Corporate Governance and Corporate Diversification Strategies

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Abstract

In this paper we wish to analyze the causality relationship between corporate governance and the corporate diversification strategies in the context of the global economic crisis. For the beginning, we have studied several opinions of famous specialists of the area. The analysis that we have elaborated continued with the pointing out of some theories laying at the foundation of the corporate governance. Corporate governance is based on the theory of the organization and the expenses it implies, but also on the attempts to clarify the relationship between the several actors to the determination of management and corporations' operation. The main component of the study concentrated on the causality relationship corporate governance – corporate diversification. We have first analyzed the most well known reasons to approach diversification: economies of scale and range (synergies); the power on the market; stability of the profit; improvement of the financial performance; growth of the company's size.

Starting from these analyses, we have identified the relationship between the company's value and the structures of the corporate governance in the context of diversification. In consequence, a number of advantages obtained by the manager as a result of the diversification prevent him from adopting a concentrated position for the company. The one suffering from these actions is the company itself, which is submitted to a value reduction because of the inefficient policies based on agency conflicts on the level of the division or following the lack of managerial experience in multiple domains.

Keywords: *analysis, corporate governance, diversification, company value, strategy.*

JEL classification: G34, O16.

Introdcution

There is a series of studies analyzing the relationship between corporate governance and corporate diversification. New terms such as corporate governance, corporate diversification strategies occupy an important place within the specialty literature, especially given the fact that recent events on the financial market (the case of the WorldCom, Enron, Parmalat, Adelphia companies) have aroused even more the interest of the researchers. According to Muscalu, et al (2012), nowadays, there are many persons that consider social responsibility when they choose the company they work for, the company they invest in or the company whose products they buy There are several questions connected to the efficiency of the diversification strategy, to the company's motivation to use this strategy – even if it is value reducing – or to maintain it, to the

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existence of agency conflicts within diversified companies and the attempt to reduce these conflicts (Ileana, 2008). We will refer below to some studies that concentrate on the connection between corporate governance and diversification, as it has been seen by a series of specialists. Frederic Perdreau (2001) studied the connection between the performance of the acquisitions made by French organizations and the share of capital held by managers. He tried to analyze if the managerial ownership of capital motivates them to avoid value destruction decisions for shareholders and to point their actions more towards value creating strategies. The relation between corporate governance and diversification has also been treated by Jensen and Meckling (1976). In their opinion, if managers administrate a relatively small ownership, their interests could not coincide with those of shareholders. It has been demonstrated that private companies are less aligned with those of shareholders. They might wish to develop the company, even if this is not in the best interest of shareholders.

1. The Concept of Corporate Governance

„You cannot expect that those who administrate other people's money to be just as careful and attentive as they were with their own" (Smith, 1976). All around the world there are companies involved in famous financial scandals, such as: WorldCom, Parmalat, Anderson, Enron, Xerox, Merrill Lynch, Allied Irish Bank, Alder Hey, Sellafield, Maxwell, BCCI (Bank of Credit and Commerce International) etc. The causes leading to these scandals are presented in figure 1.

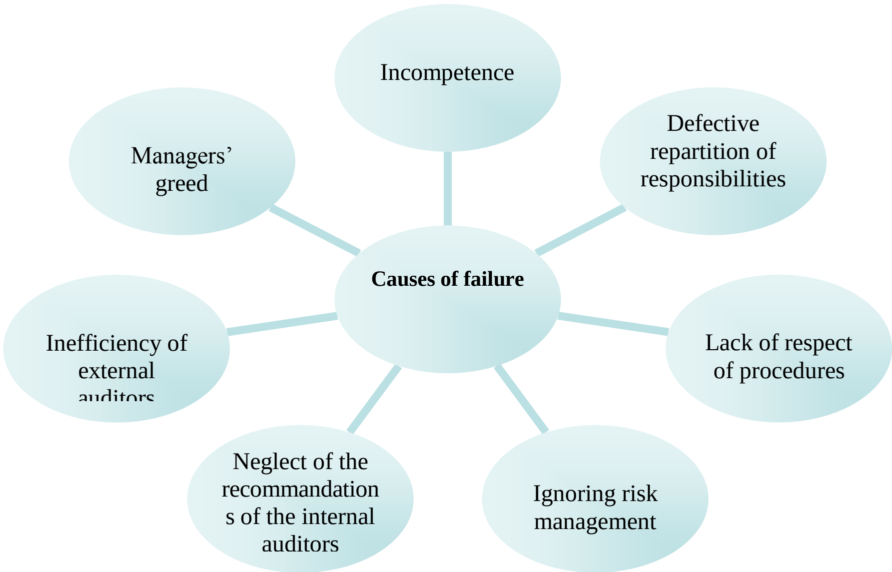

Figure 1 Causes of companies' failure

Corporate governance can be approached from a restraint, but also from a larger point of view. In a restraint approach, it can be defined as the totality of economic and legislative means helping to the fulfilment of the investors' interests.

