THE CONCEPT OF CORPORATE GOVERNANCE

Corporate governance has been defined (in the Cadbury Report, 1992) as follows: 'Corporate governance is the system by which companies are directed and controlled.' It involves balancing the interests of the many stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community.

Governance should not be confused with management.

Management is concerned with running the business operations of a company. Governance is about giving a lead to the company and monitoring and controlling management decisions, so as to ensure that the company achieves its intended purpose and aims.

Management is about making business decisions: governance is about monitoring and controlling decisions, as well as giving leadership and direction. 'If management is about running business, governance is about seeing that it is run properly': (Professor Bob Tricker, 1984).

In order to understand what corporate governance is, it might be helpful to think about what it is not.

i. Corporate governance is not about management activities, and management skills and techniques. The powers of executive management to direct a business is an aspect of governance, but how they use those powers to direct business activities is not.
ii. Corporate governance is not about formulating business strategies for the company. However, the responsibility of the board of directors and other senior managers for deciding strategy is an aspect of governance.

Corporate governance is concerned with matters such as

i. In whose interests is a company governed?
ii. Who has the power to make decisions for a company?
iii. For what aims or purposes are those powers used?
iv. In what manner are those powers used?
v. Who else might influence the governance of a company?
vi. Are the governors of a company held accountable for the way in which they use their powers?
vii. How are risks managed?

The separation of ownership from control

Problems arise with corporate governance because of the separation of ownership of a company from control of the company. This is a basic feature of company law.

- A company is a legal person: In law, a company exists independently of its shareholders, who own it.
- The constitution of a company usually delegates the powers to manage a company to its board of directors. The board of directors in turn delegates many of these management powers and responsibilities to executive managers.
- The directors act as agents for the company. Their responsibilities are to the company, not the company's shareholders.
- However, it is widely accepted that companies should be governed in the interests of their owners, the shareholders. However the interests of other groups, such as the company's employees, might also have a strong influence on the directors.

Problems arising from the separation of ownership and control

The separation of ownership and control creates problems for good corporate governance, because:

- the directors of a company might be able to run the company in a way that is not in the best interests of the shareholders
- but the shareholder might not be able to prevent the directors from doing this, because the directors have most of the powers to control what the company does.

When the shareholders of a company are also its directors, problems with corporate governance will not arise. When a company is controlled by a majority shareholder, problems with governance are unlikely, because the majority shareholder has the power to remove any directors and so can control decisions by the board of directors.

Problems with corporate governance arise when a company has many different shareholders, and there is no majority shareholder. In these companies, the board of directors have extensive powers for controlling the company but the shareholders are relatively weak. The directors ought to be accountable to the shareholders for the way they are running the company. However in practice the shareholders might have little or no influence and do not have the ability to prevent the directors from running the company in the way that the directors themselves consider to be best.

Problems of corporate governance are therefore particularly severe in large companies where shareholders continually buy and sell their shares, so that many shareholders are not long-term investors in the company that, for a time at least, they partly own. This is why attempts to improve corporate governance have focused mainly on stock market companies (listed companies) and to a lesser extent on smaller public companies and large private companies.

Ownership and control in non-corporate entities

The separation of ownership from control can affect the quality of governance in non-corporate entities, as well as companies.

In any entity, it should be possible to identify owners and controllers:

- The owners might be the government, or the 'public'. In the case of a charity organisation, the owners might be a section of the public.
- Those in control. The power to govern a non-corporate body might be given to a management committee (or for example in the UK, a board of trustees). Appointments to the management committee might be made by the owners, or by means of a procedure that is specified by the constitutional rules of the entity.

The relationship between owners and controllers is different in a non-corporate entity compared with a company. The aims of a non-corporate entity also differ from the profit-seeking aims of a company. Even so, the possibility of governance problems can arise. There is a risk that the controllers of an entity will not run its affairs in a way that meets the needs or expectations of its owners

Corporate governance: laws and guidelines

It is well recognised that there is good governance and bad governance.

- Bad governance occurs when an entity is governed in a way that is inconsistent with certain concepts and practices. Often, bad governance means that a company is governed in the interests of its directors personally, rather than in the best interests of its owners (or other important interest groups).
- Good governance is based on certain key concepts and practices, which are described later. It involves adherence to governance guidelines, which helps ensure that a company is operated in a way that will ensure that the company's overall vision are consistently pursued and achieved. This will usually be in the interest of its owners.

To some extent, good governance is supported by the law. In Nigeria, for example, the directors of a company owe certain duties to their company (these duties are included in **Companies and Allied Matters Act**, 1990). The Act also requires the directors of a company to present an annual report and accounts to the shareholders; this helps to make the directors accountable to the shareholders of their company.

