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# **A SCRUTINY OF CORPORATE GOVERNANCE**

by

**Emmanuel Adegbite<sup>1</sup>**

## **ABSTRACT**

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*The 2009 global economic recession, attributable to the shock of major corporate scandals and failures, is sufficient to bring the discussion of corporate governance and responsibility back to its basics. Indeed the debate on the definition and essence of corporate governance is being revitalised and discussants are increasingly concerned about what the terms ‘corporate governance’ and ‘good corporate governance’ represent. This paper provides a multi-theoretical and multi-disciplinary scrutiny of the corporate governance literature in an attempt to promote good corporate governance and stimulate a new knowledge-creating environment for future research.*

## **INTRODUCTION**

“The origins of the word governance can be found in the Latin ‘gubernare’ meaning to rule or to steer, and the Greek ‘kybernetikos’ which means . . . (steering, eds.). Norbert Wiener used the Greek root as the basis for cybernetics - the science of control in man and machine. The idea of steersman - the person at the helm - is a particularly helpful insight into the reality of governance”

Tricker (1984:9)

“Governance is a cybernetic concept.....Cybernetics critically refers to the feedback and control mechanism by which a system, and any system for that matter, keeps itself oriented towards the goals for which it was created”

Rwegasira (2000: 258)

Corporate governance discourse has developed rapidly over the past two decades. Particularly, the academic research in the field of corporate governance has witnessed an exponential increase since the 1992 Cadbury report in the UK and more recently since the 1997 literature review of Shleifer and Vishny. Furthermore, the seminal papers of Jensen and Meckling (1976) and that of Fama and Jensen (1983) remain well referenced in the corporate governance literature. However the shock of major corporate scandals and failures is sufficient to bring the discussion of corporate governance and responsibility back to its basics (Child and Rodrigues 2003). The debate on the definition and essence of corporate governance is being gradually revitalised and discussants are increasingly concerned about what the terms ‘corporate governance’ and ‘good corporate governance’ represent. What is the aim of corporate governance? What is it there to achieve? To what extent is it always important or becomes important only in the advent of a scandal? Which is good or bad corporate governance?

The seemingly endless list of corporate governance definitions requires scrutiny due to the apparent incoherence. Whilst some discussants have called it a fancy term for the way by which directors and auditors handle their responsibilities towards shareholders, some others have used the term as though it was synonymous with shareholder democracy (Maw and Craig-Cooper 1994). Indeed the underlying philosophy of corporate governance can be

ranked on a continuum. At one end of the continuum, corporate governance can be perceived as the ways in which investors assure themselves of getting a return on their investments (Shleifer and Vishny 1997). At the other end, it can constitute the system of checks and balances, both internal and external to companies, which ensures that companies discharge accountability and social responsibility to all stakeholders (Solomon 2004). Grounded in agency theory, the former definition perceives corporate governance as a means to align managerial interests with that of shareholders. The sole goal of this alignment is to maximise shareholder value. The latter definition is based on a broader orientation which stipulates that managers should strive to balance and maximize the interests of all parties with a stake in the firm. Given the varying ideological definitions which range between this Shareholder-----Stakeholder continuum, this paper offers a less normative approach to the subject but one with clearer perspectives. As a result, it generates a robust discussion based on insights from a multi-disciplinary theoretical review, thus creating a better understanding of the subject.

This paper is structured as follows. First, I provide an overview of the evolution of intense discussions on corporate governance, emphasising the impacts of relevant recent and current occurrences, in order to investigate why corporate governance matter. Thereafter, I conduct a survey of literature on corporate governance definitions in order to register the associated multi-disciplinary, multi-contextual and multi-ideological disparities. The evidences of convergence of the two theoretical models of corporate governance are subsequently analysed, in an attempt to investigate the extent to which the potential 'hybrid' model points us in the direction of good corporate governance. Following on, some parameters of good corporate governance are considered. Lastly, the worth of good governance in today's corporations is highlighted in the conclusion.

## **DOES CORPORATE GOVERNANCE MATTER?**

“The proper governance of companies will become as crucial to the world economy as the proper governing of countries”

James Wolfensohn, Former President of the World Bank, 1999.

