to be a fundamental determinant of how its governance system evolves.

While equity ownership is largely diffuse in both the UK and US, the UK market does provide some striking differences which have implications for the effectiveness of blockholder monitoring in the UK. Franks and Mayer (1997) document how equity ownership in the US is concentrated in the hands of individuals, whereas, in the UK, financial institutions control most of the equity.

Roe (1990) also discusses the legal barriers which US financial institutions face in building up large stakes in individual companies. However, UK companies aren't subject to such restrictions, allowing them to build higher equity stakes and participate more in corporate governance. For example, US insurance companies may invest only 20% of their assets in equities and no more than 2% in any one company, Short and Keasey (1999).

Additionally, Faccio and Lasfer (1999) discuss how the legal duties of blockholders in the UK are less stringent than those of their US counterparts. US institutions may be subject to legal proceedings for a breach of duty if they fail to disclose their future plans, which is not a potential problem for UK financial institutions.

Such obstacles for US institutions may contribute to Short and Keasey's (1999) note that US institutions hold approximately two thirds of that of UK institutions. Also US pension funds tend to hold a lower proportion of domestic equities.

They also point out that the extreme geographical clustering of UK financial institutions in London may allow for more informal coalitions between blockholders and contend that much of the monitoring carried out by UK institutions is done behind closed doors. This would reduce the costs of blockholder monitoring and allow for greater monitoring on the part of UK financial institutions.

This sentiment is echoed by Franks et al. (2001), who find that equity issues by poorly performing companies along with low interest coverage on debt are the main determinants of involuntary top management turnover in the UK. In explaining this they argue that whilst institutions may remain passive during the general course of business,

when the company begins to search for additional funds, this is where these institutions take an active role in company decision making.

The more stringent rights provisions in the UK may lead to existing shareholders exerting greater power over company management when these managers require external financing. Whilst they find that changes in block ownership lead to higher levels of top management turnover, such purchases are not specifically targeted at poor performers.

The above point to greater significance in the role of blockholders within the agency framework of the UK corporate sector. This may lead to increased monitoring of managerial decisions, but at the same time, greater power on the part of blockholders may lead to higher levels of self-serving behavior on the part of such investors.

However, Short and Keasey (1999) discuss that many US institutions are governed by ERISA legislation which requires them to vote at company meetings, UK institutions have generally been criticized for their lack of participation at such meetings. Hampel (1998) even went so far as to consider making institutional voting mandatory in the UK, however, they decided not to formally intervene, Georgen and Renneboog (1998).

Further to this, disclosure of block shareholdings is a much speedier process in the UK. Shareholders purchasing a stake of greater than 3% and changes by more than 1% in such stakes in the UK must notify the company within 2 days of the purchase. In contrast, disclosure within 10 days of the purchase of a 5% stake, along with the filing of a Schedule 13D statement with the Securities and Exchange Commission (SEC) are required for US purchasers. Any changes in such stakes should be disclosed 'promptly.'

This increased disclosure is likely to enhance the potential for managerial entrenchment as it provides management with greater awareness of a takeover threat.

Furthermore, Franks et al. (2001) argue that minority protection laws in the UK reduce the controlling abilities of dominant shareholders. Also, the generally liberal view of takeovers in the UK may lead to a lesser role for active investors in UK corporate governance.

Also, in their analysis of UK pension fund holdings, Faccio and Lasfer (2000) find that over time the value of the companies that these funds invest in decreases. Also, the funds don't cause governance improvements, such as compliance with the recommendations of the Cadbury committee, nor do these funds sell their under-performing stakes. Similarly, Faccio and Lasfer (1999) find a substantially negative relationship between the stake of block shareholders and corporate value in their sample of UK firms.

On the other hand, Short, Zhang and Keasey (2002) find that the presence of a financial institution holding a stake of greater than 5% in companies leads to higher dividend payouts, as compared to companies without the presence of such institutional shareholders. High dividend payouts may greater reliance on external capital markets, which are effective monitors of company management, Franks et al. (2001).

4.4.4. Summary and the Need for greater distinction of Blockholders

From the above evidence, the influence of blockholders on corporate value is at best debatable. Bethel et al.'s (1998) results suggest that activist blockholders may be of benefit in influencing corporate governance, however, there is evidence that these

blockholders may become as self-serving as the management they are supposed to monitor. The results of Bethel et al. and the arguments of Mehran (1995) suggest that greater distinction amongst different types of blockholders may be required, in a similar fashion to the distinction made between different types of company directors. The results of this section can be found in table 5.

4.5. The Market for Corporate Control

Takeovers may occur in relation to the earnings retention conflict between shareholders and management. Jensen (1986) argues that takeovers occur in response to breakdowns of internal control systems in firms with substantial free cash flows and organisational policies which are wasting resources. In short, where management are using resources inefficiently. The market for corporate control can therefore serve to transfer control of the firm's assets to more efficient managers.

4.5.1. A Disciplinary Mechanism for Poorly Performing Management

Where managers fear that they may lose their jobs following takeovers, they may react by investing these free cash flows in more efficient investment projects. Safieddine and Titman (1999) find that targets of failed takeover attempts significantly increase their leverage in the period immediately following the failed bid. These firms then tend to sell off under-performing company assets in order to increase focus on key profitable investments, perhaps reversing previously unprofitable diversification policies.

Jensen and Ruback (1983) show that shareholders in successful takeover targets realise substantial wealth increases, indicating a potential for improved performance, which the previous management had failed to utilise.

Martin and McConnell (1991) identify two motives for takeover; efficiency gains and disciplining poorly performing management. They find the performance of disciplinary targets, where top management depart following the takeover, was no worse than the market average, but worse than their industry average. Non-disciplinary targets perform as well as their industry average. They find that CEO turnover in target firms increases following a takeover. This is consistent with the takeover market disciplining managers who fail to maximise shareholder wealth.

4.5.2. The UK Market for Corporate Control

Franks and Mayer (1996) argue that the UK takeover market is similar in its level of activity to the US market. This can largely be attributed to the diffuse ownership structures which characterise UK and US companies, where large ownership stakes by any one individual are generally a deterrent to takeover bids. At the same time, they argue that UK market has stricter legislation on takeover defences. For example, the takeover Code in the UK strictly forbids companies adopting poison pills once a takeover bid has been adopted. Short and Keasey (1999) also argue that UK firms generally are less active in their use of takeover defenses, largely due to monitoring from institutions.

