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A Comprehensive Study on Corporate Governance in an International Context

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ABSTRACT

This paper describe that how to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. A good corporate governance image enhances the reputation of the organization and makes it more attractive to customers, investors, suppliers.

Keywords-- Stake holder, Fraud, Business corporation

I. INTRODUCTION

Corporate governance is "the system by which companies are directed and controlled". (Cadbury Committee, 1992). It involves a set of relationships between a company's management, its board, its shareholders and other stakeholders; it deals with anticipation or mitigation of the conflict of interests of stakeholders. An important theme of corporate governance is the nature and extent of accountability of people in the business, and mechanisms that try to decrease the principal–agent problem.

In contemporary business corporations, the main external stakeholder groups are shareholders, debt-holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees. It guarantees that an enterprise is directed and controlled in a responsible, professional, and transparent manner with the purpose of safeguarding its long-term success. (Donaldson, L., & Davis, J. H. 1994). Thus, the corporate is run under governed body.

II. IMPORTANCE OF CORPORATE GOVERNANCE

The contemporary business environment is characterised by uncertainty and risk, making it increasingly difficult to forecast and control the tangible and intangible factors which influence firm performance (Bettis & Hitt, 1995). In such a dynamic environment, boards become very important for smooth functioning of organisations.

Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor managers' behaviour, an independent third party (the external auditor attests the accuracy of information provided by management to investors. An ideal control system should regulate both motivation and ability.

As per the Cadbury Committee in connection to the Maxwell pensions scandal, we recognised that it was not actually a new concept at all and that as long as there has been large-scale trade people have recognised the importance of corporate governance that is, responsibility in the managing of money and the perform of commercial activities. With globalisation infinitely increasing the scale of trade and the size and complexity of corporations and the bureaucracies constructed to attempt to control it, the importance of corporate governance and internal regulation has been amplified as it becomes increasingly difficult to regulate externally. We can understand the importance of corporate governance from the following points.

- **Integrity**: The boards and management of companies carrying out their duties in an ethical way. Integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. They must maintain transparency in disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.
- Topicality **the bonus culture**: could better corporate governance in financial institutions and their remuneration policies have prevented the credit crunch and resulting financial crisis?

- The **regulatory framework**: Introducing more regulation has clearly failed - we need better regulation which ensures businesses recognise the importance of corporate governance must be as an integral part of management, not a box ticking exercise.
- The Corporate Governance board ability monitors the firm's function of its access to information. Executive directors own superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial improvement, provide and give access to resources (Hillman, Canella & Paetzold, 2000).
- In the context of the corporate governance mostly well trained **Directors are elected or appointed,** because prevention is better than a cure, so including knowledge of the principles and practice of corporate is being governed. (Hill, Green & Eckel, 2001; Bart & Bontis, 2003)
- Boards also have a responsibility to initiate organisational change and facilitate processes that support the organisational mission (Andrews, K. R. 1980).

III. THEORETICAL BACKGROUND

The United Kingdom Cadbury Report (Cadbury, 1992, p 15) defined corporate governance as "the system by which companies are directed and controlled". Due to large a number of recent corporate collapses good corporate governance has emerged as a global issue.

A number of theoretical perspectives are used in explaining corporate governance and problems.

3.1 Corporate Governance and the role of Non-executive directors

As seen by the Cadbury Committee Report corporate governance is the system by which companies are directed and controlled. Boards of Directors are responsible for the governance of their companies. The shareholder's role is to appoint the directors. Boards of Directors consist of two types of directors - executive and non-executive. The responsibilities of the executive directors include, setting the company's strategic objectives, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardships. (Judge, W. Q., & Zeithaml, C. P. 1992) (Andrews, K. R. 1980). Non-executives are appointed on a part-time basis and perform various duties including (in some cases) acting as the company's chairperson and sitting on various key committees such as Nominations, Remuneration, and Audit Committees. Nonexecutives are seen as 'guardians' of the corporate good and act as 'buffers' between the executive directors and the company's outside shareholders. (Sison, L.V., and Kleiner, B.H. 2001)

3.2 Need of non-executives

1. Legally and commercially they are seen as an important guarantee of integrity and accountability of companies. It is assumed that the interests of those who invest in the company will be safeguarded by the presence of nonexecutives who can exercise independent judgement.
2. Non-executive directors can contribute valuable external business expertise to the affairs of the company. Non-executive directors can often see risks and opportunities for the company, which might have been overlooked by the company's executives who are typically deep in the day-to-day running of the business.
3. The role of the non-executive directors can be particularly important when the executive chairman or chief executive of the company is especially entrepreneurial or overbearing by moderating excesses.