Thus, the types of investments within the economy of a state have an important part in the orientation and sustainment of powerful and balanced corporate governance. This way corporate governance is actually one of the expressions of the property rights regime.

The given regime exists in any type of economic mechanism and it has mainly the role to emphasize the specific character of the economic mechanism. In a wider approach, corporate governance represents the totality of control norms and mechanisms applied, with the purpose of protecting and harmonizing the interests, which are in many cases contradictory, of all the stakeholders of the company. In the new knowledge based economy the leaders' roles increase in complexity and impact as they contribute to new types of governance. They have to be able to build up a general climate that is able to support both individual, but also the organizational learning (Nastase, Hotaran, 2011).

Studies recently elaborated by the World Bank are treating corporate governance in a larger approach, without limiting themselves to the relationships between owners and managers, but also considering the main stakeholders of the company. The World Bank defines corporate management as "a combination of laws, regulations and conduct codes voluntarily adopted, which guarantee the company's possibility to attract financial and human capital necessary to its activity and the possibility to organize its activity in an efficient manner, in order to insure its existence through the generation of long term value for its shareholders and the society as a whole".

1.1. Fundamental theories for corporate governance

In 1996, Hawley & Williams have made an overview of the literature referring to the corporate governance present in the US as fundamental documentation for the Organization for Economic Cooperation and Development - OECD. Corporate governance is based on the organizational theory and the expenses it implies, but also on the attempts to clarify the relationship between the different participants to the determination of the management and of the operation of corporations.

The main theories that fundament corporate governance are presented in figure 2.

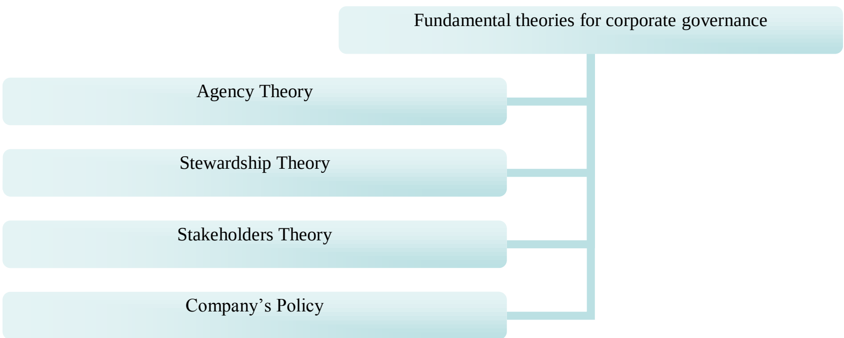

Figure 2 Fundamental theories for corporate governance

1.2. The necessity of corporate governance

The acceleration of globalization (Morariu, 2008) has been followed by important changes at the level of the organizations, which have changed their mode of operation, as well as at the level of governments that have to establish and maintain an adequate legal frame.

Good governance within an organization reduces risks, increases performance, opens the way to financial markets, brings competitive goods and services on the market, improves the managerial style, and shows transparency to all the interested parties and social responsibility. The lack of mandatory rules and structures could lead to chaos in business.

By corporate governance one aims to build a structure allowing a high degree of freedom, within the limits of the law, and including some principle changes, in accordance with the international transparency standards.

The principles of corporate governance (Ghiţă M., 2008) are outlined in figure 3.

