**CORPORATE GOVERNANCE**

**INTRODUCTION**

The term ―corporate governance‖ is susceptible of both narrow and broad definitions. **Narrowly defined**, it concerns the relationships between **corporate managers, directors and shareholders**. It can also encompass the relationship of the corporation to stakeholders and society. More broadly defined, ―corporate governance‖ can encompass the **combination of laws, regulations, listing rules and voluntary** private sector practices that enable the corporation to attract capital, perform efficiently, generate profit, and meet both legal obligations and general societal expectations.

**Meaning of Corporate Governance** Providers of corporate finance, whether they are individuals or pension funds, mutual funds, banks or other financial institutions, or even governments require assurances that their investments will be protected and will generate returns. These assurances are at the heart of what effective corporate governance is all about (Mengistae & Xu, 2004).

This definitional range underscores the reality that corporate managers, directors and investors all function within a larger business and legal environment that shapes behavior. But no matter what the definition, at its heart, corporate governance concerns the means by which a corporation assures investors that it has well-performing management in place and that corporate assets provided by investors are being put to appropriate and profitable use (Coopers, 2007). The concept of corporate governance is gaining momentum because of various factors as well as the changing business environment. The EEC, GATT and WTO regulations have also contributed to the rising awareness and are compelling us to think in terms of adhering to the good governance practices. Corporate governance, by the very nature of the concept, cannot be exactly defined. However, there can be no two opinions that ―effective accountability to all shareholders is the essence of corporate governance (Mengistae & Xu, 2004).‖

The following definition should help us to understand the concept better. ―Corporate governance is not just corporate management; it is something much broader to include **a fair, efficient and transparent administration to meet certain well-defined objectives** (Bryan, Nash & Patel, 2002). It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs (Mengistae & Xu, 2004). When it is practiced under a well-laid out system, it leads to the building of a legal, commercial and institutional framework and demarcates the boundaries within which these functions are performed (Coopers, 2007).‖ Corporate governance cannot disregard the diverse interests - shareholders, lenders, employees, government, etc. It is believed that shareholders would increasingly assert their rights, hitherto virtually unknown; similarly the lending institutions, having to justify their performance in a market-driven environment, have no choice but to demand effective and efficient corporate governance; besides FIIs with substantial foreign investment in India would demand greater transparency and internationally recognized sound corporate practices (Bryan, Nash & Patel, 2002). The new paradigm of governance to bring about quality corporate governance is not only a necessity to serve the diverse corporate interests, but it is also a key requirement in the best interests of the corporate themselves (Mengistae & Xu, 2004).

**Objectives of Corporate Governance**

Good governance is integral to the very existence of a company. It inspires and strengthens investor's confidence by ensuring company's commitment to higher growth and profits. It seeks to achieve following objectives:

1. A properly structured Board capable of taking independent and objective decisions is in place at the helm of affairs;

2. The Board is balanced as regards the representation of adequate number of non-executive and independent directors who will take care of the interests and well-being of all the stakeholders;

3. The Board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information;

4. The Board has an effective machinery to sub serve the concerns of stakeholders;

5. The Board keeps the shareholders informed of relevant developments impacting the company;

6. The Board effectively and regularly monitors the functioning of the management team;

7. The Board remains in effective control of the affairs of the company at all times.

8. The overall endeavor of the Board should be to take the organization forward, maximize long-term values and shareholders‘ wealth.

**Elements of Effective Corporate Governance**

Corporate governance practices vary across nations and firms, and this variety reflects not only distinct societal values, but also different ownership structures, business circumstances and competitive conditions. It may also reflect differences in the strength and enforceability of contracts, the political standing of shareholders and debt holders, and the development and enforcement capacity of the legal system (Coopers, 2007).

In developed countries, the discussion of corporate governance improvement tends to assume in place well-developed and well-regulated securities markets; laws that recognize shareholders as the legitimate owners of the corporation and require the equitable treatment of minority and foreign shareholders; enforcement mechanisms through which these shareholder rights can be protected; securities, corporate and bankruptcy laws to prevent bribery that enable corporations to transform -- to merge, acquire, divest and downsize -- and even to fail; anti-corruption laws to prevent bribery and protections against fraud on investors; sophisticated courts and regulators; an experienced accounting and auditing sector, and significant corporate disclosure requirements (Bryan, Nash & Patel, 2002). Developed countries are also more likely to have well-developed private sector institutions, such as organisations of institutional investors, and professional associations of directors, corporate secretaries and managers, as well as rating agencies, security analysts and a sophisticated financial press (Qi,Wu & Zhang, 2000). Many developing and emerging market nations have not yet fully developed the legal and regulatory systems, enforcement capacities and private sector institutions required to support effective corporate governance (Mengistae & Xu, 2004). Therefore, corporate governance reform efforts in these nations often need to focus on the fundamental framework.

Reform needs vary, but often include basic stock exchange development, the creation of systems for registering share ownership, the enactment of laws for basic minority shareholder protection from potential self-dealing by corporate insiders and controlling shareholders, the education and empowerment of a financial press, the improvement of audit and accounting standards, and a change in culture and laws against bribery and corruption as an accepted way of doing business (Mengistae & Xu, 2004).