Some companies require non-executives to see them through a period of corporate transition such as changes in ownership, re positioning of the business, etc. However, it must also be recognised that there are potential limitations on the effectiveness of nonexecutives. They are only employed on a part-time basis and are likely to have other work commitments. Thus, they may be unable to devote sufficient time to the company to really understand the needs of the company and what's going on. The non-executive directors may lack the expertise to understand (on a part-time basis) highly technical and complex business issues. More particularly they may lack the information. (Christopher Pass. 2002).

3.3 The Cadbury Committee Report 'Code of Best Practice' (as further developed by the Hempel Committee Report,) made the following main recommendations regarding non-executives:

1. The Board of Directors should include nonexecutive directors of sufficient calibre and number "for their views to carry significant weight in the Board's decisions".
2. Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments and standards of conduct. The majority of non-executives should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their judgement, apart from their fees and shareholdings. Their fees should reflect the time which they commit to the company.

3. More generally the Cadbury Committee recommended that the roles of the company. Chairperson and Chief Executive should be separated rather than undertaken by one person.

3.4 The Hempel Committee Report made further recommendations:

a) Non-executive directors should constitute at least one-third of the total Board of Directors.
b) A company's Nominations Committee, Remuneration Committee and Audit Committee, "should be composed largely of non-executive directors".
c) The appointment of a 'senior' non-executive director whose task it would be to coordinate between the executive and non-executive board members

3.5 Empirical Results CEO duality and firm characteristics

Compares firm characteristics and performance measures for dual versus non-dual CEO firms. We find significant differences in most of the variables. For corporate governance mechanisms, dual-CEO firms have larger board size, suggesting that dual CEO firms have poorer governance and more inefficient board. Interestingly, dual CEO firms also have higher CEO ownership, which might be required to more strongly bring into line the interests of CEO and shareholders. Dual-CEO firms also have higher institutional ownership and financial leverage, indicating more external monitoring, which also might be required to reduce agency problem resulting from the increased power of dual-CEOs. Similarly, we found a relatively high percentage of independent directors in dual CEO firms. (Ang, J. S.; R. A. Cole and J. W. Lin 2000), The results suggest that dual CEO firms might suffer poor corporate governance from the board; however, alternative mechanisms (CEO ownership, oversight from institutional investors, more independent board members, creditors, etc.) might come to play and reduce the agency costs for CEO duality. There is no significant difference in operating expense ratio between non-dual CEO and dual-CEO firms, while dual-CEO firms have significantly higher asset utilization ratio than non-dual CEO firms. The results indicate that the agency costs of dual-CEO firms are not higher than those of non-dual CEO firms.

In publicly-traded U.S. corporations, boards of directors are largely *chosen* by the President/CEO and the President/CEO often takes the Chair of the Board position for his/herself (which makes it much more difficult for the institutional owners to "fire" him/her). The practice of the CEO also being the Chair of the Board is known as "duality". While this practice is common in the U.S., it is relatively rare elsewhere. In the U.K., successive codes of best practice have recommended against duality.

In many countries including the U.S., regulators and investors have become more and more strongly recommending separation of CEO and chairman duties. The issue of CEO duality is relation to firm characteristics, ownership characteristics, agency costs, and firm performance. Our empirical findings provide clear answers to the research. We find significant differences in firm characteristics between dual and non-dual CEO firms. (Gomez-Mejia, L. R., &Wiseman, R. 2007). However, our multivariate tests find no evidence that CEO duality has a significant effect on firm performance. It is important to note that we find the existence of endogeneity in CEO duality, indicating that the corporate leadership structure is endogenously and optimally determined, given firm characteristic and ownership structure. Westphal, J.D. & Zajac, E.J. (1995), (CEO DUALITY AND FIRM PERFORMANCE AN ENDOGENOUS ISSUE - *Chia-Wei Chen*, J. Barry Lin**, Bingsheng Yi****)

3.6 Theoretical and empirical study on Boards diversity on firms' performance

Three underlying theories may be identified.

3.6.1 Cognitive resource diversity theory posits that rich and diverse inputs from heterogeneous team members serve to improve the creative potential as well as the information-processing capacity of the team, resulting in higher decision-making quality (Gong, 2006; Jackson, 1992).

3.6.2 Social capital theory predicts that heterogeneous team members are more likely to have no overlapping external ties, providing the team with more valuable opportunity structures and wider access to external resources (Adler & Kwon, 2002; Gabbay & Zuckerman, 1998; Rosenthal, 1997).

3.6.3 Signalling theory suggests that a diverse team membership will appeal to the interests of stakeholders, generating support and increasing legitimacy of Top Management Team actions and decisions (Gong, 2006; Oxelheim & Randoy, 2003).