Whilst the subject of corporate governance has benefited from an enormous scholarly attention in recent times, what is deeply lacking in the literature is a definitive motive behind these discussions. Why is corporate governance important? The author calls for a multi-theoretical and multi-disciplinary scrutiny of the corporate governance motive and agenda. This is vital to the survival and continued/future relevance of the already vast literature. It is worth noting that scholars have studied corporate governance less as a planned, systematic inquiry, but more as a response to observed problems in corporations which has resulted in the subject evolving as an aggregate of disparate studies without collective coherence (Murphy and Topyan 2005). Furthermore, whilst the recent scandals have enabled the rapid development of the subject, they could also account for some of the unresolved/never-to-be resolved conceptual disparities associated with. Four decades ago, it would have been unlikely to anticipate that the subject would come to occupy such dominance on scholarly minds, notwithstanding its multi-disciplinary allure. However, in preparing for a stimulating and new knowledge-creating environment for future research, scholarly repository may benefit from unifications in reasoning, and lessening of disciplinary conflicts.

No doubt, the term “corporate governance” is relatively new in both public and academic debates, even though the issues it addresses have existed for ages (Farinha 2003). However, recent history has been characterised by high profile corporate scandals which have seriously

undermined the confidence of the investing public in corporate governance. Here I concisely examine some of these notable scandals, and how they have transformed the corporate governance landscape. The Maxwell scandal, as at the time it occurred, could be described as the biggest example of corporate corruption. Consequentially it injected the matter of corporate governance and accountability into academic minds. For example, corporate governance discourse in the UK originated from a series of corporate misconducts in the late 1980s and early 1990s, following the scandals at BCCI bank and Maxwell pension funds (FRC 2006). The Maxwell's scandal specifically highlighted the need to separate the role of the chairman from the CEO, and further marked a scrutiny of the functions of non-executive directors as well as audit firms.

Furthermore, corporate governance is hardly taught in today's lecture rooms without reference to the Enron scandal. The former seventh largest company in America has taken its place as one of the largest corporate bankruptcies in history. The scandal particularly drew attention to the following; the need for auditors to scrutinise executive directors' excesses; the importance and responsibilities of non-executive directors; and the need for all corporate stakeholders (shareholders, senior management, board directors and auditors) to behave responsibly (FRC 2006). The aftermaths were global spontaneous reactions including the rapidly passed Sarbanes Oxley Act in the US and the revisions to the UK Combined Code. Countries in sub-Saharan Africa also responded, and the 2003 Code of Corporate Governance in Nigeria is a notable example. In the post-Enron age, the paradigm of corporate governance changed. However, current global economic crisis has further highlighted the need to challenge the postulate upon which our understanding of the corporate governance phenomenon is based. Is there an alternative to the "over-liberated" freedom of modern capitalism?

## **WHAT IS CORPORATE GOVERNANCE?**

Notably there are no agreed definitions or boundaries for investigating corporate governance (Turnbull 2000); this has created a sense of intellectual vertigo in the ever increasing debate over corporate governance reforms (Pound 1993). Simply put, the definition of corporate governance depends on one's view of the world (Gillan 2006). The model of corporate governance has thus been defectively defined and perhaps the best way to describe the concept is to list a few of the different definitions rather than mentioning one (Maw and Craig-Cooper 1994). These definitions vary across countries/regions, being contingent on differing legal, political, economic, cultural and ethical environmental underpinnings. However, the presence of several definitions in the literature is an indication that the academy of corporate governance is a rich one (Maassen 2000). These definitions vary in simplicity, scope and breadth.

A narrow definition is that of Shleifer and Vishny (1997) which describe a means through which suppliers of finance to corporations are assured that they get a return on their investment. Keasy, Thompson and Wright (1997) also defined corporate governance as the system of accountability of corporations' senior management to shareholders. Both definitions refer to the existence of potential conflicts of interests, arising from the separation of firms' ownership and control, over the partition of wealth generated by the firm (Farinha 2003). Issues relating to corporate governance thus "arise in an organisation whenever two conditions are present. First, there is an agency problem, or conflict of interest, involving members of the organisation.....;second, transaction costs are such that this agency problem cannot be dealt with through a contract" (Hart 1995: 678). Thus corporate governance has traditionally invoked



a narrow consideration of the relationships between the firm's shareholders and management, as mediated by its board of directors (Bradley et al. 2000).