In addition to differences in the development of legal and regulatory systems and private institutional capacity, nations differ widely in the cultural values that mould the development of their financial infrastructure and corporate governance (Allen and Qian, 2005). These differences in culture may make certain concepts difficult to accept. For example, concern in some Asian cultures with personal integrity and reputation can pose barriers to the concept of bankruptcy. Likewise, the long history of communism in Russia may have impacted that culture understands of property rights.

Ultimately, corporate governance and the framework that supports it must have relevance to a nation‘s own unique legal environment and cultural values. While common elements of effective governance can be identified to enable national systems to attract global capital and heighten investor confidence -- and some market driven convergence of systems may be inevitable -- governance reform is largely a matter for each nation and the private sector within each nation to determine (Bryan, Nash & Patel, 2002).

In April 1998 an influential report detailed the common principles of corporate governance from a private sector viewpoint. The OECD Business Sector Advisory Group on Corporate Governance, chaired by renowned governance expert Ira M. Millstein, focused on ―what is necessary by way of governance to attract capital (Chen, Fan & Wong, 2002).‖ According to the Peng (2001), government intervention in the area of corporate governance is likely to be most effective in attracting capital if focused on four essential areas:

1. **Fairness**: Ensuring the protection of shareholder rights, including the rights of minority and foreign shareholders, and ensuring the enforceability of contracts with resource providers.

2. **Transparency**: Requiring timely disclosure of adequate, clear and comparable information concerning corporate financial performance, corporate governance and corporate ownership.

3. **Accountability**: Clarifying governance roles and responsibilities, and supporting voluntary efforts to ensure the alignment of managerial and shareholder interests, as monitored by boards of director and·

4. **Responsibility**: Ensuring corporate compliance with the other laws and regulations that reflect the respective society‘s values.

Underlying the Millstein Report is the notion that corporate governance depends on the private sector for implementation. While government provides the structure for governance, corporate governance happens inside the corporation, and depends on investors, boards and managements‘.

**CONCLUSION**  In this unit, you have learnt the meaning, objectives and elements of effective corporate governance. This should therefore enable you to fully understand other management related concepts that will be discussed later.

More so, corporate governance can only be successful when practitioners are focused, fair, accountable, transparent and responsible. This is the hallmark of successful private ventures and the tin-line between successful and failing governmental organisations. Since the goal of every organisation is to achieve pre-set objective, the board must ensure that this is reasonably and timely done by infusing expertise into every actions and reactions across board.

**SUMMARY**

This unit is all about the meaning, objectives and elements of effective corporate governance as well as the major sources of power. Although these sources are interwoven and interrelated, a leader‘s capability to influence others is dependent on the power he has. Major objective of good corporate governance system includes: The Board has an effective machinery to sub serve the concerns of stakeholders; the Board keeps the shareholders informed of relevant developments impacting the company, the Board effectively and regularly monitors the functioning of the management team; the Board remains in effective control of the affairs of the company at all times, a properly structured Board capable of taking independent and objective decisions is in place at the helm of affairs, the Board is balanced as regards the representation of adequate number of non-executive and independent directors who will take care of the interests and well-being of all the stakeholders. Essentially, corporate governance will be efficient if actors are transparent, fair, accountable and responsible in their dealings. After all, the overall mission of the Board should be to take the organization forward, maximize long-term values and shareholders‘ wealth.

**SELF ASSESSMENT EXERCISE**

1. How would you define corporate governance?

2. Explain the objectives of corporate governance?

3. Explain clearly five elements of corporate governance?

**TUTOR-MARKED ASSIGNMENT**

1. Clearly distinguish between leadership and explain clearly five elements of corporate governance.

2. Which of the elements of corporate governance do you think is based on force? Explain.

**WHY CORPORATE GOVERNANCE MATTERS**

**INTRODUCTION**

As markets become more open and global, and business becomes more complex, societies around the world are placing greater reliance on the private sector as the engine of economic growth. In both developed and developing nations, a growing proportion of economic activity takes place in firms organized as corporations. Corporations are creatures of law; societies allow corporations to be created by law because they recognize that incorporation provides an efficient form of organization, and society benefits as a result (Anderson & Reeb, 2003).

Corporations mobilize and combine capital, raw material, labor, management expertise and intellectual property from a variety of sources to produce goods and services that are useful to members of society. In so doing, corporations purchase goods and services, generate jobs and income, distribute profits, pay taxes, and contribute to foreign exchange. In sum, corporations contribute to economic growth and development, which lead to improved standards of living and poverty alleviation, which in turn should lead to more stable political systems. Corporate governance is important because the quality of corporate governance impacts: (a) the efficiency with which a corporation employs assets; (b) its ability to attract low-cost capital; (c) its ability to meet societal expectations; and (d) its overall performance (Anderson & Reeb, 2003).