The Sarbanes-Oxley Act 2002 in the USA introduced a range of legal measures designed to improve the quality of corporate governance in the US, following the spectacular collapse of several large corporations (such as Enron and WorldCom) where bad corporate governance was held largely to blame. In some countries, such as the UK, where laws on corporate governance are not strong, guidelines or codes of governance principles and practice have

been issued. The guidelines are voluntary, but are backed by major financial institutions, stock exchanges and investment organisations. For example:

- **The code of Corporate Governance in Nigeria** issued by the **Securities and Exchange Commission** requires that all public companies whose securities are listed on a recognized securities exchange shall comply with the principles and provision of the code just as the code shall from the basis of the minimum standard of their corporate behaviour.
- Listed companies in the UK are required to comply with The UK Corporate Governance Code (previously known as the Combined Code) or explain why they have failed to do so.
- Similarly, Singapore has a Code of Corporate Governance, issued by the Ministry of Finance.
- A more general set of corporate governance guidelines has been issued by the Organisation for Economic Co-operation and Development (OECD), which all countries are encouraged to adopt i. as a minimum standard for good corporate governance.

Corporate Governance Issues

So what are the key issues in corporate governance, which establish how well or badly a company is governed? The main areas covered by codes of corporate governance are as follows:

i. **The role and responsibilities of the board of directors**. The board of directors should have a clear understanding of its responsibilities and it should fulfil these responsibilities and provide suitable leadership to the company. Governance is therefore concerned with establishing what the responsibilities of the board should be, and making sure that these are carried out properly.

ii. **The composition and balance of the board of directors**. A board of directors collectively, and individual directors, should act with integrity, and bring independence of thought and judgment to their role. The board should not be dominated by a powerful chief executive and/or chairman. It is therefore important that the board should have a suitable balance, and consist of individuals with a range of backgrounds and experience.

iii. **Financial reporting, narrative reporting and auditing**. The board should be properly accountable to its shareholders, and should be open and transparent with investors generally. To make a board properly accountable, high standards of financial reporting (and narrative reporting) and external auditing must be upheld. The major 'scandals' of corporate governance in the past have been characterised by misleading financial information in the company's accounts – in the UK, for example, Maxwell Communications Corporation and Polly Peck International, more recently in Enron and WorldCom in the US and Parmalat in Italy. Enron filed for bankruptcy in 2001 after 'adjusting' its accounts.

WorldCom, which collapsed in 2002 admitted to fraud in its accounting and its chief executive officer was subsequently convicted and jailed.

iv. **Directors' remuneration**. Directors work for a reward. To encourage their commitment to achieving the objectives of their company, they should be given suitable incentives. Linking remuneration to performance is considered essential for successful corporate governance. However, linking directors' pay to performance is complex, and remuneration schemes for directors have not been particularly successful. Directors' pay is an aspect of corporate governance where companies are frequently criticised.

v. **Risk management and internal control**. The directors should ensure that their company operates within acceptable levels of risk, and should ensure through a system of internal control that the resources of the company are properly used and its assets are protected.

vi. **Shareholders' rights**. Shareholders' rights vary between countries. These rights might be weak, or might not be exercised fully. Another aspect of corporate governance is encouraging the involvement of shareholders in the companies in which they invest, through more dialogue with the directors and through greater use of shareholder powers – such as voting powers at general meetings of the company.

vii. **Corporate social responsibility and ethical behaviour** by companies (business ethics) are also issues related to corporate governance.

GOVERNANCE ISSUES FOR OTHER TYPES OF ORGANISATIONS

Most of the writing on governance is about corporate governance, i.e. the governance of corporate limited and usually listed companies. This is very important area; it links to the agency problem (see later) and the need for investors to trust and support the directors that have been appointed as the 'stewards' of their investments. The health of capitalist economic systems including the valuation of securities and the security of long-term shareholder value are all dependent on effective and robust systems of corporate governance. However, governance issues also apply to other types of organisations. These different types of organisations have different governance issues to profit making companies in private ownership. However, there is an overriding similarity in that in each case the stakeholders will be concerned that the entity is being managed in a way that fulfils its underlying purpose.

Governance in public sector organisations

Public sector organisations are those that are directly controlled by one or more parts of the state and exist to implement specified tasks which serve government policy for example in areas like health care, education and defence. The size of the public sector varies in different countries. In some countries government might retain control of industries which the government deems to be of key national interest. Of course governments view on this might change leading to the privatisation of formally government owned entities. This would require a valuation of the entity for sale to the investment community. The opposite could also occur with a government deciding that an industry should be taken into government ownership

(nationalisation). Public sector organisations include: hospitals; schools; local government authorities; nationalised companies; and other non-governmental organisations (NGOs)

The public at large are a key stakeholder in public sector entities. Their focus is likely to be on value for money rather than the achievement of profits. The public are often concerned that public sector organisations are over-bureaucratic and unnecessarily costly.