In addition to this, Faccio and Lasfer (2000) argue that disclosure requirements of 3% for block shareholders in the UK, compared to 5% in the US, provide management

with greater awareness of potential bidders. This increases their ability to initiate steps designed to block such takeovers without violating any legislative practices.

In the UK there is a takeover threshold of 30%. Any individual or organisation breaching this is required to immediately required to make an offer for the remaining shares at a minimum price which is set at the highest price paid by the offeror during the preceding twelve months.[20] Furthermore, any investor with a stake of greater than 15% must disclose any takeover plans they have for the company, Franks et al. (2001).

In their UK analysis of the disciplinary function of the market for corporate control, Franks and Mayer (1996) find that hostile takeovers are associated with significantly higher levels of top management turnover, and corporate re-structuring. However, they find little evidence of a difference in the prior performance of hostile and non-hostile takeovers, suggesting that takeovers don't specifically discipline poorly performing firms in the UK.[21]

This is confirmed in a further analysis of disciplinary mechanisms for poorly performing top management in the UK. Franks et al. (2001) again find that whilst takeovers produce a significant increase in top management turnover, this is not necessarily associated with poor past performance, except over a prolonged period.

4.5.3. The Failings of the Market for Corporate Control

Mikkelson and Partch (1997) find that the level of takeover activity may also be an important factor in determining whether this mechanism is effective in disciplining management. They find a significant relation between top management turnover and

[20] The exception to this is the purchase of share stakes in firms that are experiencing financial distress.

performance during an active takeover period, but no such relation during an inactive period. In contrast, Denis and Kruse (2000) find that performance enhancing corporate restructurings persist following declines in performance, regardless of whether these occur during an active or inactive takeover period.

Jensen and Ruback (1983) also suggest that the threat of takeover won't be enough to ensure complete coherence between managerial actions and shareholder wealth. This can be attributed largely to the costs of organising takeovers, in particular the high bid premiums. Management may actively seek to reduce the probability of takeover since it may result in loss of personal wealth and reputation.

4.5.4. How effective is the Market for Corporate Control in disciplining Management

The evidence above is largely inconclusive concerning the effectiveness of the market for corporate control in disciplining corporate managers. It is generally seen as a last resort, only when target managers have been performing very poorly. This is perhaps attributable to the high costs and disruption associated with a company being taken over. Table 6 provides a summary of the points in this section.

4.6. Managerial Remuneration

The structure of executive compensation contracts can have a large influence in aligning the interest of shareholders and management. Compensation contracts, and their revision, represent a financial incentive for management to increase company value. Higher levels

[21] However, Franks and Mayer use only a two-year sample period and test only hostile takeovers to assess the disciplinary affects of the UK takeover market.

of such incentives should ultimately lead to higher company performance, Jensen and Meckling (1976).

Compensation generally takes four forms;[22] basic salary, accounting-based performance bonuses, executive stock option schemes and long-term incentive plans (LTIP's). Baker, Jensen and Murphy (1988) argue that the level of pay determines where managers work, but the structure of the compensation contract determines how hard they work. Effective compensation contracts should provide management with sufficient incentive to make value maximising decisions at the lowest possible cost to shareholders.

4.6.1. Salary

Executive salaries are likely to be determined by the managerial labor market, along with other factors including the size of the firm and the manager's position in the 'corporate ladder.' Jensen and Murphy (1990), however, contend that equilibrium in managerial labor markets will prevent large salary cuts for poorly performing managers.

Therefore, this mechanism will be ineffective in giving managers incentives to make value maximising decisions. This is perhaps emphasised by their finding that for every $1,000 dollar change in firm value, the CEO's salary changes by 2 cents.

In their study of the top 500 companies in the UK, Conyon and Murphy (2000) find that the median CEO receives a base salary of £240,000, which comprises 59% of their total compensation. This is in comparison to a median of £317,000 in the US, which only comprises 29% of total compensation.

[22] There are perhaps limitless forms of executive compensation. Others elements may include pension contributions, stock bonuses, and long-term accounting based incentive schemes. However, the major academic research in this area that I am aware of has centered on these four key elements of compensation and this is what shall be discussed here.

4.6.2. Accounting Based Bonus Schemes

Basing bonuses upon accounting measures of performance provides an improved mechanism for aligning manager's interests with those of the company's shareholders. Banker, Lee and Potter (1996) report evidence of this in the retail sector, where they find that sales in 15 firms improve after the introduction of accounting based bonus schemes.

However, Healy (1985) and Jensen and Murphy (1990) argue that paying executives on the basis of accounting variables provides an incentive for management to directly manipulate the accounting system, and favour projects with short-term accounting returns at the expense of long-term positive NPV investment.

Weisbach (1988) finds higher accounting earnings in the year prior to the removal of a CEO and Dechow and Sloan (1991) report that R&D expenditures decline prior to the retirement of a CEO. Such results suggest that accounting based bonus schemes are at best a clumsy means of providing managerial incentives and may actually exacerbate an executive time-horizon problem.

Bonuses related to company sales may further encourage earnings retention and firm size growth, which doesn't always equate with shareholder wealth growth. Accounting bonuses may also lead to a focus on the determining variables of these compensation plans, perhaps leading managers to neglect other aspects of performance.

In the UK, Conyon and Murphy (2000) find that bonuses account for 18% of total pay for CEO's, they were received by 81% of their sample, and for those who received them, the median award was £91,000. In comparison, 83% of US CEO's received bonuses, but the median was £270,000 which comprised 17% of total pay.

The above analysis indicated that UK CEO's receive 77% of their total pay in terms of cash based compensation, in comparison to 46% for their US counterparts. However, after controlling for other factors known to affect executive compensation, Conyon and Murphy find that US CEO's receive 46% higher cash compensation than their US counterparts.