1) Effective corporate governance promotes the efficient use of resources both within the firm and the larger economy. When corporate governance systems are effective, debt and equity capital should flow to those corporations capable of investing it in the most efficient manner for the production of goods and services most in demand, and with the highest rate of return. In this regard, effective governance helps protect and grow scarce resources, and helps ensure that societal needs are met. In addition, effective governance should make it more likely that those Managers who do not put scarce resources to efficient use, or who are incompetent or at the extreme corrupt, are replaced.

2) For related reasons, effective corporate governance assists firms (and economies) in attracting lower-cost investment capital by improving both domestic and international investor confidence that assets will be used as agreed (whether that investment is in the form of debt or equity). For corporations to succeed in competitive markets, corporate managers must innovate relentlessly and efficiently, and constantly evolve new strategies to meet changing circumstances. This requires that managers have latitude for discretionary action. However, as Adam Smith recognized long ago, managers may have incentives to deviate from acting in the interests of capital providers. Therefore, rules and procedures to protect capital providers are necessary. These include: independent monitoring of management; transparency as to corporate performance, ownership and control; and participation in certain fundamental decisions by shareholders (Anderson & Reeb, 2003).

**3)** To be successful in the long term, corporations must comply with the laws, regulations and expectations of the societies in which they operate. Corporations have proven to be neither inherently good nor bad. Many corporations take their responsibilities as corporate citizens seriously and contribute greatly to civil society. Unfortunately, however, some corporations are opportunistic and seek to profit, for example, from the use of child labor or without regard to environmental impact. Such examples represent not only failures of corporate responsibility and firm governance, but larger failures of government to provide the framework needed to hold corporations responsible on issues that are important to a given society. **4)** When corporate governance is effective, it provides managers with oversight and holds boards and managers accountable in their management of corporate assets. This oversight and accountability combined with the efficient use of resources, improved access to lower-cost capital and increased responsiveness to societal needs and expectations should lead to improved corporate performance. Effective corporate governance may not guarantee improved corporate performance at the individual firm level; there are simply too many other factors that impact firm performance. But it should make it more likely that managers focus on improving firm performance and are replaced when they fail to do so (Anderson & Reeb, 2003). **.**

**MAIN CONTENT**

**Corporate Governance Theories**

For the purpose of this paper various corporate governance theories have been reviewed: agency, stakeholders and resource dependency theory, stewardship theory, social contract theory legitimacy theory and political theory.

**1 Agency Theory**

Much of the research into corporate governance derives from agency theory (see Figure 1). Since the early work of Berle and Means in 1932, corporate governance has focused upon the separation of ownership and pedals which results in principal-agent problems arising from the dispersed ownership in the modern corporation. They regarded corporate governance as a mechanism where a board of directors is a crucial monitoring device to minimize the problems brought about by the principal-agent relationship. In this context, agents are the managers, principals are the owners and the boards of directors act as the monitoring mechanism (Mallin, 2004). Moreover, literature on corporate governance attributes two factors to agency theory. The first factor is that corporations are reduced to two participants, managers and shareholders whose interests are assumed to be both clear and consistent. A second notion is that humans are self-interested and disinclined to sacrifice their personal interests for the interests of the others (Daily, Dalton & Cannella, 2003).

The agency role of the directors refers to the governance function of the board of directors in serving the shareholders by ratifying the decisions made by the managers and monitoring the implementation of those decisions. This role has been examined in a large body of literature (Fama & Jensen, 1983; Baysinger & Butler, 1985; Lorsch & MacIver, 1989; Baysinger & Hoskisson, 1990; Daily & Dalton, 1994). Much of this research has examined board composition due to the importance of the monitoring and governance function of the board (Pearce & Zahra, 1992; Barnhart, Marr & Rosenstein, 1994; Daily & Dalton, 1994; Gales & Kesner, 1994; Bhagat & Black, 1998; Kiel & Nicholson, 2003;), because according to the perspective of agency theory the primary responsibility of the board of directors is towards the shareholders to ensure maximization of shareholder value. The focus of agency theory of the principal and agent relationship (for example shareholders and corporate managers) has created uncertainty due to various information asymmetries (Deegan, 2004). The separation of ownership from management can lead to managers of firms taking action that may not maximize shareholder wealth, due to their firm specific knowledge and expertise, which would benefit them and not the owners; hence a monitoring mechanism is designed to protect the shareholder interest (Jensen & Meckling, 1976). This emphasizes the role of accounting in reducing the agency cost in an organization, effectively through written contracts tied to the accounting systems as a crucial component of corporate governance structures, because if a manager is rewarded for their performance such as accounting profits, they will attempt to increase profits which will lead to an increase in bonus or remuneration through the selection of a particular accounting method that will increase profits.