A fairly broader definition which is consistent with that of Cadbury (1992) is provided by the OECD (1999). This definition describes corporate governance as a set of relationships between a company's board, shareholders and other stakeholders, which provides the system by which companies are directed and controlled. Corporate governance is thus concerned with structures within which a corporation receives its basic orientation and direction (Rwegasira 2000). Here, both definitions refer to corporate governance as a tool which must ensure transparency, accountability and control. O'Sullivan, (2003) defined corporate governance as concerned with the institutions that influence how business corporations allocate resources and returns. She further argued that corporate governance shapes who makes investments decisions in corporations, what type of investments are made, and how returns are distributed. Corporate governance can therefore be said to describe all the influences affecting the institutional processes involved in organizing the production and sales of goods and services (Turnbull 1997). John and Senbet (1998) also defined corporate governance as the mechanism through which stakeholders exercise control over corporate insiders and management in order to ensure that their interests are protected.

In an attempt to harness the aforementioned definitions, corporate governance becomes an umbrella term relating to concepts, theories and practices of corporate participants as well as the inter- relationships between boards, stockholders, senior management, regulators, auditors and other legitimate stakeholders (Cochran and Wartick 1998; Maasen 2000). Monks and Minow (2001) stressed that these inter- relationships must work in ways which ensure that the right questions are asked, and that they get the right answers. They further argued that the aim

must be to create sustainable value for the firm. The OECD (2001) report also describes these inter- relationships as involving various rules and incentives, which provides the structure through which the objectives of the company are set, the means of achieving them, as well as the ways to monitor performance.

Conclusively, Turnbull's (1997) outlined the conceptual, cultural, contextual and disciplinary scopes of corporate governance and registered that there is ambiguity in the meaning of the phenomenon. He went further to assert that this ambiguity extends to other terminologies often associated with the subject, for example, 'control' and 'regulation'. Whilst definitional variance helps to enrich academic discussions, future debates on corporate governance need to address this issue before deciding what might be achieved. Clarity of the goal of corporate governance is imperative to sustainable good corporate behaviour. As a result, whether corporate governance is seen as a subject or as a goal, a healthy definition is instrumental to any successful governance reform.

### **WHAT THEN IS GOOD CORPORATE GOVERNANCE?**

The lack of clarity of the goals and concerns of corporate governance does not only cast doubts on the relevance of the subject but has also distorted scholarly interpretation and approach to the term "good corporate governance". While corporate governance has no doubt benefited from considerable attention from the numerous stakeholders of today's corporations, startlingly however, there remains no universally accepted definition despite numerous academic discourses on the subject. Indeed, while there are notable and exhaustive definitions in the literature, it is important to note, at this juncture, that it is unlikely for any one definition to fully describe the complex relationships within the realm of corporate governance, and to achieve universal acceptance. Certainly understanding the philosophy

and rudiments of good corporate governance would therefore require a less normative approach to the subject but one with clearer perspectives.

In an attempt to progress the foregoing discussions on the corporate governance agenda, it is important to look into the subject of convergence to investigate to what extent it points us in the direction of a universally accepted definition/motive of corporate governance. Are national systems of corporate governance converging? If they are, to what extent does convergence indicate the globally accepted postulate of good corporate governance? There are two dominant systems of corporate governance: the Shareholder (outsider) model prevalent in the UK and the US and the typical Stakeholder (insider) model of Germany and Japan. Definitions of corporate governance have traditionally differed theoretically along these two major standpoints. The Anglo-Saxon economics and finance literatures put shareholder primacy at the core of corporate governance and strive to ensure that there are mechanisms in place to align the interests of firms' managers with their shareholders so as to reduce managers' self-serving behavioural tendencies. At the other end of the spectrum, the traditional German and Japanese stakeholder models take a broader look at the firm and consider the legitimate interests of other firms' stakeholders with a view to providing long-term sustainable value for all stakeholders.

<b>Shareholder</b>	<b>Stakeholder</b>
executive and non-executive directors are fiduciaries of shareholders;	executive and non-executive directors are fiduciaries of a variety of claimants;
executive and non-executive directors should adopt	executive and non-executive directors should balance

policies consistent with the maximization of shareholder wealth;	pluralistic claims;
profitability and economic efficiency are the standards of efficacy;	profitability and economic efficiency are important in addition to survival, long-term growth and stability;
the corporation is subordinate to the interests of shareholders.	the corporation is seen as a superordinate entity.