4.6.3. Executive Stock Options

The use of stock options in executive compensation plans is generally seen as the one of the most effective means of tying the interests of managers and shareholders, as they are seen as a substitute for managerial shareholdings. Such options give management the right to buy company stock at a fixed price at given times in the future. The higher the value of the firm, the higher the value of the options and the profit managers can make upon exercising them.

Under option pricing theory the value of such stock options will increase along with the risk of the firm's underlying assets. Agrawal and Mandelker (1987) report that stock options encourage management to make investment and financing decisions which increase the variance of the firm's assets.

Additionally, Fenn and Liang (2000) find that higher levels of managerial stock options lead to higher levels of share repurchases. Under Black-Scholes option pricing theory, the value of stock options will decline with the present value of future dividend payments, providing management with an incentive to substitute repurchases for dividends. To the extent that repurchases are treated favourably in tax terms, this will be in the best interests of the company's shareholders.

Conyon and Murphy (2000) document that options grants comprise 10% of total compensation for UK CEO's, but 42% of total compensation in the US. Moreover, the median option grant in the UK is £69,000 and £1,142,000 for US CEO's, representing an incredible divergence between the characteristics of pay in the UK and US.

While such studies provide evidence of executive compensation schemes tying the wealth of management to their shareholders, they don't provide evidence that such schemes increase shareholder wealth. However, Mehran (1995) finds such a positive relationship between the percentage of CEO's total compensation package in stock options and corporate value.[23] This points towards such compensation packages being effective means of motivating managers to act in their shareholder's best interests.

4.6.4. Long-Term Incentive Plans

The final method of executive compensation to be discussed is that which comes from long-term incentive plans (LTIP's). Although they generally take many different forms, their common feature in the UK is an award of stock in the company upon the achievement of long-term performance criteria, such as EPS growth above a given percentage in the following five years. In the US, they generally tend to either take the form of restricted stock or multi-year bonus plans.

They tend to be granted at a zero, or nominal,[24] exercise price. Similar to stock options, LTIP grants are generally termed under the classification of 'equity-based compensation.' In the UK, LTIP grants account for 9% of total compensation, and have a

[23] Mehran (1995) proxy's corporate value using Tobin's Q, which future studies have found managerial share ownership is endogenous with respect to. He fails to take account for this, and there may be a possibility that the structure of executive compensation packages is also endogenous to corporate value.
[24] I.e. an exercise price of 0.1p

median value of £161,000 for the 32% of sample companies which utilised them, Conyon and Murphy (2000). Such grants are less common in the US, where only 19% of companies make use of them, but the median CEO still receives £325,000, which comprises 4% of their total compensation.

However, one major criticism of both LTIP grants and option grants arises from the problem of managerial risk aversion. The cost of such means of compensation is higher to the company than the value derived by company directors, as risk aversion leads them to discount the value of such modes of compensation.

4.6.5. Executive Compensation in the UK

In the UK, disclosure requirements of executive compensation have lagged someway behind their US counterparts. It is only recently following the publication of the Cadbury (1992), Greenbury (1995) and Hampel (1998) reports in the UK that any reasonable and consistent disclosure of UK executive compensation has occurred. Prior to these reports, full disclosure of director's remuneration was poor in comparison to US companies, particularly in relation to equity-based compensation. Therefore research similar to that described above has yet to take place in the UK.

Specifically, Greenbury (1995) is highly supportive of LTIP grants which are performance contingent with reference to appropriately benchmarked companies. Whilst stock options provide management with strong financial incentives to perform, they may also tend to reward even relatively poorly performing management in times of rising stock market, such as that seen during the tech-boom of the late nineties.

However, Conyon and Murphy (2000) provide a comparative analysis of CEO pay in the UK and the US. They find that UK executives earn far less than their US counterparts. CEO's in the US receive 46% higher cash compensation and 150% higher total compensation than UK executives. Additionally, the find that effective ownership percentages suggest that in the US a median CEO will receive 1.48% of any changes in shareholder wealth, but UK CEO's will receive only 0.25%. They attribute these differences to the greater use of share options in the US due to institutional and cultural differences between the two countries. This was despite both having relatively similar economies and corporate governance structures.

The Greenbury (1995) report makes recommendations for moves away from the large focus on cash-based compensation documented by Conyon and Murphy (2000), who report that 77% of UK CEO's total pay is in the form of salary and cash bonuses. It may be interesting to view how effective these recommendations have proved to be. However, Conyon and Sadler (2001) find that larger companies are more likely to pay their CEO through equity based compensation. In addition larger companies are more likely to utilise LTIP grants, as compared to option grants in smaller firms.

Additionally, Greenbury makes recommendations for structure of remuneration committees which set director's pay. It suggests that these committees be comprised only of independent, non-executive directors. Compliance with these recommendations may in theory also lead to more appropriate managerial incentives. Finally, directors should have limited tenures in their positions, and should require frequent re-election to the board. This is to prevent the granting of excessively long-term contracts which increase the cost of dismissing management for poor performance.

The disclosure requirements of Greenbury (1995) are far more stringent than those of US companies. Conyon and Sadler (2001) discuss how Greenbury requires full disclosure for a Black-Scholes style option valuation for both current and past option grants paid to the company's directors. This is in contrast to US disclosure requirements which require full information for only the current option grant, in addition they must report on the intrinsic value of all unexercised options, however, this means that only options that are in the money will have a value placed upon them.

These authors summarise the disclosure requirements of Greenbury as (i) the number of shares under option at the beginning and end of the year (ii) the number of options granted, exercised and lapsed during the year (iii) the exercise price of all options (iv) the dates for which the options may be exercised and the experation date (v) the cost of the options (if any) (vi) the market price of the shares at the date of the exercise for options exercised during the year and (vii) a summary of any performance criteria on which exercise of the options is conditional. Firms that reveal information for conditions (i) through to (v) are said to be providing full information disclosure.

Alternatively, companies may provide (i) the total number of share options held (ii) the weighted average exercise price of the stock of unexercised options held and (iii) the maturity date of the longest dates unexercised option. Such companies are said to provide information in concise form.