Arising from the above is the agency problem on how to induce the agent to act in the best interests of the principal. This results in agency costs, for example monitoring costs and disciplining the agent to prevent abuse (Shleifer & Vishny, 1997). Jensen and Meckling (1976) define agency costs: the sum of monitoring expenditure by the principal to limit the aberrant activities of the agent; bonding expenditure by the agent which will guarantee that certain actions of the agent will not harm the principal or to ensure the principal is compensated if such actions occur; and the residual loss which is the dollar equivalent to the reduction of welfare as a result of the divergence between the agents decisions and those decisions that would maximize the welfare of the principal. However, the agency problem depends on the ownership characteristics of each country. In countries where ownership structures are dispersed, if the investors disagree with the management or are disappointed with the performance of the company, they use the exit options, which will be signaled through reduction in share prices. Whereas countries with concentrated ownership structures and large dominant shareholders, tend to control the managers and expropriate minority shareholders in order to gain private control benefits (Spanos, 2005) Source: *Allen, Qian and Qian, (2007)*

The agency model assumes that individuals have access to complete information and investors possess significant knowledge of whether or not governance activities conform to their preferences and the board has knowledge of investors‘ preferences (Smallman, 2004). Therefore according to the view of the agency theorists, an efficient market is considered a solution to mitigate the agency problem, which includes an efficient market for corporate control, management labour and corporate information (Clarke, 2004). According to Johanson and Ostergen (2010) even though agency theory provides a valuable insight into corporate governance, its‘ applies to countries in the Anglo-Saxon model of governance as in Malaysia. Various governance mechanisms have been discussed by agency theorists in relation to protecting the shareholder interests, minimizing agency costs and ensure alignment of the agent-principal relationship. Among the mechanisms that have received substantial attention, and are within the scope of this study, are the governance structures (Davis, Schoorman & Donaldson, 1997).

**2 Stakeholder Theory**

This theory centers on the issues concerning the stakeholders in an institution. It stipulates that a corporate entity invariably seeks to provide a balance between the interests of its diverse stakeholders in order to ensure that each interest constituency receives some degree of satisfaction (Abrams, 1951). However, there is an argument that the theory is narrow (Coleman, 2008: 4) because it identifies the shareholders as the only interest group of a corporate entity. However, the stakeholder theory is better in explaining the role of corporate governance than the agency theory by highlighting different constituents of a firm (Coleman, 2008: 4). With an original view of the firm the shareholder is the only one recognized by business law in most countries because they are the owners of the companies. In view of this, the firm has a fiduciary duty to maximize their returns and put their needs first. In more recent business models, the institution converts the inputs of investors, employees, and suppliers into forms that are saleable to customers, hence returns back to its shareholders. This model addresses the needs of investors, employers, suppliers and customers. Pertaining to the scenario above, stakeholder theory argues that the parties involved should include governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees and the general public. In some scenarios competitors and prospective clients can be regarded as stakeholders to help improve business efficiency in the market place.

Stakeholder theory has become more prominent because many researchers have recognized that the activities of a corporate entity impact on the external environment requiring accountability of the organization to a wider audience than simply its shareholders. For instance, McDonald and Puxty (1979) proposed that companies are no longer the instrument of shareholders alone but exist within society and, therefore, has responsibilities to that society. One must however point out that large recognition of this fact has rather been a recent phenomenon. Indeed, it has been realized that economic value is created by people who voluntarily come together and cooperate to improve everyone‘s position (Freeman et. al., 2004). Jensen (2001) critiques the Stakeholder theory for assuming a single-valued objective (gains that accrue to a firm‘s constituency). The argument of Jensen (2001) suggests that the performance of a firm is not and should not be measured only by gains to its stakeholders. Other key issues such as flow of information from senior management to lower ranks, interpersonal relations, working environment, etc. are all critical issues that should be considered. Some of these other issues provided a platform for other arguments. An extension of the theory called an enlightened stakeholder theory was proposed. However, problems relating to empirical testing of the extension have limited its relevance (Sanda et. al., 2005).

In order to differentiate among stakeholder types, Anderson and Reeb, (2003) :classification was adopted; consubstantial, contractual and contextual stakeholders (see Figure 2). Consubstantial stakeholders are the stakeholders that are essential for the business‘s existence (shareholders and investors, strategic partners, employees). Contractual stakeholders, as their name indicates, have some kind of a formal contract with the business (financial institutions, suppliers and sub-contractors, customers). Contextual stakeholders are representatives of the social and natural systems in which the business operates and play a fundamental role in obtaining business credibility and, ultimately, the acceptance of their activities (public administration, local communities, countries and societies, knowledge and opinion makers). Rajan and Zingales (1998) and Zingales (1998) argue that the company has to safeguard the interests of all who contribute to the general value creation, that is, make specific investments to a given corporation. These firms-specific investments can be diverse and include physical, human and social capital. These specific investments do not execute, nor is evaluated independency from the firm functioning.

**3 Resource Dependency Theory**

The basic proposition of resource dependence theory is the need for environmental linkages between the firm and outside resources. In this perspective, directors serve to connect the firm with external factors by co-opting the resources needed to survive (Pfeffer and Salancik, 1978). Thus, boards of directors are an important mechanism for absorbing critical elements of environmental uncertainty into the firm. Williamson (1985) held that environmental linkages or network governance could reduce transaction costs associated with environmental interdependency. The organization‘s need to require resources and these leads to the development of exchange relationships or network governance between organizations. Further, the uneven distribution of needed resources results in interdependence in organizational relationships. Several factors would appear to intensify the character of this dependence, e.g. the importance of the resource(s), the relative shortage of the resource(s) and the extent to which the resource(s) is concentrated in the environment (Donaldson and Davis, 1991).