In the UK, a Good Governance Standard was published by the Independent Commission for Good Governance in Public Service. This sets out six core principles of good corporate governance for public service corporations.

i. 'Good governance means focusing on the organisation's purpose and on outcomes for citizens and service users'. This means having a clear understanding of the purpose of the organisation, and making sure that users of the service receive a high-quality service and that taxpayers (who pay for the service) get value for money.
ii. 'Good governance means performing effectively in clearly defined functions and roles'. The governing body of the organisation is comparable to the board of directors in a company. It must be clear about what its responsibilities are, and it should carry these out. The responsibilities of executive management should also be clear, and the governing body is responsible for making sure that management fulfils its responsibilities properly.
iii. 'Good governance means promoting values for the whole organisation and demonstrating the values of good governance through behaviour'. Integrity and ethical behaviour are therefore seen as core governance issues in public sector entities.
iv. 'Good governance means taking informed, transparent decisions and managing risk'. Risk management and the responsibility of the governing body for the internal control system is as much a core feature of governance in public sector entities as in companies.
v. 'Good governance means developing the capacity and capability of the governing body to be effective'. This issue is concerned with the composition and balance of the governing body. 6 'Good governance means engaging stakeholders and making accountability real'. In companies, the relationship between shareholders and the board of directors is an important aspect of governance, and companies and shareholders are encouraged to engage in constructive dialogue with each other. In public sector organisations, the constructive dialogue should exist between the governing body and the general public and particular interest groups.

PRINIPLES OF GOOD GOVERNANCE

1. Fairness

In corporate governance, fairness refers to the principle that all shareholders should receive fair treatment from the directors. At a basic level, it means that all the equity shareholders in a company should be entitled to equal treatment, such as one vote per share at general meetings of the company and the right to the same dividend per share. In the UK for example, the

concept of fair treatment for shareholders is supported by the law (which provides some protection for minority shareholders against unjust treatment by the directors or the majority shareholders). However, in some countries, the law provides little or no protection for minority shareholders. For example, in a takeover bid for a company, the law might permit a higher price to be offered to large shareholders than the price offered to small shareholders.

2. Openness/transparency

Openness or transparency means 'not hiding anything'. Intentions should be clear, and information should not be withheld from individuals who ought to have a right to receive it. Transparency means clarity. In corporate governance, it should refer not only to the ability of the shareholders to see what the directors are trying to achieve. It also refers to the ease with which an 'outsider', such as a potential investor or an employee, can make a meaningful analysis of the company and its intentions. Transparency therefore means providing information about what the company has done, what it intends to do in the future, and what risks it faces.

- In public sector organisations and government, openness means telling the public, and not making decisions 'behind closed doors'.
- In listed companies (stock market companies) openness includes matters such as:

a. Requiring major shareholders to declare the size of their shareholding in the company, and;

b. Requiring the board of directors to announce to the stock market information about any major new developments in the company's affairs, so that all shareholders and other investors are kept informed.

3. Independence

Independence means freedom from the influence of someone else. A principle of good corporate governance is that a substantial number of the directors of a company should be independent, which means that they are able to make judgements and give opinions that are in the best interests of the company, without bias or pre-conceived ideas. Similarly, professional advisers to a company such as external auditors and solicitors should be independent of the company, and should give honest and professional opinions and advice.

- The independence of a director is threatened by having a connection to a special interest group. Executive directors can never be independent, because their views will represent the opinions of the management team. Similarly, a retired former executive might still be influenced by the views of management, because he or she shares the 'management culture'. Directors who represent the interests of major shareholders are also incapable of being independent.
- The independence of external auditors can be threatened by over-reliance on fee income from a client company. When a firm of auditors, or a regional office of a national firm, earns most of its income from one corporate client there is a risk that the auditors might choose to accept what they are told by the company's management, rather than question them

rigorously and risk an argument. It has been suggested that this occurred in the Houston office of Andersen's, the audit firm that collapsed in 2002 as a result of the Enron scandal.

- Familiarity can also remove an individual's independence, because when one person knows another well he is more likely to accept what that person tells him and support his point of view. Auditors are at risk of losing their independence if they work on the audit of the same corporate client for too many years.

4. Honesty and integrity (probity)

It might seem obvious that honesty should be an essential quality for directors and their advisers. An individual who is honest, and who is known to be honest, is believed by others and is therefore more likely to be trusted. However, honesty is not as widespread as it might be. Business leaders, as well as political leaders, may prefer to 'put a spin' on the facts, and manipulate facts for the purpose of presenting a more favourable impression. Integrity is similar to honesty, but it also means behaving in accordance with high standards of behaviour and a strict moral or ethical code of conduct. Professional accountants, for example, are expected to act with integrity, by being honest and acting in accordance with their professional code of ethics. If shareholders in a company suspect that the directors are not acting honestly or with integrity, there can be no trust, and good corporate governance is impossible.