Conyon and Salder (2001) estimate the value of a sample of options of UK CEO's under the assumptions of full disclosure, concise disclosure and US regulations. They find that previous studies valuing US executive compensation have not been significantly biased in their estimates of option values. However, this has been largely due to two

conflicting biases which have served to cancel one another out. Firstly, options that are in the money have been undervalued due to errors in estimating the time to maturity of such options, on the others hand, options which are out of the money have been overvalued due to the disclosure of a weighted average exercise price of options in the US. While significant errors are likely to have arisen during the rising stock markets of the past 20 years, if the current economic downturn is to continue, then the overvaluation of out of the money options is likely to pose a serious problem for researchers in executive compensation in the future.

4.6.6. Is Managerial Remuneration Effective in Reducing Agency Conflicts?

The above evidence tends to suggest that corporate executives are indeed rewarded in accordance with how well they perform for their shareholders. In addition, the use of equity based compensation plans appears to be the best means of encouraging managers to make value maximising decisions.

Additionally, Kole (1997) finds systematic variation in the terms of executive compensation plans, where these differences are driven by the characteristics of the company's assets. This would indicate that company's tend to set executive compensation contracts (at least partially) with respect to minimising the agency conflicts inherent within their contracting nexus. For example, companies with long-term investment opportunities should be expected to employ compensation plans with contingencies which cause executives to forfeit compensation if they leave the company. She is also highly critical of previous studies which fail to incorporate such aspects of compensation in their analysis.

The arguments of Brennan (1994, 1995a) suggest that perhaps monetary incentives alone are insufficient in aligning the interest of corporate managers and shareholders. Indeed, Baker et al. (1988) concede that executive compensation contracts are unlikely to ensure complete coherence between managers decisions and shareholder's wealth, since at some point management will yield to behavioural notions such as fairness, which don't enter into the agency framework.

Perhaps more significantly for the doubters of the effectiveness of executive compensation as a means of appropriately rewarding top management is the consistent finding that by far the most important determinant is company size. As such, managers face a potentially overwhelming incentive to expand firms beyond their optimal level in order to simply maximise compensation. A synopsis of the main theoretical and empirical findings on executive compensation can be found in table 7.

4.7. Managerial Share Ownership

The final method of reducing agency conflicts to be discussed in this paper is managerial share ownership. Jensen and Meckling (1976) argued that as ownership of the company by inside managers increases, so to does their incentive to invest in positive NPV projects and reduce private perquisite consumption.

4.7.1. Ownership Incentives

Benston (1985) finds a significant relationship between changes in shareholder's wealth and changes in the value of executive shareholdings. He also finds that such

shareholdings help to tie the financial interests of directors who are close to retiring to shareholder's gains and losses.

However, this study can only conclude that managers and shareholders gained and lost together. In addition, the fraction of the manager's total wealth that is tied to the company's performance is unobservable.

Ownership incentives are a key factor in the success of Management Buy-Outs (MBO's). Kaplan (1989) finds significant increases in a company's operating performance following such events and attributes much of these findings to the high levels of managerial equity ownership within these companies.[25]

Fenn and Liang (2000) find that large managerial shareholdings provide management with incentives to distribute cash flow to shareholders when agency problems are at their greatest. Additionally, Denis et al. (1997) find that executive ownership is associated with greater corporate focus, indicating that the severity of the managerial risk-aversion problem may be reduced through higher equity stakes.

Also, Hull and Mazachek (2001) find a negative relationship between managerial ownership and the negative market reaction to new equity issues. Such ownership may provide a signal that management are not merely issuing overvalued equity as they are likely to suffer from any share price falls which would be anticipated under the pecking order of capital structure.

4.7.2. Managerial Entrenchment

However, there is evidence that inside ownership may lead to the problem of managerial entrenchment. This occurs where management gains so much power within the firm that

they are able to pursue their own interests (which don't necessarily equate with wealth maximisation) at the expense of outside shareholders, Fama and Jensen (1983). With larger voting power managers can make decisions which maximise their utility from the company, even when this results in lower or negative returns from their stockholdings.

Stulz (1988) argues that entrenchment may occur from a lack of external market discipline since it is harder to remove managers where they control large portions of the company. Existing management are able to drive bid premiums up to the point where bidders no longer view the target as a positive NPV investment. Additionally, Bethel et al. (1998) and Weisbach (1988) document an inverse relationship between disciplinary events and managerial share holdings. This would indicate that powerful managers are difficult to discipline even when they are poor performers.

Additionally, both Denis et al. (1997) in the US and Dahya et al. (1998) in the UK document a more positive market reaction to forced top management turnover where the incumbent had held a larger equity stake. Both studies also document an increase in external control events following the departure of an entrenched top officer.

Several studies have supported this entrenchment hypothesis when examining the direct relationship between ownership and corporate value. Morck et al. (1988), McConnell and Servaes (1990) and Hermalin and Weisbach (1991) all document non-monotonic relationships between insider ownership and corporate value.[26] While the results of these studies are inconsistent with one another, this could be attributed to sampling differences, Kole (1995).

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[25] However, it should be noted that such companies tend to be highly levered.

[26] Morck et al. document two turning points where value increases between 0 and 5% and at levels of ownership greater than 25%. Between 5 and 25% value declines with ownership. McConnell and Servaes document a quadratic relationship where value increases initially and then declines at ownership levels of

Faccio and Lasfer (1999) also contend that managerial entrenchment may result in the CEO creating a board that is unlikely to monitor. Such a board will make external discipline unlikely and decreases the board's ability to provide internal discipline to the CEO.

4.7.3. Entrenchment and the UK Institutional Framework

The US and the UK are largely similar in terms of their contractual nexus, both characterised by market-based contracting environments, liquid stock markets and diffuse ownership structure, Faccio and Lasfer (1999). However, these authors discuss a variety of factors which may influence the extent to which UK managers may become entrenched.

Section 4.4.3 discusses characteristics of blockholder monitoring which may lead to management requiring higher levels of ownership to become entrenched. If managers are subject to greater levels of monitoring, they will require higher levels of ownership to insulate themselves from such controls.

However, Faccio and Lasfer (1999) also document evidence indicating that UK managers may be able to become entrenched at lower levels of ownership, this is summarized in section 4.5.2. To the extent that these failings of external markets allow management greater power within organizations, they may require lower levels of control to become entrenched.