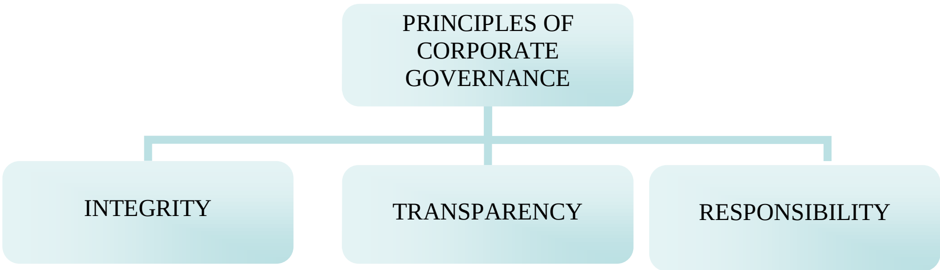

Figure 3 Principles of corporate governance

Integrity is the concept approaching the concern for the interests of others and social responsibility. Transparency is a fundamental principle for the organizations that want to learn. Without being open there is no evolution, no performance, so no efficiency, in the conditions of financial stability (financial balance). Responsibility is the most important principle of corporate governance, but unfortunately the least understood and the most rarely respected within the organization. Assuming responsibility implies following several steps: the clarity of solutions and responsibilities; the need to respond in front of the person who charged you with the responsibility; the person to whom you respond must have sufficient and concrete information for doubting the employees' affirmations; the way of assuming responsibility must be open to independent examination; the existence of a well intended mechanism of rewards and sanctions, that would function correctly and continuously. Corporate governance (Morariu, 2008) helps the economy and organizations to attract investors and sustain on a long term the economic performances (figure 4).

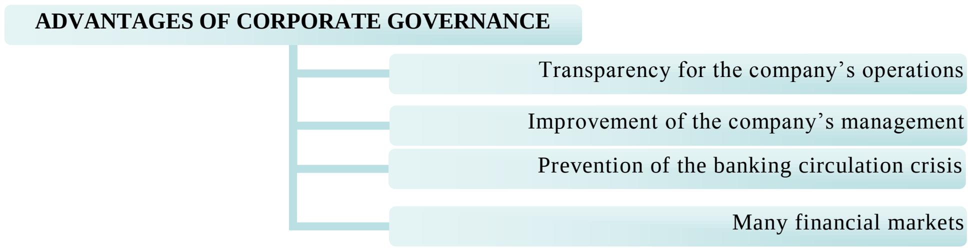

Figure 4 Advantages of corporate governance

Practicing corporate governance can lead to the increase of the public confidence in the integrity of the privatization process, it guarantees that the respective country will obtain the best performance for its investments, which will lead to general economic growth. Corporate governance has evolved a lot lately, becoming the real plus that the organizations can demonstrate, in the transparency offered to the public and media, in the opportunity to offer a high quality and cost competitive services, including through the activities obtained by externalization or partnership.

2. The Causality Relationship Corporate Governance – Corporate Diversification

2.1. Diversification strategy – reasons for diversification

"Each company chooses the types of business in which it will get involved, the degree of using its expertise and resources and the corresponding degree of diversification. The diversification strategy represents the degree in which the activity on the market of a new product uses the general management's ability and the created administrative structure". Companies have used diversification strategies from the 1960s and 1970s. The main advantages of diversification have been the higher capacity of indebtedness, risk reduction, tax deductions, scale economies, gains' stability. But the efficiency of the diversification strategy becomes a subject of doubt at the beginning of the 1980s. There is a series of determinative factors for diversification, such as resources, the administrative reasons connected to diversification, or stimulus coming from the external environment (antitrust regulations, fiscal laws) as well as from the internal one (such as avoiding the loss of value, the reduction of the global risk of the company).

2.2. The role of the diversification strategy

Diversification reduces risk without affecting incomes. Differently from the diversification of the investment portfolios, the benefits of the corporate diversification are not so obvious. The corporate diversification represents the transfer of an organization to a new segment of activity, by processes of internal development of the business, or by acquisitions, generating changes within the administrative structure, the internal organization and operation systems and the managerial processes. Corporate diversification refers to the involvement of companies in distinct businesses in order to create value for pleasing and keeping the shareholders, by the synergic integration of a new business within an already existing one, increasing this way the competitive advantage of the first one. Developing a diversification strategy at transnational level is considered to be a complex process made up of four steps (Mendes-da-Silva ş.a., 2004) such as:

- ✓ The decision on the changes necessary to the positioning of the company within the industries chosen for diversification;
- ✓ Actions taken for the maximization of the company's performance after diversification;
- ✓ The realization of benefits and their transformation into competitive advantages;
- ✓ The evaluation of the profit perspectives of each business unit in order to distribute resources.