Additionally, directors may serve to link the external resources with the firm to overwhelm uncertainty (Hillman, Cannella Jr & Paetzols, 2000), because managing effectively with uncertainty is crucial for the existence of the company. According to the resource dependency rule, the directors bring resources such as information, skills, key constituents (suppliers, buyers, public policy decision makers, social groups) and legitimacy that will reduce uncertainty (Gales & Kesner, 1994). Thus, Hillman et al. (2000) consider the potential results of connecting the firm with external environmental factors and reducing uncertainty is decrease the transaction cost associated with external association. This theory supports the appointment of directors to multiple boards because of their opportunities to gather information and network in various ways.

**4 Stewardship Theory**

In contrast to agency theory, stewardship theory (see Figure 3) presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis, 1991). The fundamentals of stewardship theory are based on social psychology, which focuses on the behavior of executives. The steward‘s behavior is pro-organizational and collectivists, and has higher utility than individualistic self-serving behavior and the steward‘s behavior will not depart from the interest of the organization because the steward seeks to attain the objectives of the organization (Davis, Schoorman & Donaldson, 1997). According to Smallman (2004), where shareholder wealth is maximized, the steward‘s utilities are maximized too, because organizational success will serve most requirements and the stewards will have a clear mission. He also states that, stewards balance tensions between different beneficiaries and other interest groups. Therefore stewardship theory is an argument put forward in firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance.

Stewardship theory sees a strong relationship between managers and the success of the firm, and therefore the stewards protect and maximize shareholder wealth through firm performance. A steward, who improves performance successfully, satisfies most stakeholder groups in an organization, when these groups have interests that are well served by increasing organizational wealth (Davis, Schoorman & Donaldson, 1997). When the position of the CEO and Chairman is held by a single person, the fate of the organization and the power to determine strategy is the responsibility of a single person. Thus the focus of stewardship theory is on structures that facilitate and empower rather than monitor and control (Davis, Schoorman & Donaldson, 1997). Therefore stewardship theory takes a more relaxed view of the separation of the role of chairman and CEO, and supports appointment of a single person for the position of chairman and CEO and a majority of specialist executive directors rather than non-executive directors (Clarke 2004).

**5 Social Contract Theory**

Among other theories reviewed in corporate governance literature social contract theory, sees society as a series of social contracts between members of society and society itself (Gray, Owen & Adams 1996). There is a school of thought which sees social responsibility as a contractual obligation the firm owes to society (Donaldson 1983). An integrated social contract theory was developed by Donaldson and Dunfee (1999) as a way for managers make ethical decision making, which refers to macro-social and micro-social contracts. The former refers to the communities and the expectation from the business to provide support to the local community, and the latter refers to a specific form of involvement.

**6 Legitimacy Theory**

Another theory reviewed in the corporate governance literature is legitimacy theory. Legitimacy theory is defined as ―a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate with some socially constructed systems of norms, values, beliefs and definitions‖ (Suchman, 1995). Similar to social contract theory, legitimacy theory is based upon the notion that there is a social contract between the society and an organization. A firm receives permission to operate from the society and is ultimately accountable to the society for how it operates and what it does, because society provides corporations the authority to own and use natural resources and to hire employees (Deegan, 2004).

Traditionally profit maximization was viewed as a measure of corporate performance. But according to the legitimacy theory, profit is viewed as an all-inclusive measure of organizational legitimacy (Ramanathan, 1976). The emphasis of legitimacy theory is that an organization must consider the rights of the public at large, not merely the rights of the investors. Failure to comply with societal expectations may result in sanctions being imposed in the form of restrictions on the firm's operations, resources and demand for its products. Much empirical research has used legitimacy theory to study social and environmental reporting, and proposes a relationship between corporate disclosures and community expectations (Deegan, 2004).

**Political Theory Po**litical theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1983). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments‘ favour. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms‘ mechanism (Hawley and Williams, 1996).

**CONCLUSION**

In this unit, you have learnt the reasons for corporate governance and theories of corporate government. However, corporate governance is important because it brings about the efficiency with which a corporation employs assets; its ability to attract low-cost capital; its ability to meet societal expectations; and its overall performance (Anderson & Reeb, 2003).

Also, various theories of corporate governance were adequately reviewed i.e agency theory, stakeholders and resource dependency theory, stewardship theory, social contract theory legitimacy theory and political theory. For instance, while these theories are based on one aspect of the organisation, some of them are simply a contradictory of the other. A case in reference is the Stewardship theory (a contrast of Agency Theory) presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis, 1991). The fundamentals of stewardship theory are based on social psychology, which focuses on the behavior of executives.

**SUMMARY**

This unit is all about why corporate governance and theories that supported it. Actually, these sources are interwoven and interrelated, a leader‘s capability to influence others is dependent on the power he has. Importance of corporate governance includes: it brings about the efficiency with which a corporation employs assets; its ability to attract low-cost capital; its ability to meet societal expectations; and its overall performance (Anderson & Reeb, 2003).