In addition, Georgen and Renneboog (1998) argue that the UK is well-known for its strong minority protection laws. The 'fraud on the minority' rule is specifically

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49 and 38% in 1976 and 1986 respectively. Hermalin and Weisbach report three turning points at 1, 5, and 20%.

designed to protect minorities from expropriation by controlling shareholders and company management. Specifically, major shareholders may not blatantly make decisions designed to benefit themselves and damage the wealth of outside shareholders.[27]

Direct evidence of entrenchment in UK companies is provided by Dahya et al. (2002). Similarly to Denis et al. (1997) in the US, they find an inverse relationship between performance related top management turnover and the proportion of equity held by management.

Both Faccio and Lasfer (1999) and Peasnell, Pope and Young (2000) document a U-shaped relationship between director's shareholdings and the proportion of non-executive directors on company boards.[28] The initial decline is due to convergence of interests where less external monitoring is required, however, at higher levels of ownership non-executives begin to increase due to an internally generated demand for increased monitoring, arising from the problem of managerial entrenchment.

Faccio and Lasfer (1999) and Short and Keasey (1999) examine UK companies in search of similar relationships to those documented in previous US studies. Both report similar non-monotonic relationships as observed by Morck et al. (1988), with turnings points at 19.68 and 54.12%, and 12.99 and 41.99% respectively.[29,30] They suggest that such results represent management becoming entrenched at higher levels of insider

[27] DeAngela and DeAngelo (2000) provide an interesting case study of the controlling Chandler family had attempted to do this in their case study of the Times Mirror Company.
[28] Faccio and Lasfer (1999) find that the critical inflection point is 12%, after which companies become less likely to employ non-executives.
[29] Whilst Faccio and Lasfer use Tobin's Q, Short and Keasey use market valuation ration and return to shareholder's equity. The market valuation ratio is measured as market value of common equity over book value of equity minus any intangible assets.

ownership in the UK, citing differences in legal procedures and investors types for such findings.

When examining the relationship between executive ownership and top management turnover, Dahya et al. (1998) find that CEO ownership stakes of as little as 1% can allow a poorly performing top manager to entrench their position. This result is consistent with the finding for US CEO's by Denis et al. (1997).

4.7.4. Endogenity and Heterogeneity in the Insider Ownership – Corporate Value Relation

Kole (1995) argues that heterogeneity in the relative size of the firms in different samples will be a major factor in determining the different results from various studies that have attempted to model a non-linear relationship between ownership and corporate value.

However, Demsetz and Lehn (1985) contend that a company's ownership structure should be thought of as an endogenous outcome that reflects and influence of the company's shareholders and the firm's contracting environment.

Cho (1998) argues that results such as Morck et al. (1988) and the UK studies mentioned above may be misspecified due to the endogenity of managerial ownership.[31] Jensen and Mecking (1976) had argued that ownership structure affects performance since it reduces managerial perquisite consumption, and therefore, increases investment.

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[30] In their overall sample, Faccio and Lasfer find an insignificant relationship between ownership and corporate value. The turning points reported are those for their sub-sample of above median growth, as measured by the firm's P/E ratio.

[31] In an attempt to control for reverse causality, Short and Keasey (1999) use lagged variables for managerial ownership and take average performance over the next four years and panel data with year effects dummies. However, Himmelberg et al. (1999) contend that a firm's contracting environment changes very slowly over time, and as such, the techniques of Short and Keasey may still fail to properly control for endogenity.

However, Cho contends that these variables are likely to be interdependent and uses a system of simultaneous equations to prove his hypothesis. He finds that insider ownership is a function of the market value of equity and corporate value (Tobin's Q). However, Q is affected by investment and not insider ownership. Finally, investment is affected by Q and the liquidity of the firm, and not by insider ownership. He concludes that investment affects corporate value, which in turn affects managerial ownership. Such findings contradict Jensen and Meckling's (1976) theory that shareholdings by inside managers are an effective means of inducing these managers to make value maximising decisions for their shareholders.

Similarly, Demsetz and Villalonga (2001) find no evidence of a systematic relationship between ownership and corporate value within a re-examination of the Demsetz and Lehn (1985) study.[32,33] However, these authors conclude that ownership is negatively related to corporate value, suggesting that management may prefer to hold lower stakes in highly valued companies. Whilst inconsistent with Cho (1998), parralels can be drawn with Denis and Sarin (1999) who find the poor share price performance

[32] In a side note they are also critical of the use of managerial ownership and Tobin's Q. This is on the basis that managerial ownership will represent a group a various parties who do not necessarily share the same corporate objectives. Also, Q is a forward looking measure, whereas it would be better to use a backward measure such as profit rate to look at what management has achieved. However, their alternative measure of ownership structure takes the stake of the five largest shareholders. In practice this is again an imperfect measure where less than five of these largest shareholders may have a stake that is greater than the disclosure threshold for company reports. Additionally, investors are generally more concerned with share prices than accounting performance and, on this basis alone, a market based measure of value such as Q is likely to be a more important measure of how shareholders perceive management to be doing their jobs.

[33] In addition, both Cho (1998) and Demsetz and Villalonga (2001) model ownership as a pre-determined function. Cho employs the spline specification of Morck et al. (1988) in addition to a linear function within his robustness testing. Demsetz and Villalonga (2001) model ownership as a logarithmic function. Neither of these studies attempts to utilise other potential functional relationships between ownership and value. Following the arguments of McConnell and Servaes (1990) and Kole (1995) it may be that a systematic relationship does exist between ownership and value that these authors have failed to accurately model.

leads to increased equity stakes by company management, perhaps in an attempt to entrench themselves from potential control threats.