Diversification is seen as a function of the managerial decisions, representing decisive factors for the company's future, and a cause of the problems encountered by the transnational company. Connected to the coordination, planning and control from the level of the top management. Thus, diversification is seen as a strategy with two main objectives: the improvement of the execution of basic processes and the emphasis of the structural position of a business unit. In their attempt to identify the existing relationship between the diversification strategy and its effects on the organization, several studies have mentioned different forms of diversification. The most common classification contains two variants: the sectorial diversification (the company's operations being spread on several segments of productive activities) and the geographical one (the company's operations are spread within a geographic space). The typology of diversification strategies elaborated by Richard Rumelt in his 1975 study used three indicators:

- ✓ Specialization ratio: the proportion of the incomes of an organization that can be attributed to its main activity;
- ✓ The ratio of similarity of the activities: the proportion of the incomes of an organization that can be attributed to the largest group of similar activities;
- ✓ The vertical integration ratio: the proportion of incomes of an organization coming from the total of the raw, intermediary and finished products belonging to a sequence of production activities vertically integrated.

There are four types of organizations based on their diversification strategy.

a) Single business – represents any organization that gets 95% of its revenues from one of its activities.
b) Dominant business – any organization that obtains 70-94% of its revenues from one of its activities (the main activity). The dominant businesses divide into four groups:
    - ✓ Vertical dominant business – any organization with dominant business and which is vertically integrated;

- ✓ Constrained dominant business – any organization with a dominant business which diversifies built around a single strong point;
- ✓ Linked dominant business – any organization with a dominant business that diversifies based on one or several strong points or starting from one or several resources. The strong point can differ in accordance with the activity segment of the organization;
- ✓ Unrelated dominant business – any organization with a dominant business with diversification activities that are not connected to the dominant activity.

c) Related business – any organization that gets less than 70% of its sales from a single activity and that develops activities, which are connected. The related business divides into two groups:
   - ✓ Constrained linked business – any organization with a related activity that diversifies around a single strong point or resource associated to the initial activity;
   - ✓ Related linked business – any organization with a related business that diversifies based on one or several strong points or starting from one or several resources.

d) Unrelated business – any organization that gets less than 70% of its sales from a single activity and that approaches unrelated activities. These businesses also divide into two subchapters:
   - ✓ Multi-business – any organization with an unrelated business that develops a few simple activities and belonging to different sectors;
   - ✓ Unrelated portfolio – any organization with unrelated business that develops several activities from different sectors.

2.3 Features of the diversified companies compared to those of concentrated companies

It was noticed that the weight of long-term debts in the total of the assets is higher for the diversified companies by almost 4%, suggesting a higher degree of indebtedness. The dimension of the expenses for research and development is sensibly reduced, the total assets having a higher value for the diversified companies, as the value created for shareholders (the profit obtained by shareholders as owners over the earnings requested by shareholders as investors) is significantly reduced.

The stocks of the CEO (Chief Executive Officer), directors and managers are reduced by about 6,6% in multi-segmented companies than the average of the companies with a single segment. Generally, the CEO of diversified companies has a salary and benefits with 100.000 $ higher and 400.000 $ more for his options stock than the one of the companies that has not chosen a diversification strategy.

As for the compensations' sensibility to the price of the stocks, in the undiversified companies CEO gets compensations that are higher by 1,4 $ for every change by 1.000 $ in the fortune of the shareholders, while in the diversified companies the growth is only of 1,11 $ suggesting a reduction of 20% of the degree of sensibility of the salary to the performance (Anderson s.a, 2000).

The degree of replacement of managers is significantly higher in diversified companies, the frequency of the replacement of the CEO being of 7,8% in multi-segmented companies compared to 5,8% in those with a single segment. The relationship between the degree of replacement of managers and the performance of a company is not significantly different from the one existing in concentrated companies.

Diversified companies have more external managers, a higher degree of replacement of managers and a similar sensibility of the business figure to the price of stock.

In average, diversified companies, unlike those undiversified, have larger administration boards (with about one manager more), but include with 6% more external managers (connected to the company only by the function they hold) and 5% less internal managers (who are employees of the company and have into their portfolios stocks of the company). The period of occupation of a CEO position is about 10 years in diversified companies compared to 14 years within concentrated companies.