Also, various theories of corporate governance were adequately reviewed i.e agency theory, stakeholders and resource dependency theory, stewardship theory, social contract theory legitimacy theory and political theory. Hence, in order to ultilised corporate governance opportunities, these numerous corporate governance strategies and theories must be harness and properly channel as at when necessary bearing in mind the principle of unity of purpose, transparency, accountability, equity and responsibility from the parts of the board of directors and top managers in the top echelon of the organisation.

**5.1 SELF ASSESSMENT EXERCISE**

1. Explain vividly the reasons for corporate governance?

2. Explain the theories of corporate governance?

3. Clearly distinguish between stakeholder theory and stewardship theory under corporate governance.

**4.** Distinguish between legitimacy theory and political theory under corporate governance**.**

**GOOD GOVERNANCE, VALUE ADDITION AND DUE PROCESS**

**INTRODUCTION**

In today‘s knowledge driven economy, demonstrating excellence in skills has become the ultimate tool in the hands of board of directors to leverage competitive advantage. Adoption of good corporate governance practices provides long-term sustenance and strengthens stakeholders‘ relationship

**Good Governance**

What benefits or value addition the corporate are likely to achieve through sound and effective corporate governance practices? The answer, as provided by Abor and Nicholas, (2014) runs as follows and the road map is factors which add greater value through good governance, may be summarized as follow:

• Adoption of good governance practices stability and growth to the enterprise.

• Good governance system, demonstrated by adoption of good corporate governance practices, builds confidence amongst stakeholders as well as prospective stakeholders.

• In today‘s knowledge driven economy, demonstrating excellence in skills has become the ultimate tool in the hands of board of directors to leverage competitive advantage.

• Adoption of good corporate governance practices provides long-term sustenance and strengthens stakeholders‘ relationship.

• A good corporate citizen becomes an icon and enjoys a position of respect.

• Potential stakeholders aspire to enter into relationships with enterprises whose governance credentials are exemplary.

**Corporate Governance Rating/ Benchmarking and Due Process**

It was the belief of the Securities and Exchange Board of India (―SEBI‖) that efforts to improve corporate governance standards in India must continue. This is because these standards themselves were evolving in keeping with market dynamics (Adelman, Jenkins, & Kemmis, 2012).

According to SEBI sources, SEBI has no intention to making rating of governance of listed companies mandatory. According to SEBI, it may be wrong to conclude that governance norms compelled companies to sacrifice long-term interests or outlook in the pursuit of short-term interests and responses to market signals (Albaum & Peterson, 2012). SEBI has commissioned a study to determine the cost of compliance incurred by companies in respect of the regulatory framework, including Clause of the listing agreement. The Narayana Murthy committee on corporate governance code had gone about its work in a highly professional and democratic manner and SEBI wanted that the professionals should study the issues raised and its recommendations, including the proposal for facilitation of whistle blowing‘; ICRA which rated companies, adopted certain parameters and procedures for the purpose and the agency clarified that it normally required four to six weeks and the rating was not an audit or certification of regulatory compliance by the listed company and the exercise was not a guarantee against fraud (Anderson, Mansi, & Reeb,2012). Its primary focus in the rating was on the business processes. Key variables analyzed in rating included the shareholding structure, governance structure, management processes, board structure and processes, stakeholder relationship, transparency and disclosures and financial discipline (Berle, & Means, 2010). Measuring Corporate governance practice: It may be noted that Standard & Poor has recently launched a new service, known as Corporate Governance Scores, to evaluate corporate governance practices, both at a country and at a company level. In the case of country governance assessment, the analysis starts with an evaluation of governance issues at the country level (Cole & Mehran, 2010). Depending upon the level of support, a country would be assessed as providing ―strong support‖, ―moderate support‖ or ―weak support‖.

The other part of the analysis is concerned with company analysis which is concerned with evaluating the practices at individual companies. Standard and poor assigns scores to a company‘s overall practices using a synthesis of the OECD‘s and other international codes and guidelines of corporate governance practices (Conger, Finegold & Lawler, 2009). The analysis has four main components as identified by Doidge, Karoly, and Rene, (2004), these four components and sub categories are as follows:

**Component 1** concerned with ownership structure, relates to transparency of ownership structure, concentration and influence of ownership.

**Component 2** concerned with financial stakeholder relations, has subcategories such as regularity of, access to, and information on shareholder meeting, voting and shareholder meeting procedures and ownership rights.

**Component 3** concerned with financial transparency and information disclosure comprises sub-categories like quality and content of public disclosure, timing of, and access to, public disclosure and independent and standing of the company‘s auditor.

**Component 4** concerned with board structure and process is related to Board structure and composition, role and effectiveness of board, role and independence of outside directors and directors and executive‘s compensation, evaluation and succession policies.

The Anglo-Saxon system focuses primarily on the shareholder, while others, such as the German system, attempt to achieve a greater balance of interest between shareholders and other external stakeholders (creditors, employees, the community, the environment etc.). By addressing the interest of both creditors and shareholders, the scoring model recognizes the importance of stakeholder‘s right beyond the rights of the shareholder (McConaughty, 1998). Finally how can corporate governance scores benefit different sections?