5. Responsibility and accountability

The directors of a company are given most of the powers for running the company. Many of these powers are delegated to executive managers, but the directors remain responsible for the way in which those powers are used.

- An important role of the board of directors is to monitor the decisions of executive management, and to satisfy themselves that the decisions taken by management are in the best interests of the company and its shareholders.
- The board of directors should also retain the responsibility for certain key decisions, such as setting strategic objectives for their company and approving major capital investments.

A board of directors should not ignore their responsibilities by delegating too many powers to executive management, and letting the management team 'get on with the job'. The board should accept its responsibilities.

With responsibility, there should also be accountability. In a company, the board of directors should be accountable to the shareholders. Shareholders should be able to consider reports from the directors about what they have done, and how the company has performed under their stewardship, and give their approval or show their disapproval. Some of the ways in which the board are accountable are as follows:

i. Presenting the annual report and accounts to the shareholders, for the shareholders to consider and discuss with the board. In Nigeria for example, this happens at the annual general meeting of the company.

ii. If shareholders do not approve of a director, they are able to remove him from office. Individual directors may be required to submit themselves for re-election by the shareholders at regular intervals. In Nigeria for example, it is common practice for directors to be required to retire every three years and stand for re-election at the company's annual general meeting.

In the UK, it is recognised that individual directors should be made accountable for the way in which they have acted as a director. The UK Corporate Governance Code includes a provision that all directors should be subject to an annual performance review, and should be accountable to the chairman of the company for the way in which they have carried out their duties in the previous year. It might be argued that a board of directors is not sufficiently accountable to the shareholders, and that there should be much more accountability.

6. Reputation

A large company is known widely by its reputation or character. A reputation may be good or bad. The reputation of a company is based on a combination of several qualities, including commercial success and management competence. However, a company might earn a good reputation with investors, employees, customers and suppliers in other ways. As concerns for the environment have grown, companies have recognised the importance of being 'environment-friendly' or 'eco-friendly'. Reputation is also based on honesty and fair dealing, and on being a good employer.

i. Investors might be more inclined to buy shares and bonds in a company they respect and trust. Some investment institutions are 'ethical funds' that are required to invest only in 'ethical' companies.
ii. Employees are more likely to want to work for an employer that treats its employees well and fairly. As a result, companies with a high reputation can often choose better-quality employees, because they have more applicants to choose from.
iii. Consumers are more likely to buy goods or services from a company they respect, and that has a reputation for good quality and fair prices, and for being customer-friendly or environment-friendly.

Companies that are badly governed can be at risk of losing goodwill – from investors, employees and customers.

7. Judgment

Directors make judgments in reaching their opinions. All directors are expected to have sound judgment and to be objective in making their judgements (avoiding bias and conflicts of interest). In its principles of corporate governance, for example, the OECD states that: 'the board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.' Independent non-executive directors are expected to show judgment that is both sound and independent. Rolls Royce, for example, in an annual report on its corporate governance, stated that: 'The Board applies a rigorous process in order to satisfy

itself that its non-executive directors remain independent. Having undertaken this review in [Year], the Board confirms that all the non-executive directors are considered to be independent in character and judgment.

Nolan's Seven Principles of Public Life

While the concepts described above are for companies, they also have application in public sector entities and not-for-profit entities, as well as to. This is evident in Nolan's Seven Principles of Public Life. These were issued in the UK by the Nolan Committee on Standards in Public Life, which was set up in 1995 to report on standards of behaviour amongst politicians and in the civil service and other public sector bodies.

The seven principles are as follows:

1. **Selflessness**: Holders of public office should not make decisions that are in their personal self-interest. Their decisions should be based entirely on concern for the public interest.
2. **Integrity**: Holders of public office should not put themselves under any financial obligation or other obligation to another individual or organisation that might influence how they act in the course of carrying out their duties.
3. **Objectivity:** Holders of public office, in awarding contracts or making recommendations, should base their decisions on merit.
4. **Accountability:** Holders of public office are accountable to the public and should submit themselves to public scrutiny.
5. **Openness:** Holders of public office should be as open as possible about the decisions they take and the reasons for those decisions. They should only withhold information when this is in the public interest.
6. **Honesty**: Holders of public office have a duty to declare any conflicts of interest they might have, and should take steps to resolve them whenever they arise.
7. **Leadership:** Holders of public office should promote and support these principles by setting an example with their own behaviour and giving a lead to others.