However, Himmelberg et al. (1999) interpret similar results as evidence of optimal contracting relationships within different firms. They argue that what may be optimal for one firm, may not be optimal for another. Firms will choose between these various mechanisms depending on what is optimal for their individual contracting environment.[34]

However, in alternative testing using an instrumental variables approach they find strong evidence which is consistent with that of previous studies. This is consistent with Hermalin and Weisbach (1991) who find a non-linear relationship between managerial ownership and corporate value using an instrumental variables approach.[35]

Where insider ownership is to be thought of as the outcome of the firm's contracting environment, a number of variables may be seen as important. Ownership will be negatively related to firm size. Performance is also important, however the effects of this are unclear. Cho (1998) finds that directors hold larger stakes in firms with higher corporate value, but this is in contrast to Demsetz and Villalonga (2001) who find the opposite effect. Denis and Sarin (1999) find that poor share price performance leads to higher equity stakes by corporate boards, perhaps in an attempt to entrench

[34] While Himmelberg et al. (1999) find no causal relationship between ownership and value, Zhou (2001) is critical of the methodology used in this study and argues that such a relationship may still exist. Himmelberg et al. use a panel data methodology with firm fixed effects and argue that this removes any cross-sectional relationship between ownership and value. Therefore, changes in corporate value are expected to arise as a result of within firm changes in managerial ownership. However, Zhou contends that if ownership is important to long-term managerial incentives then its affect would show up in cross sectional tests. Since managers seek to maximize their long-term utility from the firm, small changes in ownership from year to year do not necessarily indicate meaningful changes in managerial incentives. Additionally, he argues that any study of the effects of ownership on corporate value must also include the incentives provided by executive stock options in fully considering this relationship.

management who are more likely to be subject to disciplinary measures. Business risk leads to lower levels of managerial ownership, Demsetz and Lehn (1985). However, opportunities for insider trading in high risk firms may actually encourage management of such companies to own higher ownership stakes.

Core and Larcker (2002) assume a model whereby firms choose an optimal level of managerial incentives when they contract (e.g. Demsetz and Lehn (1985)) but that transaction costs prohibit continuous re-contracting, e.g. Morck et al. (1988). Therefore, they examine the pre and post performance of a sample of companies which adopt target ownership plans for their corporate executives. Such firms are characterised by low managerial ownership and poor industry-adjusted share price returns prior to the adoption of these plans. The introduction of such plans is typically followed by significant increases in ownership, significantly greater stock price performance in the following 6 months as compared to their control firms, and significant increases in operating performance.

4.7.5. Uncertainty of the Benefits of Managerial Ownership

The evidence on the benefits of managerial share ownership tends to generally be mixed. While the theoretical arguments for increased incentives are unquestionable, evidence suggests that insider ownership may also come at the cost of entrenchment. Many factors can influence the relationship between insider ownership and corporate value, and recent evidence tends to suggest that causality may even operate in the opposite direction. Table 8 discusses the main points provided in the above section.

[35] Whilst they achieve full significance with OLS regression, their instrumental variables approach provides significance only between 0 and 1%, and 1 and 5%. While the signs remain consistent, they fail to find

4.8. Summary of Agency Cost Reducing Mechanisms

The above section has provided a summary of the vast research which has been conducted in the field of agency theory and corporate governance designed to minimise its damage to shareholder wealth. In general, the only strong conclusion which appears to have been suggested is that what is optimal for one firm at one point in time, need not be so for another.

In efficient markets it could be argued that firms and investors will choose between these various devices based upon their optimal contracting relationships. While, at the same time, large divergences of interest by management always carries the threat of external market discipline from labor markets and the market for corporate control.

5. Conclusions

The research reviewed above provides many great insights into the 'nexus of contacts' which Jensen and Meckling (1976) originally discuss as their basis for a theory of the firm. It can be seen that very few strong conclusions upon the importance of each conflict, and mechanisms for resolving these, has truly been determined.

The arguments of Kole (1995) and Himmelberg et al. (1999) perhaps summarise this research most conclusively. They argue that such agency conflicts are heterogeneous across different firms in different industries, and most likely different cultures. Himmelberg et al. refer to differing firms with different contracting environments, which refreshes an important point from Jensen and Meckling's (1976) original theory, that no two firms will have the same 'nexus of contracts.'

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significance for ownership ranges between 5 and 20% and over 20%.

The scope of each type of agency conflict will differ from one firm to another, as will the effectiveness of governance mechanisms in reducing them. As has been proved, and then often questioned again, each type of governance mechanism *can* be important in reducing the agency costs of the separation of ownership and control. What is required is a more detailed understanding of what makes these mechanisms important for some firms and ineffective for others.

Examining the UK as an alternative to the US stock market provides some important considerations which may be of vital importance in both countries for understanding the importance of each type of mechanism. It appears that institutional characteristics of the UK market result in management requiring higher levels of ownership to gain sufficient power to become entrenched and insulated from external discipline. At the same time, higher managerial awareness of the threat of takeover perhaps leads to entrenchment at lower levels, as does the potentially ineffective market for corporate control in disciplining management.

Furthermore, the lesser regulation of UK institutions, in comparison to their US counterparts, adds to their ability to participate in corporate governance. The regulation provided by Cadbury (1992), Greenbury (1995) and has also had a major impact upon the structure of corporate boards and disclosure of executive compensation.

For future research in this area, there are currently three key areas which appear to be vastly under-explored. International research into corporate boards and discipline from the market for corporate control has been forthcoming, however, there appears to be very little research carried out involving many of the other governance mechanisms which control agency problems. While disclosure requirements – particularly with

respect to executive compensation – differ across international markets, more research could be conducted into effectiveness of the other mechanisms discussed above in various countries. Such studies would perhaps allow a greater understanding of which aspects of our own markets influence the effectiveness of these devices in disciplining management for divergences from the interests of their shareholders.

Secondly, greater distinction must be made in the treatment of certain variables when empirical testing is carried out. The studies of Bethel et al. (1998), Core et al. (1999), Lin et al. (2000) and the arguments of Mehran (1995) highlight the need for a greater depth of research. This should particularly be the case for research into block shareholders. Empirical studies generally still refer to blockholders as one group. Without such distinctions, we are not able to gain a full understanding of why exactly certain investor types, or director types, contribute to either better or worse monitoring of management.

Finally, the recent work of Cho (1998), Hermalin and Weisbach (1998) and Himmelberg et al. (1999) examines the potential problems of past empirical research, in it's failing to control for endogenity. These studies have since found that corporate governance characteristics of companies are inter-dependent, and previous research which fails to control for this is at best misspecified. This calls into question how many other previous studies are misspecified in their treatment of governance variables as exogenous.