Investors can use the scores to identify and compare corporate governance standards of different companies in their portfolios or the risk characteristics associated with the corporate governance practices of potential investments. Corporate governance scores and the accompanying analysis also help investors understand how a company‘s management treats the interest or shareholders, including minorities (Conger, *et.al*, 2009).

**CONCLUSION**

In this unit, you have learnt the good governance and corporate governance rating/benchmarking and due process. The conclusion drawn was that good governance has major advantages in corporate organization with the influence of leadership with the situation for the organizational goals to be achieved. A sophisticated and well articulated corporate governance will bring about stability and growth to the enterprise; good governance system, demonstrated by adoption of good corporate governance practices, builds confidence amongst stakeholders as well as prospective stakeholders; demonstrating excellence in skills has become the ultimate tool in the hands of board of directors to leverage competitive advantage and provides long-term sustenance and strengthens stakeholders‘ relationship.

**SUMMARY**

This unit is all about good governance and corporate governance rating/benchmarking and due process and its implication on organization. To ensure good corporate governance rating, organisations must primary focus on key variables i.e the shareholding structure, governance structure, management processes, board structure and processes, stakeholder relationship, transparency and disclosures and financial discipline (Berle, & Means, 2010).The other part of the analysis is concerned with company analysis which is concerned with evaluating the practices at individual companies.

The analysis has four main components as identified by Doidge, Karoly, and Rene, (2004), these four components and sub categories are as follows: *Component 1* concerned with ownership structure, relates to transparency of ownership structure, concentration and influence of ownership; *Component 2* concerned with financial stakeholder relations, has subcategories such as regularity of, access to, and information on shareholder meeting, voting and shareholder meeting procedures and ownership rights; *Component 3* concerned with financial transparency and information disclosure comprises sub-categories like quality and content of public disclosure, timing of, and access to, public disclosure and independent and standing of the company‘s auditor and *Component 4* concerned with board structure and process is related to Board structure and composition, role and effectiveness of board, role and independence of outside directors and directors and executive‘s compensation, evaluation and succession policies.

C**orporate Governance System Varies Significantly Among Different Countries**.

In a highly dispersed shareholding system, such as is the case in the U.S., members of the board of directors are granted the responsibility of monitoring executives. Internal corporate governance systems in Germany and Japan, on the other hand, rest with large shareholders. This is because their business and legal systems allow concentrated and cross shareholdings. The actions of these large shareholders appear to be a combination of aggressively controlling the management as well as a friendly one (Bryan and Patel, 2002). Corporate financial managers are expected to act on behalf of shareholders, with the goal of obtaining a reasonable return on their investments. Once the board fails in its duty, share prices would fall and institutional shareholders with a large stake would assume the responsibility of the board of directors. These actions could either be supportive or unfriendly towards the incumbent management team (Bethel *et al.*, 1998).

**Shareholder Activism**

Shareholder activism involves the task of aggressive monitoring and controlling the firm's management for the purpose of enforcing changes in the firm's structure of internal control and increasing shareholders wealth. It is generally found that shareholder activism tend to be beneficial to all investors in terms of appreciation of their wealth. Bryan and Patel, (2002), studied the influence of TIAA-CREF corporate governance practices for firms in its investment portfolios during 1992-1996. It was found that at least 87 percent of the target firms took actions in line with the terms negotiated by TIAA-CREF. Bryan and Patel, (2002), further concluded that the benefits of activism tended to depend upon the type of issues involved. The magnitude of benefits though appears to be small or insignificant. Board diversity issue had resulted in negative abnormal return, whereas confidential voting resulted in positive abnormal return. Mengistae and Xu, (2004) reviewed the operating performance for 51 firms targeted by CALPERS during 1987-93. He found that shareholder wealth tend to increase for firms that adopt or settle, and decreases for firms that resist.

However, there were no statistically significant changes in performance as measured by operating income, and cash flows. Bethel *et al.* (1998), reviewed the nature of investor activists' block share purchases in the 1980s and found that the target firms were highly diversified and with poor performance. It was found that activists' efforts had resulted in abnormal share price appreciation, operating profitability, asset divestitures, and a decrease in acquisitions. Their sample included 425 firms during 1980-89. Activist investors were found to be able to influence firm policies during the 1980s even though takeovers typically did not take place in the targeted firms. Thus, suggesting that the market for partial control can play an important role in reducing the agency costs. This is the result of the separation of ownership and control in U.S. corporations. The greatest profitability improvements were observed two and three years after block purchases, and in firms that invested assets after such actions.

Mengistae and Xu, (2004) on the other hand, suggest that activism on the part of public pension funds does not appear to increase the market value of their holdings. The U.S. capital markets possess a high degree of operational efficiency. This flexible system facilitates and allows activist shareholders to pursue trading in large quantity of shares without incurring a market impact or undue transactions costs. It also resolves the ―free rider‖ problem. The ―free rider‖ problem may arise due to the fact that all shareholders would tend to benefit from the actions taken by a select group of activist shareholders, even though the cost is borne solely by the activists (Shanghai Stock Exchange, 2003).

