APPROACHES TO CORPORATE GOVERNANCE

Reasons For The Development Of Corporate Governance Codes

Codes of corporate governance, in different forms, have been developed in most countries where there is a stock exchange. The main reason for codes of good corporate governance is to help and protect investors. This is because:

i. Investors need reliable information about companies, to decide whether to invest in shares or (if they already hold shares) whether to sell them. Financial reporting by companies and external auditing should therefore be reliable. Investors should also be given other information to help them make their investment decisions, such as information about future prospects of the company, internal control and risk management and directors' remuneration.
ii. Investors need to be protected against unethical or dishonest behaviour by company management. For example, there must be strict laws against insider dealing, to prevent managers from making personal profits at the expense of other investors.

Many investment institutions invest in the stock markets of many different countries. They can choose which markets to invest in, and can choose to avoid stock markets where they believe that governance practices are poor and investors are treated badly.

Countries have developed corporate governance codes and practices because they want to attract and keep investment capital, especially from global institutional investors. This is because investment capital helps the country's economy to develop and its companies to prosper. Pressure for better corporate governance has come mainly for two reasons:

i. The collapse of major stock market companies in a major financial centre, where investors have lost substantial amounts of money and the cause of the collapse has been largely attributable to bad corporate governance.
ii. Pressure from institutional investors in countries with well-developed corporate governance codes or rules.

The International Corporate Governance Network (ICGN) is an entity formed in 1995, whose members consist of major institutional investors, companies, banks and other interested groups. Its aim is to encourage the development of good corporate practices worldwide. It has published a statement on global corporate governance principles (revised 2005), which gives an indication of why corporate governance matters so much to institutional investors. The statement commented that the governance of a corporation is one of the key factors that investors consider when they decide where to allocate their investment capital. ICGN members considering making investment decisions also consider the market's governance profile.

Corporate Governance Codes and Different Models of Corporate Ownership

Codes of corporate governance are applied to major stock market companies (companies quoted on the stock exchange). Laws and regulations on corporate governance issues are also mainly applied to stock market companies. This is not surprising, as the main reason for codes of governance is to help and protect investors.

Other companies can normally decide what system of corporate governance they want, and they are not required to comply with any established principles or rules. However, these companies might decide to apply these principles or rules because they think that:

- it is ethically correct to do so, or
- it will improve the performance of the company.

Rules-Based Approach to Corporate Governance

A rules-based approach to corporate governance is based on the view that companies must be required by law (or by some other form of compulsory regulation) to comply with established principles of good corporate governance. The rules might apply only to some types of company, such as major stock market companies. However, for the companies to which they apply, the rules must be obeyed and few (if any) exceptions to the rules are allowed.

Advantages

i. Companies do not have the choice of ignoring the rules.
ii. All companies are required to meet the same minimum standards of corporate governance.
iii. Investor confidence in the stock market might be improved if all the stock market companies are required to comply with recognised corporate governance rules.

Disadvantages

i. The same rules might not be suitable for every company, because the circumstances of each company are different. A system of corporate governance is too rigid if the same rules are applied to all companies.
ii. There are some aspects of corporate governance that cannot be regulated easily, such as negotiating the remuneration of directors, deciding the most suitable range of skills and experience for the board of directors, and assessing the performance of the board and its directors.

Corporate governance rules: practical applications

Every country with a stock market should have some rules of corporate governance. The UK for example, which is associated with a principles-based approach to corporate governance, has some statutory rules (as well as Nigeria). Examples of statutory rules in the UK and Nigeria are as follows.

i. With some exemptions, mainly for small and medium-sized companies, companies are required to submit a directors' report and financial statements to the shareholders each year. This is a key aspect of accountability of the directors to the company's owners.
ii. The financial statements should be audited.
iii. Quoted companies (companies whose shares are traded on a stock exchange) must prepare a directors' remuneration report each year, and present this to the shareholders.
iv. The Companies Act 2006 (in the UK) and the Companies and Allied Matters Act 2004 (in Nigeria) specify duties that the directors owe to their company.

The difference between countries that take a rules-based approach and those that take a principles-based approach to corporate governance is mainly one of emphasis. Some countries have more rules than others, and rely more on the enforcement of rules to achieve the required standard of governance. The country most associated with a rules-based approach is the USA.

The rules-based approach in the US: Sarbanes-Oxley Act 2002

In the US, corporate governance was not regarded as important until the collapse of several major companies in 2001 and 2002, and large falls in the stock market prices of shares of all companies. This major setback for the US stock exchanges damaged investor confidence. It was recognised fairly quickly that one of the reasons for the unexpected collapse of several companies ('corporations') was poor corporate governance. Enron and WorldCom were the two most notorious examples, but there were others too. There were several well-publicised cases where:

i. A company in serious financial difficulties was dominated by a chief executive and a small number of other senior executives, who appeared to be running the company in their own interests, without concern for the interests of shareholders (other than themselves).
ii. Financial reporting was misleading.
iii. Financial controls were weak and inadequate to prevent the misleading reporting, and to prevent fraudulent activities by some executives.

Politicians soon became involved in analysing the problems in the stock market and the collapse of companies such as Enron and WorldCom. This involvement of politicians soon led to new legislation to improve standards of corporate governance. This was the Sarbanes-Oxley Act 2002, which was named after its two main sponsors in the US Congress.

ASSIGNMENT: What are the main governance aspects of the Sarbanes-Oxley Act. *Give a summary.*

Principles-Based Approach to Corporate Governance

A principles-based approach to corporate governance is an alternative to a rules-based approach. It is based on the view that a single set of rules is inappropriate for every company. Circumstances and situations differ between companies. The circumstances of the same company can change over time. This means that:

- the most suitable corporate governance practices can differ between companies, and
- the best corporate governance practices for a company might change over time, as its circumstances change.

It is therefore argued that a corporate governance code should be applied to all major companies, but this code should consist of principles, not rules.

- The principles should be applied by all companies.
- Guidelines or provisions should be issued with the code, to suggest how the principles should be applied in practice.
- As a general rule, companies should be expected to comply with the guidelines or provisions.
- However, the way in which the principles are applied in practice might differ for some companies, at least for some of the time. Companies should be allowed to ignore the guidelines if this is appropriate for their situation and circumstances.
- When a company does not comply with the guidelines or provisions of a code, it should report this fact to the shareholders, and explain its reasons for non-compliance.

This approach is sometimes called **comply or explain**. It applies in the UK, for example. With a ***comply or explain*** approach, stock market companies should be required to present a corporate governance statement to their shareholders, in which they state that:

i. they apply the principles in the code of corporate governance (the code that applies to companies in that stock market), and
ii. either the company has:
- complied with all the provisions or guidelines in the code for applying the principles in practice, or
- explain their non-compliance with any specific provision or guideline