**Figure 1.2 Shareholder and Stakeholder Perspectives of Corporate Governance**

Source: Gedajlovic (1993:53-54)

Figure 1.2 shows that when these competing perspectives are taken into consideration, the corporate governance concern becomes unclear, such that definitions of corporate governance and the roles of corporate boards can move on a continuum from a purely shareholder view to a purely stakeholder view (Maassen 2000). On one hand, the shareholder –centred model includes dispersed ownership, strong legal protection for shareholders and traditional disregard for other stakeholders. The priority is to enhance shareholders’ value. On the other hand, the stakeholder model requires that all parties affected by managements’ decisions, including managements themselves, shareholders, employees, customers, suppliers, the environment, and the government must all be considered fairly. As a result, whilst shareholders occupy a significant position, managements seek to balance the interests of a large group of stakeholders in ways which aim to ensure that the decision making process is consensus-oriented. The focus of the stakeholder model is on the whole network of formal

and informal relations which determine how control is exercised within corporations and how the risks and profits are distributed among various stakeholders (Lane 2003).

The growing economic globalisation has stimulated a brilliant debate on the similarities and differences between national corporate governance systems; it has particularly highlighted the emergence of a single 'best' approach to corporate governance (McCahery and Renneboog 2002). To what extent does a particular corporate governance model have a clear-cut competitive advantage over the other? Given that countries across the world would have to adopt the most competitive model, this question is key and underlying to the subject of convergence. Research evidences as represented in the extant literature on corporate governance suggest the shareholder model is winning the debate. Discussants, notably law and economics academics proclaim the superiority of the Anglo-Saxon oriented corporate governance model (Goergen, Martynova and Renneboog 2005). Consequentially, there are traces of convergence. Shleifer and Vishny (1997) reported that corporate governance systems in Germany, Japan, and the US indicate a trend towards uniformity. Some of the principal factors driving economies towards convergence include the failure of alternative models and the competition for global commerce, (Shleifer and Vishny 1997; Braendle and Noll 2006).

However, we must take an important caution. Palepu, Khanna, and Kogan (2002) argue that whilst nations may formally adopt corporate governance systems which resemble those elsewhere, the acceptance of the enshrined principles may significantly lag in their legislations. Although, functional convergence is a reality (Halpern 1999), this brings to bear the extent to which convergence indicates the convergence of principles and philosophies about the corporate character or simply a convergence of structures. No doubt, the

convergence debate is far from being settled. The process is essentially on-going. Whilst the equilibrium of evidence appears to be tilted in favour of a convergence towards the Anglo-Saxon model, the literature remains puzzling and contradictory. In an attempt to reconcile both models of corporate governance, some scholars have talked about the 'enlightened shareholder value' or 'instrumental stakeholder theory' or 'strategic corporate social responsibility' or 'the good firm' (Parkinson 1995; Jones 1995; Kay and Silberston 1995; Filatotchev, Jackson, Gospel and Allcock 2006), as the hybrid model. This hybrid possibly points in the direction of good corporate governance, given that it harmonises the strengths of the two traditional models.

## **PARAMETERS OF GOOD CORPORATE GOVERNANCE**

The foregoing discussions have clearly shown that there is no universally accepted definition for the term "good" corporate governance. Indeed whilst this paper makes no attempt to resolve the debate between shareholder and stakeholder orientations, it is important to note that both perspectives share some common prescriptions in promoting basic accountability of executive directors for the stewardship of company assets (Filatotchev et al. 2006). In this vein, the notion of good corporate governance can be usefully discussed. It certainly imbibes elements from the two traditional models. For example, good corporate governance entails the maximization of shareholder value legally, ethically and in a sustainable way while ensuring fairness to all stakeholders, including customers, employees, partners, governments and local communities (Murthy 2006). A good corporate governance structure is the one which "selects the most able managers and makes them accountable" Tirole (2001: 2). This structure will not only ensure that executives respect the rights and interests of stakeholders, but also make sure that stakeholders act responsibly with regard to the resources invested in and generated by the enterprise (Filatotchev et al. 2006). To this extent, good corporate

governance becomes a reflection of a company's values, culture and policies, in relation to its stakeholders, and its commitment to these values (Murthy 2006). This may also imply significant public interest elements which regulate the purposes for which managerial power over the corporation may be legitimately administered (Parkinson 1993).

