Corporate Governance Principles and Practices

Introduction

This essay aims to provide a critical overview of the concept of corporate governance in the modern world. The work begins by defining corporate governance and its link to the organisation, before identifying the general governance structure of the organisation, including relevant controls, incentives and monitoring. This is followed by a critical assessment of the role of the governing body in directing and controlling the organisation, as well as distinguishing the role of management and the governing body. It also describes how an organisation can achieve good governance, through compliance with codes and also strategic activities. In the second section, the essay looks to analyse the rules and regulations of the Governing Body Code. This includes identify different corporate governance codes to achieve good governance and considering the similarities and differences of various theories affecting corporate governance development. It also identifies ways to minimise conflicts of interest, and how to develop transparency, accountability, direction and control in the system and processes of the organisation.

Task 1: Evaluate the system of corporate governance to direct and control any organisation

1.1 Defining Corporate Governance and its link to the organisation

In general, corporate governance has a range of definitions depending on the jurisdiction and the type of organisation being governed. However, the IFC (2010, p6) provides a broad definition of corporate governance as “the structures and processes for the direction and control of companies”. This establishes the core link to the organisation as corporate governance is a mechanism of directing and controlling the organisation. In the absence of corporate governance, an organisation will thus not be directed towards the goals of its core stakeholders, nor will it be controlled enough to ensure that these goals are achieved without excessive levels of risk (Tricker, 2011). As a result of this, corporate governance is necessary not only to ensure positive outcomes for an organisation, but also to avoid negative outcomes. This can be linked to the core goals of a corporate governance system, which is to reduce the agency costs of running the organisation, hence increasing its value to owners (IFC, 2010). Such costs particularly relate to those associated with a modern and diverse

organisation, where the managers and owners are often different individuals, may have different goals, and hence corporate governance is needed to ensure that the goals of the owners are the ones ultimately pursued by the organisation. In the case of a business corporation, this primarily relates to the shareholders, and the achievement of long-term shareholder value increasing (IFC, 2010).

1.2 The general governance structure of the organisation

Given that the core aim of corporate governance is to direct and control companies, the general governance structure of an organisation is designed with this in mind. As such, contemporary corporate governance is often structured around a range of behavioural controls, designed to address the agency costs which stem from the divergence in the goals of managers and the goals of investors (IFC, 2010). In particular, there are often a range of bonuses provided to managers to encourage them to enhance profits and grow the company share price, thus providing them with financial rewards for achieving investor goals. However, these are often limited in their effectiveness, as managers are able to pursue other objectives to achieve their goals regardless of the interests of shareholders (Tosi et al, 2000). As such, corporate governance structures have evolved to impose more controls and monitoring around managers, to ensure higher levels of accountability (Yang et al, 2011).

A core element of this system is the board of directors. This involves the requirement for most companies to have a board comprised of the executive managers who run the company and non-executive directors to monitor and control the managers (Bruner, 2011). The board thus exerts overall control of the company, ensuring that the actions of managers are overseen and constrained by other directors who do not have direct control over corporate resources, and thus in theory cannot incur agency costs. Under the 'Anglo' corporate governance structure of countries such as the US and the UK, these directors sit on a single board, which votes around important corporate decisions such as acquisitions and investments, to ensure they are beneficial to shareholders (Goldberg et al, 2016). At the same time, in 'continental' systems such as France and Germany, there is often a dual board structure, with a supervisory board that sits above the managers, thus ensuring stronger control over their actions (Forbes and Hodgkinson, 2015).

1.3 The role of the governing body to direct and control the organisation

Regardless of the specific structure of the governing body, and whether it is referred to as a board of directors or by some other name, it plays a strong role in directing and controlling the organisation. In particular, the contemporary corporate board is responsible for voting on most important decisions, ensuring that the governing body directs the strategy of the organisation towards the interests of the owners (Tricker, 2011). At the same time, most governing bodies also have various committees and internal structures responsible for monitoring and controlling different aspects of the wider governance system. This includes audit, nomination and remuneration committees, which in theory are kept independent from the managers and used to oversee the auditing of the financial statements and the nomination and remuneration of managers (Azeem et al, 2013). As such, even when the governing body does not exert direct control over aspects of the organisation's operations, it has broad discretion to monitor them. Under the best practice model of corporate governance, these committees and the overall board are run by independent directors, with no link to the managers, thus meaning that they are able to make impartial decisions around the direction of the organisation and ensure its success (Chhillar and Lellapalli, 2015).

