Four lenses on governance

MODULE 3 | PART A.4 | STUDENT COMPANION

Each theory starts from an assumption about how people with power behave. The assumption decides which safeguards make sense.

Theory	Assumption about people	Whose relationship	Governance response
Stewardship (inside view)	Stewards naturally act for the owners	Directors and shareholders	Trust and freedom to act; financial reports as the stewards' account
Agency (inside view)	Self-interested, and they know more than the owners	Principals and agents	Monitoring, bonding and pay design to align interests
Stakeholder (outside view)	Managers must balance many groups' claims	Everyone affected, inside and out	Engage, prioritise and account publicly to each group
Corporate social responsibility (outside view)	Entities should contribute to society	The community and its causes	Programs that benefit the community and engage employees

Why it matters. Audits, audit committees, independent directors and long-term pay design are agency theory in practice: each one reduces information asymmetry or lines up the agent's interests with the owners' interests.

Agency costs: who bears them?

Monitoring costs
Borne by the principal

Spent watching the agent: compulsory annual reporting and audit, plus optional reviews and scorecards.

Bonding costs
Borne by the agent

Commitments the agent accepts to show alignment: deferred bonuses, shareholding requirements, disclosures.

Residual loss
Borne by the principal

Value still lost despite monitoring and bonding: excessive perks, empire building, risk avoidance, short horizons.

What causes agency costs?

Information asymmetry | poor communication | poor understanding | innocent self-interest | deliberate but legal self-interest | illegal self-interest such as fraud

Residual loss in four forms

MODULE 3 | PART A.4 | IMAGINED EXAMPLES AT SUMMIT LOGISTICS LTD

Form	What it looks like	Why shareholders lose
Excessive perks	Lavish offices, cars and memberships charged to the company	Lower profit and less cash available for owners
Empire building	Buying a rival mainly for status and a bigger salary	Growth that adds size but not value
Risk avoidance	Managers on fixed salaries reject good but risky projects	Higher returns that diversified owners wanted are forgone
Short time horizons	A retiring CEO cuts maintenance to lift this year's bonus profit	Long-term damage arrives after the agent has left

Real case - Tyco International. Former chief executive Dennis Kozlowski was convicted in 2005 after using company money for extravagant personal spending. Perks became crime, but the agency problem was the same: the agent's interests displaced the owners' interests.

Real case - Patagonia, 2022. The founder's family transferred the company: voting shares to a trust that protects its values, and non-voting shares (the vast majority) to a non-profit that uses profits not reinvested to fight the environmental crisis. Stakeholder and social responsibility thinking built into ownership.

Practice questions

MODULE 3 | PART A.4 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - label the agency cost

Imagine a listed company called **Harbourside Wind Ltd**. Label each event as a monitoring cost, a bonding cost or residual loss, and say who bears it.

Event	Your label and who bears it
(a) Shareholders pay for the annual external audit.	
(b) The CEO agrees that 40% of her bonus is paid in shares she can't sell for three years.	
(c) A 'leadership retreat' for the CEO and two friends at a luxury resort is charged to the company.	
(d) The board pays consultants to build a dashboard tracking the CEO's targets.	
(e) Managers on fixed salaries reject a promising but risky turbine project to protect their jobs.	
(f) The CFO publishes a register of her outside interests and accepts a clawback of bonuses if results are restated.	

Question 2 - which theory explains it?

Name the theory that best explains each choice: (a) a board gives its long-serving founder-CEO wide authority and relies mainly on the annual report; (b) a company forms an audit committee and links bonuses to three-year shareholder returns; (c) a mining company consults landholders, Traditional Owners, employees and councils before approving a new site; (d) a bank gives every employee two paid volunteering days a year with local charities.

Harbourside Wind, Summit Logistics and the apartment-sale illustration are imagined examples. Real cases: Tyco International (conviction of former CEO, 2005); Patagonia ownership transfer (September 2022). Study guide reference: Module 3, Part A, section 3.4.

Worked answers

MODULE 3 | PART A.4 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Harbourside Wind Ltd

Event	Label	Who bears it and why
(a) External audit	Monitoring (compulsory)	Principal: the owners pay to check the agent's reporting.
(b) Bonus paid in locked shares	Bonding	Agent: she accepts a restriction that ties her wealth to the shareholders'.
(c) Resort 'retreat' with friends	Residual loss (excessive perks)	Principal: company money funds personal benefit.
(d) Target dashboard	Monitoring (discretionary)	Principal: an optional tool for watching performance.
(e) Risky project rejected	Residual loss (risk avoidance)	Principal: returns that diversified owners would accept are forgone.
(f) Interests register and clawback	Bonding	Agent: voluntary commitments that signal alignment.

Tip: ask who bears the cost. Principals pay for monitoring and suffer residual loss; agents bear bonding costs, and many bonding costs are restrictions rather than dollars.

Question 2 - which theory?

- **(a) Stewardship theory:** the founder is trusted as a steward, and the annual report is the formal account to owners.
- **(b) Agency theory:** an audit committee reduces information asymmetry, and long-term pay builds goal congruence.
- **(c) Stakeholder theory:** managing relationships with many affected groups and balancing their interests.
- **(d) Corporate social responsibility theory:** supporting community causes and engaging employees beyond their work.

Answers apply the theories as explained in the lesson. Other defensible answers are possible where a choice reflects more than one theory, provided the reasoning links to the theory's assumption about people.