However, these theories do not actually open the "black box" or help to explain "the psychological and social processes that are driving executive behaviour" (Hambrick, 2007). A conceptual review and three empirical essays are employed to approach the research topic from different angles. The key message is that Top Management Team age and firm performance relationship is non-linear, context dependent, recursive, and can be both direct and indirect (moderating). In one way or another, each of our three empirical essays conceptualizes and measures contextual influences. This proves to an effective way to help us explain why age matters to firm performance, not only that age matters to firm performance. There is a U-shaped relationship between TMT average age and firm performance.

The relationship between TMT age and firm performance is likely to be nonlinear and negative; however, even if this occurs, it may become positive, if properly managed, if older TMT could defuse the unproductive implications of demographic faultiness and thereby enhance performance. (Bhagat & Black, 2000).

Therefore, our conclusion is that older TMTs can be as effective as younger ones, if proper contexts and strategies are developed to counteract and mediate older TMTs potential downsides and to leverage their potential advantages (Bantel, K. A., & Jackson, S. E. 1989).

3.7 Board characteristics

- Organizations should respect the rights of shareholders and they can help shareholders exercise their rights by openly and effectively communicating information to participate in general meetings.
- Organizations should recognize that they have legal, contractual, social, and market driven obligations to non-shareholder, stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.
- Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. They must maintain transparency in disclosure of material matters concerning the organization. A good corporate governance framework establishes the mechanisms for achieving accountability between the Board, senior management and shareholders, while protecting the interests of relevant stakeholders. It also sets out the structure through which the division of power in the organisation is determined. (Alessandro Minichilli, Alessandro Zattini, Sabina Nielsand and Morten Huse 2010), (Miller, T., & Triana, M,D,C. 2009)

IV. RECOMMENDATIONS ON BEST STRUCTURE AND COMPOSE

Composition of the Board It is necessary to identify the variables that best describe the structure of the board, of the selected organizations pertaining to board structure and performance have considered various components to construct the board structure variable. (Gong, Y. 2006) and (Weir, C., & Laing, D.1999)

Board Size: According to Bonn 2004, the effectiveness of the board of directors is depended upon the consensus that the board can achieve based on the level of expertise and knowledge. (Bhagat & Black, 2000). It is the opinion of most of the researchers that larger boards will gain better performance. (Barnhart, S. W; M. W. Marr and S. Rosenstein 1994), In contrast, smaller boards can agree on a particular outcome (Lange et al., 2000) and engage in genuine interactions than the larger boards. (Gabrielsson, J. 2007), (Firstenberg, Malkiel, 1994). The effectiveness can be achieved from a smaller board or a larger board; different conclusions were given by different researchers in various contexts. According to Fernando, 2007, the average number of board members in Sri Lankan companies is 7.56 per board. We can say that Board size is positively associated with firm performance. (D.N. Ranasinghe 2010).

Outside Director Proportion: The outside directors are in a position to use an intensive influence on the management because they are independent financially and is of different self interest than the inside directors hence are in a position to protect the interest of the shareholders than the inside directors (Bonnet al., 2005). More creative solutions to environmental problems, balance of power, and variety of perspectives have been recognized as the reasons for better performance by the higher proportion non-executive directors of the boards (Bonn, 2004). Hence the Proportion of outside directors is positively associated with firm performance.

Board Composition and Performance: It is identifying the nature of the BOD within the financial service organizations, in order to deliver this, descriptive statistics were deduced. The following descriptive statistics were obtained with the intention of inferring nature of board characteristics and the status of ROA and MB ratio within the financial services organizations in Sri Lanka. (D.N. Ranasinghe 2010).

V. CONCLUSION

Good corporate governance helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. It is also good business. A good corporate governance image enhances the reputation of the organization and makes it more attractive to customers, investors, suppliers.

The board should meet regularly, retain full and effective control over the company and monitor the executive management.

1. There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority,
2. The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions.
3. The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.

Non-Executive Directors

1. Non-executive directors should bring an independent judgement 10 bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
2. Non-executive directors should be appointed for specified terms and reappointment should not be automatic. They should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.

Executive Directors

1. Directors' service contracts should not exceed three years without shareholders' approval.
2. There should be full and clear disclosure of directors' total emoluments and those of the

chairman and highest-paid UK director, including pension contributions and stock options.

3. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.
4. Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

Reporting and Controls

1. It is the board's responsibility to present a balanced and understandable opinion of the company's position.
2. The board should make sure that an objective and professional relationship is maintained with the auditors.
3. The board should set up an audit committee of at least three non – executive directors which deal clearly with its authority and duties. The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.
4. The directors should report on the effectiveness of the company's system of internal control.

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