1.4 The role of management and the governing body

The role of management and the governing body is generally prescribed in modern corporate governance theories and systems. Specifically, the managers of the company are given a general directive to maximise the profits and the value of the company for the shareholders, whilst the role of the governing body is to oversee this process. The managers are thus empowered to seek out opportunities and make decisions around maximising risk-adjusted returns, whilst the governing body looks to question the objectives and assumption of managers and keep them in line with the long-term success of the organisation (Haggard and Howe, 2015). This recognises the role of managers as the agents, empowered to act on behalf of the owners but without being directly controlled by them, thus placing the governing body in a position where its role is to rectify the conflicts of interest which can result from this. However, there is an argument that whilst the role of the governing body is to control and oversee the managers, this process should not be too restrictive. This is because the governing body can become too focused on risk avoidance, resulting in excessive

conservatism which prevents the organisation from exploiting available opportunities (O'Dwyer, 2016). The governing body must thus balance the need to give managers the freedom required to exploit opportunities and take calculated risks to create value, with the need to constrain the riskier behaviours which managers may engage in.

1.5 How can an organisation achieve good governance?

In general, the development of corporate governance has taken place over a prolonged period of time. The modern process can be traced back to the Cadbury Report in 1992, and has evolved over time into detailed systems of governance and control, and thus following these closely will generally provide good governance (Tricker, 2011). For example, in the UK the Corporate Governance Code provides five core principles, namely board leadership and company purpose; division of responsibilities; composition, succession and evaluation; audit, risk and internal control; and remuneration, with clear guidelines around each (FRC, 2016). Following these, or the relevant national or international equivalent, can therfore help ensure good governance practice.

At the same time, there are also additional aspects which corporations can consider. Such as respecting the rights of all shareholders, including minority shareholders whose interests may be overlooked (Hoi and Robin, 2010), and also attending to wider stewardship concerns around managing the organisation in a sustainable manner (Monks and Minows, 2011). There are also important resources and capabilities which must be considered when trying to ensure effectiveness. In particular, the independent directors who monitor the managers need to have sufficient levels of skill and insight to ensure effective governance, and to balance the need to control managers with the need to allow them the flexibility needed to pursue valuable opportunities (Hsu and Wu, 2014). As such, truly effective governance can be seen to be that which occurs when the directors and governing body really understand the business, its needs and what makes it succeed, rather than simply following rules and guidelines (Roberts, 2018).

Task 2: Analyse the rules and regulations of the Governing Body Code

2.1 Identify different corporate governance codes to achieve good governance at the senior management level

In general, corporate governance codes around the world are defined by two main variables. The first is the primary focus of the code, either on the shareholders or on the wider stakeholders, and the second is the basis of the code, which is either based on rules or on principles (Forbes and Hodgkinson, 2015). Examples of these codes are the UK system, which is focused on the shareholders and operates on the principles basis; the US system which is focused on the shareholders and operates on the rules system; and the French and German systems, which are focused on the wider body of stakeholders and operate under the principles system (Bruner, 2011). In general, the persistent level of diversity in corporate governance codes between major nations indicates that none of these approaches to the development of corporate governance codes is absolutely superior, and in fact all codes can achieve good governance at the senior management level, provided they are implemented effectively.

The focus of the codes determines whether the governance responsibilities of senior managers are aligned with a duty to shareholders, in the form of risk adjusted profitable growth, or with a duty to stakeholders. As such, this determines whether governance is focused purely on protecting investors from agency costs and maximising the value of the firm, or whether it is focused on ensuring the firm respected the interests of all stakeholders, and indeed society as a whole, in its operations (Tricker, 2011). In contrast, the rules-based approach focuses on the establishment of fixed rules which must be adhered to, whilst the principles-based system focuses on the establishment of principles which should be followed, but are not mandatory. Under the principles-based system, companies who choose not to comply with the principles should explain why they have chosen not to, and this thus provides insight to stakeholders around the governance quality of the firm, provided the explanations are of sufficiently high quality (Shrives and Brennan, 2015).

2.2 Describe similarities and differences of various theories affecting corporate governance development

The two main theories of corporate governance are agency theory and stewardship theory. Of these, the primary theory which has affected modern corporate governance development is agency theory, which has resulted in a focus on controlling the agents of the firm, namely the managers, in order to ensure they support the interests of the principals of the firm, namely the owners (Tricker, 2011). This is hence a somewhat negative view of governance, seeing it as a system of control which is vital to prevent negative outcomes. In contrast, the stewardship theory holds that managers will tend to act as responsible stewards of the firm, and governance systems should thus support the managers in this process. A core outcome of this theory is a focus on corporate governance development designed to use the directors to provide additional support and resources to managers, to enable them to maximise their performance, rather than restricting them as under agency theory (Forbes and Hodgkinson, 2015).