For example, Mehran (1995) finds that value is positively related to the fraction of a CEO's total pay in the form of stock options. Cho (1998) finds that managers prefer to hold higher equity stakes in highly valued companies. Therefore, what is to say that

CEO's may not be able to influence a remuneration committee strongly enough to set higher levels of equity based compensation if they feel that their firm is a high performer? In addition, what effect will the composition and size of the company's board have upon a CEO's ability to do this? Questions such as these may only be answered after controlling for the interdependence and potential endogenity of various corporate governance variables.

Despite its faults, with respect to agency conflicts, the modern corporation appears to be the most popular form of corporate organisation. Perhaps this can largely be attributable to the evolution of governance mechanisms designed to limit the scope of these problems. However, these devices must continue to evolve, and greater research may be required to understand exactly what works, when it works, where it works, and most importantly why it works.

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Table 1 – Nature of Agency Conflicts

Conflict	Theoretical Arguments	Empirical Evidence
Moral Hazard	Managers consume private perquisites rather than investing [Jensen and Meckling (1976)]	Negative market reaction to announcement of the appointment of a company directors as an outsider to another board [Rosenstein and Wyatt (1994)]
	Managers invest in projects specific to their skills to increase their value to the company [Shleifer and Vishny (1989)]	
	Increase with size of company and free cash flows [Jensen (1986, 1993)]	UK executives are paid less than their US counterparts [Conyon and Murphy (2000)]
Earnings Retention	Managerial desire for corporate power may cause large shareholder losses [Brennan (1995b)	Returns to shareholders decrease as firms diversify [Lang and Stulz (1994)]
	Pay increases with firm size, leading to focus on size and not returns [Jensen and Murphy (1990)]	
	Managers prefer retentions and may invest for diversification purposes [Jensen (1986, 1993)]	
	Retentions reduce the likelihood of monitoring by external capital markets [Easterbrook (1984)]	
Time Horizon	Managers are concerned only with the cash flows during the period of their employment and this may lead to manipulation of the accounting system and favouring short-term projects over long-term investments with higher NPV's [Healy (1985)]	R&D declines as executives approach retirement [Dechow and Sloan (1991)]
		Accounting earnings higher in year prior to removal of CEO [Weisbach (1988)]
Risk Aversion	Managers will attempt to reduce their personal exposure to risk through corporate diversification and will prefer lower levels of debt even when this is beneficial to the company [Jensen (1986)]	Inverse relationship between inside equity and risk [Demsetz and Lehn (1985)]
	Despite the benefits of debt, managers prefer equity financing as debt increases likelihood of default [Brennan (1995b)]	

Table 2 – Managerial Labor Markets

Theoretical	Empirical
Managerial labor markets will discipline poorly performing management through salary revisions in present and future employment [Fama (1980)]	External labor markets use evidence on past performance in defining executive job opportunities and compensation levels [Gilson (1989)]
Equilibrium in managerial labor markets will prevent large salary revisions for poor performance [Jensen and Murphy (1990)]	Managers in firms who cut dividends are less likely to be employed as outside directors in other companies [Kaplan and Reishus (1990)]

Table 3 – Corporate Boards

Theoretical	Empirical
Boards should consist of at least three non-executive directors and should split the positions of CEO and chairman to improve monitoring and prevent one individual dominating the board [Cadbury (1992)]	CEO's more likely to be removed for poor performance on outsider dominated boards [Weisbach (1988)]
Effective boards would be largely comprised of outside independent directors to ensure better monitoring of management [Fama and Jensen (1983)]	UK performance related top management turnover is strongly related to proportion of outside directors on the company's board and strength of relationship is enhanced by adoption of Cadbury Committee's proposals, but negatively related to board size [Dahya et al. (2000)]
Outsiders have incentive to develop reputations as governance experts, insiders don't monitor effectively as they have an incentive to protect high levels of remuneration and CEO's have influence over their careers [Weisbach (1988)]	No relationship between performance related top management turnover on board composition in Japan [Kang and Shivdasani (1995)]
CEO's dominate director nomination process and won't appoint independent directors [Mace (1986)]	Outsider dominated boards reduce the ability of inside managers to block disciplinary takeovers [Cotter et al. (1997)]
Boards are less effective as they grow in size as decision making becomes slower and CEO is able to dominate with greater ease [Jensen (1993)]	Equity based compensation more prominent on outsider boards [Mehran (1995)]
Different board types are better at different jobs, insider boards may be better at unobservable (to the econometrician) tasks [Bhagat and Black (1999)]	Stock price significantly increases upon the announcement of the appointment of an outside director with increases largest in smaller companies [Rosenstein and Wyatt (1990)]
	Market reaction to appointment of outsiders depends upon the extent of company's agency problems and the characteristics of the appointee [Lin et al. (2000)]
	Convex inverse relation between board size and company value, with greatest losses arising when moving from small to medium boards [Yermack (1996)]
	CEO compensation increases with board size, percentage of outsiders appointed by CEO, and percentage of outsiders serving on three or more boards. Decreases with the percentage of insiders [Core et al. (1999)]
	Long run performance of companies with balanced boards is better than performance of outsider dominated boards [Bhagat and Black (1999)]

Table 4 – Corporate Financial Policy

Theoretical	Empirical
Debt acts as bonding mechanism which forces managers to distribute cash flows, especially in mature companies with few internal growth prospects [Jensen (1986)]	Negative relationship between company growth and leverage holds only for low Tobin's Q firms, suggesting that debt may act as disciplinary mechanism in such companies [Lang et al. (1996)]
Higher debt leads to less equity, which increases the ease with which management may accumulate larger ownership stakes [Jensen and Meckling (1976)]	Higher levels of debt is associated with higher firm value because it increases the risk of default [Harris and Raviv (1990)]
Monitoring from external capital markets when issuing debt reduces company's agency problems [Easterbrook (1984)] Role of capital structure should be to ensure socially optimal liquidation [Brennan (1995b)]	
Higher levels of debt improve liquidation decisions by increasing probability of default [Harris and Raviv (1991)]	
High debt may lead to under-investment because of the costs involved in raising new finance [Stulz (1990), Harris and Raviv (1991)]	
Dividends reduce agency problems but don't carry same binding obligation as debt payments [Jensen (1986)]	