3. Company Value and Structures of Corporate Governance in the Context of Diversification

3.1 General aspects regarding the company value

The concept of corporate governance at the level of the transnational company sends us directly to the influence of the strategic decisions concerning the creation of value. The value maximization is the responsibility of managers. The managerial behaviour regarding the wealth maximization criteria is realized through incentive resorts and control mechanisms. According to the classical financial theory the organization is an entity with a single objective: the maximization of the wealth of its owners, meaning the maximization of the profit, as the business world is a world of profit. For many economic actors, the business world is a jungle, where there are no rules for reaching your goals. They consider that in business everything is allowed, that the jungle law prevails. There is no doubt that the business world is a competitive one, and only those who manage to adapt the best to the market are the ones who survive. But obtaining economic success doesn’t rely on cheating, on disloyal practices or the complete elimination of competition. The existence of competition and of the need to obtain profit is not in a logical contradiction with a correct behaviour and the respect of the ethical standards.

Milton Friedman claimed that following profit is also a moral duty (with the minimal condition that profit would be obtained through legal ways). It is a moral duty for businessmen, as well as for managers, and this for three reasons. Friedman sustains that the disregard of obtaining profit as a main purpose of economic activity is against individual rights, is inequitable and undemocratic.

In this context, the financial theory has proposed and developed models regarding the company from totally different perspectives: it is either considered as a self standing entity with the fundamental purposes of surviving and developing, either it is more of an association created to bring profit to shareholders.

The ownership is represented by shareholders who have the necessary resources (financing, funds) but who need the specialized human capital, able to efficiently use the shareholders' funds in order to generate profit.

According to Friedman, the management's duties towards the shareholders are the result of an explicit contractual obligation. Managers are employees of the owners, and when they don't represent the economic interests of the last ones any more, they betray the trust they have been awarded, thing that could be considered immoral. There are still two interesting notions to approach namely the ownership and investor terms. Are they synonyms?

In Japan the idea of ownership has a totally different connotation as the one specific to the European culture. For the Japanese cultural environment, private property is firstly understood as a mean to promote public interests, unselfish, and only last to serve the selfish interests of the owners.

3.2 Hypothesis referring to the influence of corporate structures on the diversification strategy and its effects on the company

Here are only some questions that are very common in the specialty literature and the answer of which represents the key of success in choosing the long term orientation of the company. Why is diversification destroying value in a company while it is increasing it in another?

- Why do a lot of companies adopt diversification while a large number of them could increase their value by concentration?
- Why do transnational companies maintain the diversification strategy even if it is value destroyer?

In the attempt to find a viable answer, specialists have discussed numerous hypotheses referring to the influence of corporate structures on the diversification strategy and its effects on the company. The prevailing element of these hypotheses is the motivation at the base of the diversification strategy (corrupted managers tending to over invest or the reason to take profit from the growth opportunities).

Here are 3 hypotheses regarding this subject.

Hypothesis I: The agency conflicts are the main cause of company's decreasing value following the adoption of diversification. The supporters of the hypothesis begin from the fact that concentrated companies are evaluated with a bonus thanks to their significant gains from specialization (transparency and high liquidity). The phenomenon is also present at smaller companies with scale economies reducing administrative and maintenance costs. It is widely spread the idea that companies who adopt a concentration strategy are transacted with a bonus because they avoid additional costs anticipated during a future diversification process. In order to better describe the phenomenon, specialists have used the concept of ex ante diversification (Cronqvist and Nilsson, 2001). This concept supposes a reduction of value due to agency costs associated to the temptation of private owners for diversification hoping to obtain private benefits. The companies controlled only by the CEO or the founder (meaning by persons and not by institutions) are not able to get involved into the adoption of a concentration strategy, as they can obtain important private benefits from diversification by having the control. Because they don't support the entire cost of a possible failure, these private owners are very often tempted to engage into overoptimistic investment, extending the business on new markets or in new domains. The conclusion is that a better understanding of the unique connection between agency costs, corporate strategy and ex ante diversification value losses is obtained through an analysis of the diversification process and of the features of the companies to be diversified ownership more than through a continuous observation of the inefficiency of the diversified companies. The most important reduction is not the one in the present measuring the inefficiency of a diversified company, but the ex ante evaluated loss of value that the investors associate to certain features of the ownership, features determining the impossibility to respond to the temptation of diversification. In literature there were also contrary opinions considering the diversification decision the optimal response to the company's low performance and ignoring the possibility that through anticipated additional costs of the diversification process investors might be influenced in their evaluation of the company.