Good corporate governance can thus be described as a voluntary ethical code that specifies the process of structuring and controlling a company, and further enable it to operate efficiently and effectively through a sound board monitoring system which ensures that the best interest of the company is put first at all times (Sapovadia 2007). The bedrock of good corporate governance is thus to conduct the affairs of a company in ways which ensure fairness to all stakeholders through quality leadership, good values, transparent management, clear vision and goals, respect for the rule of law, and a sense of social and communal responsibilities (Waknis 2007). Consequentially, good corporate governance will enhance "the performance of corporations, by creating an environment that motivates managers to maximize returns on investment, enhance operational efficiency and ensure long-term productivity and growth" (Murthy 2006: 1-2). Good corporate governance structures will also encourage companies to create value (through entrepreneurial activities, continuous innovation, and development) whilst providing robust accountability and control systems that are commensurate with the risks involved (ASX 2003).

## **CONCLUSION: THE WORTH OF GOOD CORPORATE GOVERNANCE**

Corporate governance is not enough! Indeed, while corporate governance is important for sustainable value/wealth creation, good corporate governance generates wealth and manages risk in a simultaneous and continuous manner (Pitelis and Clarke 2004). It is thus possible to

conclude that good corporate governance is advantageous to business. Clearly good corporate governance maintains investor confidence in the markets (Milne 2006). Corporate governance is an important determinant of inward foreign investments and plays a determining role in the bargaining power of countries to attract foreign investments, especially low-income countries (Rueda-Sabater 2000). Bad corporate governance is costly while good corporate governance is highly beneficial. Indeed good corporate governance has long been considered crucial for enhancing the long-term value of corporate stakeholders; in today's technology-driven information age, good corporate governance is much more than good business practice but an indispensable component of market and business discipline (Levitt 2000; Cohen, Krishnamoorthy and Wright 2002 ). There are evidences to suggest that investments in firms which have bad corporate governance systems yield abnormally negative returns for prolonged periods of time while firms with good corporate governance have higher stock market valuations and increased profitability (Causey 2008). Assessing corporate governance thus become more than a box ticking exercise; the board structure, compensation practices and shareholder rights must be examined individually as well as collectively to ensure that they protect the interests of the stockholders (Milne 2006). The presence and effectiveness of these factors produce good corporate behaviour.

Good corporate governance builds credibility, first at the company level, then at the industry and country levels. High degrees of credibility and reliability are crucial elements necessary to generate investor confidence, particularly in developing market economies. Given that the private sector is the main driver of a country's economic growth in today's market economies, good corporate governance will increase the integrity and effectiveness of the private sector (DFID 2003). It will further make markets operate more effectively which will



boost the investment climate of developing countries and amongst others have the following secondary effects (DFID 2003; 2):

- Prevent business scandals, which damage trust in business.
- Increase the value placed on good corporate governance by institutional investors.
- Enable increased involvement of the private sector in service delivery.
- Prevent and deter corporate corruption.
- Allow deregulation and integration of capital markets.
- Facilitate the harnessing of domestic savings for economic growth.
- Reduce the risk of financial crisis and contagion.

The quality of corporate governance and business practices influence the kind of foreign investment a country is able to attract; good corporate governance attract good investment into important areas of the economy (Rueda-Sabater 2000). According to Jack Keenan (former CEO of United Distillers and Vintners), “good corporate governance can save a company from the trash heap!” (Pitelis and Clarke 2004). Good corporate governance will enhance the quality of managerial stewardship and eventually result in more efficient capital markets (Cohen, Krisnamoorthy and Wright 2002).

Legislation alone cannot dictate how each conflict of interests among corporate stakeholders can be resolved, but it must assure all stakeholders that the structures and processes are in place to sensibly maximize the interests of all parties; interaction and responsiveness in this wider societal context is the ultimate test of good corporate governance (Morrison 2004). Good corporate governance could also indicate good overall corporate practices; if a company is good at corporate governance, it would probably be good at accounting, risk management (Milne 2006), strategic decision making and entrepreneurship. For developing

countries, corporate governance issues do not only affect the distribution of income and wealth but also affect their competitiveness and growth potential (Rueda-Sabater 2000). There is no substitute for good corporate governance. As Dalton and Daily (1999) posit, good corporate governance makes board members to proactively develop the strategy and long-term direction of the firm, otherwise, as Jensen (1993) points out, corporate governance matters will only come to the forefront in time of corporate crisis or collapses (Cohen, Krisnamoorthy and Wright 2002). A country's corporate governance system is thus vital to the health of her companies, their access to capital, and ultimately the wealth created and retained in the country.

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