Table 5 – Blockholders and Institutional Investors

Theoretical	Empirical
Different types of blockholders perform different functions within organisations [Bethel et al. (1998)]	Positive market reaction to the appointment of an affiliated outsider (including those from blockholders) to the board [Lin et al. (2000)]
Investors with large blocks in companies may pursue their own interests, rather than attempting to maximise returns [Shleifer and Vishny (1997)]	Positive reaction to filing of Schedule 13D statement with SEC, but benefits quickly disappear unless blockholder initiates corporate restructuring [Mikkelson and Ruback (1985)]
Greater need for distinction between different types of block investors such as financial companies, diversifying companies, employee pension funds, etc. [Mehran (1995)]	Positive relationship between institutional ownership and Tobin's Q, no relationship between blockholders and Q [McConnell and Servaes (1990)] Only activist investors discipline management and improve performance in poorly performing companies [Bethel et al. (1998)]
	Large blocks may reduce liquidity of a stock and the supply of information to the market [Holmstrom and Tirole (1993)]
	Aggressive counter-bidding by blockholders reduces probability of takeover even when in shareholder's interests [Burkart (1995)]

Table 6– The Market for Corporate Control

Theoretical	Empirical
Disciplinary takeovers will occur in response to breakdowns of internal control systems in companies with large levels of free cash flow [Jensen (1986)]	Targets of failed takeover bids significantly increase leverage [Safieddine and Titman (1999)]
Threat of takeover not enough to ensure complete alignment between managerial goals and shareholder's wealth because of takeover costs [Jensen and Ruback (1983)]	Shareholders in successful takeover targets realise substantial wealth increases following takeover [Jensen and Ruback (1983)]
	Targets of disciplinary takeovers, where management departed following the takeover, were firms who were performing worse than their industry average in the US [Martin and McConnell (1991)] No relation between top management turnover and prior firm performance in UK [Franks and Mayer (1996)]
	Takeover market only disciplines management for poor performance during active periods [Mikkelson and Partch (1997)]

Table 7 – Executive Compensation

Theoretical	Empirical
Higher managerial incentives leads to higher corporate performance [Jensen and Meckling (1976)]	For every $1,000 change in shareholder wealth, CEO salary changes by 2 cents [Jensen and Murphy (1990)]
The level of pay determines where managers work, the structure of their compensation contracts will determine how hard they work [Baker et al. (1988)]	Sales performance in retail firms increases following implementation of accounting based bonus schemes [Banker et al. (1996)]
Equilibrium in managerial labor markets will prevent large salary revisions for poorly performing managers [Jensen and Murphy (1990)]	Higher accounting earnings in year prior to removal of CEO [Weisbach (1988)]
Paying executives on basis of accounting variables may lead to direct manipulation of the accounting system and encourage managers to let the firm grow beyond its optimal size [Healy (1985), Jensen and Murphy (1990)]	R&D expenditures decline prior to the retirement of a CEO [Dechow and Sloan (1991)]
Monetary incentives are not sufficient to ensure complete coherence between manager's goals and shareholders [Brennan (1994, 1995a)	The use of executive stock options overcomes risk aversion and make investment and financing decisions which increase the risk of the company's assets [Agrawal and Mandelker (1987)]
At some point managers will yield to behavioural notions of fairness and loyalty in their decisions making and not be driven by financial incentives alone [Baker et al. (1988)]	CEO remuneration significantly changed by $0.75 for every $1,000 change in firm value [Jensen and Murphy (1990)]
	Positive relationship between value and proportion of compensation which is equity based [Mehran (1995)]
	CEO's in US earn 46% higher cash compensation and 150% higher total compensation than their UK counterparts [Conyon and Murphy (2000)]

Table 8 – Managerial Share Ownership

Theoretical	Empirical
As managerial share ownership increases so to does their incentive to maximise company value [Jensen and Meckling (1976)]	Significant relationship between changes in shareholder wealth and the value of executive shareholdings [Benston (1985), Jensen and Murphy (1990)]
Entrenchment may occur through the failure of external markets discipline when management have higher ownership stakes [Stulz (1988)]	Increased managerial incentives contribute to improvements in company performance following MBO's [Kaplan (1989)]
UK institutional framework allows for managers to become entrenched at higher levels due to lower regulation and geographical clustering of institutions in the UK, leading to higher ownership and monitoring by institutions [Short and Keasey (1999), Faccio and Lasfer (2000)]	Negative relationship between performance related top management turnover and shareholdings by management [Weisbach (1988), Dahya et al. (2000)]
UK managers may become entrenched at lower ownership levels due to greater awareness of takeover threat arising from lower disclosure of block shareholdings, mandatory takeover threshold and failings of market for corporate control to discipline UK managers for poor performance [Franks and Mayer (1996), Faccio and Lasfer (2000)]	A U-shaped relation exists between insider ownership and demand for non-executive directors, the decrease arises from higher incentives, and the increase results from internal demand due to entrenchment at high ownership [Peasnell et al. (2000)]
Differences in studies measuring the effects of managerial ownership on corporate value arise due to the relevant size of the firms in samples, reflecting optimal contracting relationships [Kole (1995), Himmelberg et al. (1999)]	A non-linear relationship exists between ownership and corporate value [Morck et al. (1988), McConnell & Servaes (1990), Hermalin & Weisbach (1991), Short & Keasey (1999) and Faccio & Lasfer (2000)]
Some empirical studies are misspecified in their treatment of ownership as an exogenous variable [Demsetz and Lehn (1985), Cho (1998)]	Managers become entrenched at higher levels of ownership in the UK than US executives [Short and Keasey (1999), Faccio and Lasfer (2000)]
Endogenity of ownership reflects different firms choosing amongst different corporate governance mechanisms depending on the nature and extent of the agency conflicts within their contracting environment [Himmelberg et al. (1999)]	Higher value leads to higher insider ownership after controlling for endogenity, but not vice-versa [Cho (1998), Himmelberg et al. (1999)]