Hypothesis II: The structures of the governance determine the company's orientation to diversification with the consequence of the value reduction. The supporters of this affirmation concluded, after a great number of studies, that the structures of the governance determine significantly the diversification decision, its main result being the reduction of the transaction value of the company. Among the decisions with an important impact on the company value, the diversification of the activities has a very important percent. Corporate diversification raises suspicions concerning the presence of certain managerial interests above those of the shareholders. Thus, the manager tries through diversification to increase his power, the dimension and the growth rhythm of the company, to reduce the risk of losing his job or to become indispensable through the huge investment in domains in which he can use his specific competences. He develops the company beyond the optimal size, investing in projects with low positive results or even value destroying, because investment is nothing but a cash waste. This is why it has been sustained that it is more likely for companies who have a large amount of cash to be diversified. Moreover, it is considered that it is more likely for companies with inefficient governance to use diversification, being motivated by a wrong stimulus".

Hypothesis III: Agency conflicts represent the cause for maintaining the diversification strategy, even if the effects of reduction of the company's value are more than obvious.

The supporters of this hypothesis consider that the governance structures are decisive factors even in the decision to maintain the diversification strategy, even if it is not creating value for shareholders, but it could even reduce it. It is considered that even if they see the negative effects of diversification, managers don't take any measure that would direct the company to the initial objective of maximizing the shareholders' fortune. A reason could be the fact that managers can benefit from the diversification by the fame and power obtained with the administration of large companies, from the compensations established in accordance with the company's size, from the reduction of the risk for the undiversified personal portfolios and from the indispensability of his position within the company. This is why managers could keep a diversification strategy even if it doesn't contribute to the wealth of the shareholders. The supporters of these affirmations claim that the more stocks are owned by the company managers, the more they are tempted to diversify due to their desire to reduce personal risk. This constitutes another proof that agency connected problems are responsible for maintaining the diversification strategy even if a corporate concentration would be a value maximizing strategy. The opinions that are against this hypothesis sustain the idea that the agency problems represent only a partial explanation for maintaining the diversification strategy in spite of the substantial value reductions. In time, they claim, this strategy has been value maximizing for many companies. The recent shocks of regulation and competitive conditions have modified the relative costs and benefits that result from it. A cause for maintaining the value minimizing strategy is the fact that companies which decide to adopt diversification are those that have low performances, and a restructuration would not add to their value any more. Moreover, even if diversification doesn't create value any more, companies tends to avoid the disinvestment of certain assets if the transaction involves more costs than benefits. These costs could include, for instance, the selling costs and those involved by the termination of the contracts with different creditors or shareholders of the company. The agency theory also explains a large part of the managerial decision to maintain the diversification strategy in spite of the value reduction. It sustains that managers will follow a value destroying strategy as long as their private benefits surpass the costs. Diversification brings advantages to managers because, besides reducing the risks for their own undiversified portfolios, they also enjoy the recognition and fame of managing a large business, of a higher reward and a high degree of dependency of the company to the manager. In consequence, the number of advantages obtained by the manager from the diversification prevents him to orient the company towards concentration.

Conclusion

Corporate diversification represents the passage of an organization to a new activity segment, by internal development processes or by acquisitions, generating changes in the administrative structure, internal organizational and operation systems and in the management processes. In conclusion, the most well known reasons for adopting the diversification strategy are:

a) Scale and range economies (synergies). The merger of two companies with similar products allows them to increase production and get lower operational costs. The economies result from the low administration costs or from the capacity to produce a larger quantity with fixed lower costs (consolidated).

b) The power on the market. Acquisitions and mergers can increase the market share of the company especially when both of them are in the same domain of activity.

c) Profit stability. The acquisition of a new business can reduce risks connected to the volatility of the buying company's profit by extending the business lines of the organization.

d) Improvement of the financial performance. The bigger sized companies generate cash flows faster that can be invested in a number of efficient businesses. They act as bankers on the internal capital market.

e) Growth of the company's dimensions. The diversification is considered a way of increasing the company's dimensions.

The essential factors for limiting the exaggerated diversification tendencies and, by this, the agency problems are the government mechanisms. They have the role to discourage and reduce the effects of the managerial actions oriented toward obtaining administrative profit and not towards the corporate objectives, affecting by this the financial performance of the company. The companies where the structure of the governance is not efficient deal with a reduction of the company's value as an effect of excessive diversification. Starting with these analyses, we have identified the relationship between the company's value and the corporate governance structures in the context of diversification. In consequence, the large number of advantages obtained by the manager from diversification prevents him from orienting the company towards concentration. The one suffering from these actions is the company that is submitted to a reduction of value due to the inefficient policies based on the agency conflicts at the level of the division or because of the lack of managerial experience in multiple domains.

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