INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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NICO Asset Managers

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Topic 240: Limitations of Corporate Governance

Last week we discussed the benefits of corporate governance. We stated that corporate governance is an important aspect in any business and helps to properly distribute the responsibilities of stakeholders, lower risks, reduce wastage and build the company's reputation. This week we will look at the limitations of corporate governance as explained below:

1. Maintenance of the Separation of Roles

Corporate governance emphasizes the separation of roles between various stakeholders in an organization. This separation can sometimes lead to conflicts of interest. For instance, managers may strive to achieve goals that are not aligned to with the organizational goals, and this may cause the principal-agent problem which can harm the company in the long term. Managers often face conflicts of interest with shareholders when they try to gain personal benefits from the company's operations rather than working on maximizing shareholder wealth.

2. Insider Trading

Through corporate governance, stakeholders such as managers, the board of directors and employees have access to highly confidential information and may misappropriate it to reap profits or avoid losses. This is common under ESOP (Employee Stock Ownership Plan) schemes where employees have shares in the company. If company officials use private information for their own advantage to influence trades in the stock market, this is considered as inside trading. Insider trading is illegal in Malawi.

3. Costs of Regulation

Due to the extensive abuse of power by company officials under corporate governance, laws have been formulated to prevent misuse and abuse of power. However, complying with these laws can be very costly and stressful to many companies. Corporate governance requires certain levels of government and regulatory oversight in order to avoid high levels of corruption, and this can be expensive.

4. Board Dominance by a Few Individuals

One of the most common drawbacks in corporate governance is the dominance of the board of directors by a few senior executives. For instance, a single individual is able to influence the rest of the board of directors to action his or her own interests. In some cases, an executive can even make decisions without consulting the other directors. Boards may even fail to make unanimous decisions due to lack of information provided to other directors. The presence of non-executive directors can help to safeguard against the domination of the board by a single individual.

5. Misrepresentation of Information

Transparency is one of the essential requirements of good corporate governance, but sometimes corporate officials may falsify financial information. This can either be done to avoid paying heavy taxes or affect the value of the company shares on the stock market. In many cases, poor quality accounting information is a major problem if markets are trying to make a fair assessment of the company's value. This is a crucial drawback of corporate governance and companies get away with corrupt acts.

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