Mengistae and Xu, (2004) found that a liquid stock market is beneficial because it makes investor activism a more effective tool for corporate internal governance and control. This is because a liquid stock market makes it less costly to hold larger amounts of the outstanding shares of a target firm. In particular, in most cases other large shareholders cooperate in order to influence the management of a company.

Relationship Investing Relationship investing is defined as involved ownership in a helping and positively influencing the management for improving corporate performance. It includes an active, two-way communication between large shareholders and the management. Bryan and Patel, (2002), state that relationship investing is often referred to as the approach followed by Warren Buffett. Buffett's approach is perceived as taking an active but friendly role with directors and senior management in a patient, value-added, negotiated involvement. In effect, it is believed that Buffett brings more than money to these corporations, since he brings valuable experience and a helping hand to their management.

**Concentrated and Cross Shareholding Systems**

In Germany and Japan large percentages of shares of companies are held by banks, individuals, and other companies. Such a system is perceived as an effective way for monitoring and influencing the management, thus leading to better performance (Shanghai Stock Exchange, 2003). This cross shareholding system is also believed to be a low cost and efficient financing alternative than the capital markets. Banks in Germany are allowed to own stocks in the companies they lend to. Their large voting rights would allow these banks to remain informed and maintain control over the management (Che & Qian,1998).

. In the Japanese system, the cross shareholding, known as the Keiretsu, provides a mechanism for stockholders to control management's actions. The Presidents' Council meets on a regular basis in which the lending banks, large shareholders, and other investing firms interact with the management. The German and Japanese systems of corporate governance resemble the relationship investing (Mengistae & Xu, 2004).

Naughton and Hovey, (1999) explains that in Germany, the management board is comprised of the top managers. They include the chairman, who is the equivalent of the CEO. The supervisory board, which is the equivalent of an outside board, includes both shareholders and labor representatives. In Japan the board consists of all insiders (Peng, 2001). The president is also the CEO. A few top directors, including the president, are given special rights to represent the company. These are known as representative directors. Large shareholders have the means and the incentives to collect pertinent information regarding investment and financing activities of the firm. Yermack, (1996), state that it is feasible for large shareholders to collect information about the firm and to monitor the management.

However, while large shareholdings are not common in the U.S., majority ownerships are prevalent in Germany and Japan. Management and director turnovers are common in Germany and Japan in response to poor corporate performance. The Japanese large investors appear to be soft with the management and in Germany large investors have few incentives to discipline managers. Anderson & Reeb, (2003).conclude that firms in the U.S. rely on legal protection of investors, whereas in much of Europe and in Japan there is more reliance on large investors to exert effective internal corporate control. Bhagat and Black, (2002) observes that the difference between countries corporate governance system is as a result of differences in their legal and regulatory environments. Regulatory restrictions and limits placed on investors' holdings in the U.S. have led to dispersed holdings of stocks. Conversely, the absence of such restrictions in Japan and Germany has resulted in concentrated shareholdings.

In both Germany and Japan, unlike the U.S., banks have substantial influence in the companies they lend to. It is therefore, hypothesized that lack of a liquid financial market in Germany and Japan and the availability of low cost, long-term borrowing have contributed to the development of their respective corporate governance systems (Anderson & Reeb,2003).

On the other hand, it is believed that the ample liquidity and marketability in the U.S. financial system has created dispersed shareholdings, block trading, and facilitated relationship investing as feasible forms of corporate internal control in the U.S. Bhagat and Black, (2002) finds that the forced resignations of top managers are preceded by large and sufficient declines in operating performance and followed by large improvements in performance. However, forced resignations are rare and are due more often to external factors than to normal board monitoring. Following the management change, these firms significantly down size their operations and are subject to a high rate of corporate (Anderson & Reeb, 2003).

**CONCLUSION**

In this unit, you have learnt shareholder activism and shareholding systems. The conclusion drawn was that good governance has major advantages in corporate organization with the influence of leadership with the situation for the organizational goals to be achieved. Also, Shareholder activism involves the task of aggressive monitoring and controlling the firm's management for the purpose of enforcing changes in the firm's structure of internal control and increasing shareholders wealth. However, while large shareholdings are not common in the U.S., majority ownerships are prevalent in Germany and Japan. Management and director turnovers are common in Germany and Japan in response to poor corporate performance. The Japanese large investors appear to be soft with the management and in Germany large investors have few incentives to discipline managers.

**SUMMARY**

This unit is all about shareholder activism and shareholding systems or corporate designs around the world. Shareholder activism involves the task of aggressive monitoring and controlling the firm's management for the purpose of enforcing changes in the firm's structure of internal control and increasing shareholders wealth. However, while large shareholdings are not common in the U.S., majority ownerships are prevalent in Germany and Japan.

More so, Germany and Japan large percentages of shares of companies are held by banks, individuals, and other companies. Such a system is perceived as an effective way for monitoring and influencing the management, thus leading to better performance (Shanghai Stock Exchange, 2003). This cross shareholding system is also believed to be a low cost and efficient financing alternative than the capital markets. Banks in Germany are allowed to own stocks in the companies they lend to.