At the same time, whilst agency theory notes that managers may act in their own interests, it also recognises the potential for managers to act as strong stewards, provided they are sufficiently incentivised. A key similarity in these theories is thus around their focus on maximising the value for shareholders, by finding mutually beneficial ways to encourage managers, directors and owners to work together to ensure the success of the firm (Glinkowska and Kaczmarek 2015). Finally, the ethical theories of corporate governance have also emerged to support the development of corporate governance as a way to support and ensure ethical behaviour. These theories have similarities with both agency and stewardship theory, in that they focus on controlling the risk of unethical behaviour by managers, whilst also supporting the pursuit of virtue and responsible business practices as part of the strategy of the firm (Haggard and Howe, 2015). The combination of these theories has thus led to a governance system based on extensive safeguards and controls, but also with a recognised role of support and collaboration in pursuit of valuable outcomes.

2.3 Identify ways to minimise conflicts of interest

When looking to identify ways to minimise conflicts of interest, it is important to consider the nature of the conflict and the underlying theories. For example, agency conflicts represent a core conflict of interest in the literature, and require the controls

and incentives of the managers to be designed and adapted in order to minimise the conflict between the interests of the managers and those of the owners (Erturk et al, 2008). At the same time, the potential for conflicts of interest in this area can also be rooted in stewardship theories, which in turn indicate that conflicts occur when individuals are cooperating to achieve a desired goal, but their interests and assessments of this goal do not fully align (Aggarwal et al, 2011). In this case, there is an argument that conflicts of interest can best be resolved through the use of voluntary disclosures around corporate governance practices and decisions, providing greater oversight and allowing for the better alignment of interests (Chung and Zhang, 2011).

The other main area in which conflicts of interest can arise is around the interests of the directors of a given firm. In particular, according to Harrison et al (2010), most directors of a business have other interests, both personal and business, and there is a risk that this will create conflicts around their governance duties to the firm. As such, in order to minimise conflicts of interest, the directors need to be open and honest about their other commitments and interests, and may need to consider parting ways with other companies or disposing of investments in order to minimise these interests. Finally, conflicts of interest can emerge around the specific operations of a firm, particularly when they involve different business responsibilities. For example, the failure of Arthur Andersen has been cited as a result of conflicts of interest between the company's auditing operations and the other services it provided to Enron during the collapse of this business (Baber et al, 2014). As such, full disclosure and the separation of operations where necessary is also valuable to ensure conflicts of interest are minimise, particularly in financial services.

2.4 Identify how to develop a transparency, accountability, direction and control in the system and processes of the organisation

In order to develop transparency, accountability, direction and control in the system and processes of a financial services organisation, it is necessary to develop appropriate control systems to support the desired outcomes. Specifically, the company must ensure that its board of directors has the ability to provide agency theory control over managers, whilst also offering support in line with stewardship theory to support direction. This can be achieved by developing a strong and

professional board, which is independent of managers but also contains sufficient expertise to understand the business and govern it appropriately (Yang et al, 2011). At the same time, it will be necessary to ensure high levels of accountability by ensuring that the company as a whole is accountable to the board of directors. This requires an organisational structure which has clear reporting lines and direct accountability, ensuring that the directors have oversight of the managers, but also that individual employees can contact the board where necessary to report any issues of problems (Wood, 2011).

In addition to this, it is vital to ensure high levels of transparency in the systems of the organisation, particularly considering the risks around opacity in financial services (Baber et al, 2014). To achieve this, there is a critical importance to engage in high quality reporting, which can ensure transparency. As such, the company should consider adopting a relevant accounting framework, such as the Global Reporting Index (GRI) or the AccountAbility AA1000 framework, which ensure high levels of accountability and transparency through corporate disclosures (Williamson and Lynch-Wood, 2008). This will provide a high level of structure to the accounting systems, which in turn will support the necessary levels of transparency to ensure high quality governance outcomes. At the same time, wider accountability and transparency to stakeholders can be achieved through making a greater effort to incorporate stakeholder concerns into corporate governance systems and decision making processes, and this is the other important issue to include in the systems and processes of the organisation (Fernandez-Feijoo et al, 2014).

Conclusion

This essay has reviewed the nature of modern corporate governance. It has defined corporate governance as the process of controlling the agents appointed by the owners of an organisation, with the incentive structure and governing body representing the general governance structure of the contemporary organisation. It has also noted that the governing body directs and controls the organisation by monitoring the managers and approving major decisions, whilst noting that managers focus on creating value whilst the governing body's role is to manage risk and ensure sustainability. In light of this, an organisation can achieve good governance by following best practices and principles, but can achieve superior governance by

ensuring that the governing body understands the business and can thus govern it in a more appropriate and intelligent manner. This requires the organisation to consider issues of agency and stewardship, as well as to ensure that transparency, accountability, direction and control are included in the system and processes of the organisation. By doing this, a strong system of governance can be created to minimise conflicts of interest and maximise overall organisational performance.

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