1 Introduction to Corporate Governance

1.1 Introduction

The concept of governance is not a new one but nowadays we hear words as corporate governance, organizational governance or good governance frequently. Actually corporate governance or, as defined in ISO FDIS 26000, organizational governance is the system by which an organization makes and implements decisions in pursuit of its objectives. Simply put "governance" means: the process of decision-making and the process by which decisions are implemented (or not implemented). And according to ISO FDIS 26000, it is the most crucial factor in enabling an organization to take responsibility for the impacts of its decisions and activities and to integrate social responsibility throughout the organization and its relationships.

Communities and their environments are increasingly impacted by any kind of organization including small, medium, large-sized, domestic or multinational, private or governmental enterprises. Some people tend to relate the prominence and importance of social responsibility to issues raised by international organizations although social responsibility has ever been important for the world business long before the emergence of multinational companies. However in this book we are trying to focus on the effects related to international business.

1.2 Governance

The concept of governance has existed as long as any form of human organisation has existed. The concept itself is merely one to encapsulate the means by which that organisation conducts itself. Recently however the term has come to the forefront of public attention and this is probably because of the problems of governance which have been revealed at both a national level and in the economic sphere at the level of the corporation. These problems have caused there to be a concern with a re-examination of what exactly is meant by governance, and more specifically just what are the features of good governance. It is here therefore that we must start our examination.

When considering national governance then this has been defined by the World Bank as the exercise of political authority and the use of institutional resources to manage society's problems and affairs. This is a view of governance which prevails in the present, with its assumption that governance is a top down process decided by those in power and passed to society at large. In actual fact the concept is originally democratic and consensual, being the process by which any group of people decide to manage their affairs and relate to each other. Such a consensual approach is however problematic for any but the smallest of groups and no nation has actually managed to institute governance as a consensual process. With the current trend for supra-national organisations[1] then this seems even more of a remote possibility; nor is it necessarily desirable. Thus a coercive top down form of governance enables a society to accept leadership and to make some difficult decisions which would not otherwise be made[2]. Equally of course it enables power to be usurped and used dictatorially – possibly beneficially[3] but most probably in a way in which most members of that society do not wish[4].

This top down, hierarchical form of governance is the form of governance which normally takes place in large monolithic organisations such as the nation state. Conversely the consensual form tends to be the norm in small organisations such as local clubs. There are however other forms of governance which are commonly found. One of these is governance through the market (see Williamson 1975). The free market is the dominant ideology of economic activity, and the argument of course is that transaction costs are lowered through this form of organisation. From a governance perspective however this is problematic as there is no automatic mechanism and negotiation is therefore used. The effect of this is that governance is decided according to power relationships, which tend to be coercive for the less powerful (eg consumers). Consequently there is a need to impose some form of regulation through governments, or supra-national organisations such as the World Trade organisation, which thereby re-imposes the eliminated transaction costs. The argument therefore resolves into an ideological argument rather than an economic one.

An increasing number of firms rely upon informal social systems to govern their relationship with each other, and this is the final form of governance. This form is normally known as network governance (Jones, Hesterly & Borgatti 1997). With this form of governance there is no formal rules – certainly none which are legally binding. Instead social obligations are recognised and governance exists within the networks because the different organisations continue to engage with each other, most probably in the economic arena. This form of governance can therefore be considered to be predicated in mutual self interest. Of course, just as with market governance, power relationships are important and this form of governance is most satisfactory when there are no significant power imbalances to distort the governance relationships.

Although in some respects these different forms of governance are interchangeable they are, in reality, suited to different circumstances. Whichever form of governance is in existence, however, the most important thing is that it can be regarded as good governance by all parties involved – in other words all stakeholders must be satisfied. For this to be so then it is important that the basic principles of good governance are adhered to.

1.3 Corporate Governance

Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituent parts – that is the stakeholders, including government, the general public etc, professional, service providers, and the corporate sector. One of the consequences of a concern with the actions of an organisation, and the consequences of those actions, has been an increasing concern with corporate governance. Corporate governance is therefore a current buzzword the world over. It has gained tremendous importance in recent years. There is a considerable body of literature which considers the components of a good system of governance and a variety of frameworks exist or have been proposed.

One of the main issues, therefore, which has been exercising the minds of business managers, accountants and auditors, investment manages and government officials – again all over the world – is that of corporate governance. Often companies main target is to become global – while at the same time remaining sustainable – as a means to get competitive power. But the most important question is concerned with what will be a firm's route to becoming global and what will be necessary in order to get global competitive power. There is more than one answer to this question and there are a variety of routes for a company to achieve this.

Probably since the mid-1980s, corporate governance has attracted a great deal of attention. Early impetus was provided by Anglo-American codes of good corporate governance[5]. Stimulated by institutional investors, other countries in the developed as well as in the emerging markets established an adapted version of these codes for their own companies. Supra-national authorities like the OECD and the World Bank did not remain passive and developed their own set of standard principles and recommendations. This type of self-regulation was chosen above a set of legal standards (Van den Barghe, 2001).

After big corporate scandals, corporate governance has become central to most companies. It is understandable that investors' protection has become a much more important issue for all financial markets after the tremendous firm failures and scandals. Investors are demanding that companies implement rigorous corporate governance principles in order to achieve better returns on their investment and to reduce agency costs. Most of the times investors are ready to pay more for companies to have good governance standards. Similarly a company's corporate governance report is one of the main tools for investor' decisions. Because of these reason companies can not ignore the pressure for good governance from shareholders, potential investors and other markets actors.

On the other hand banking credit risk measurement regulations are requiring new rules for a company's credit evaluations. New international bank capital adequacy assessment methods (Basel II and Basel III) necessitate that credit evaluation rules are elaborately concerned with operational risk, which covers corporate governance principles. In this respect corporate governance will be one of the most important indicators for measuring risk. Another issue is related to firm credibility and riskiness. If the firm needs a high rating score then it will have to pay attention to corporate governance rules also. Credit rating agencies analyse corporate governance practices along with other corporate indicators. Even though corporate governance principles have always been important for getting good rating scores for large and publicly-held companies, they are also becoming much more important for investors, potential investors, creditors and governments. Because of all of these factors, corporate governance receives high priority on the agenda of policymakers, financial institutions, investors, companies and academics. This is one of the main indicators that the link between corporate governance and actual performance is still open for discussion.

In the literature, a number of studies have sought to investigate the relation between corporate governance mechanisms and performance (eg Agrawal and Knoeber, 1996; Millstein and MacAvoy, 2003). Most of the studies have showed mixed result without a clear cut relationship. Based on these results, we can say that corporate governance matters to a company's performance, market value and credibility, and therefore that the company has to apply corporate governance principles. But the most important point is that corporate governance is the only means for companies to achieve corporate goals and strategies. Therefore companies have to improve their strategy and effective route to implementation of governance principles. So companies have to investigate what their corporate governance policy and practice needs to be.

1.4 Governance systems and corporate social responsibility

Most people would say that corporate social responsibility is an Anglo-Saxon concept which has been developed primarily in the UK and the USA. Critics however would say that it is only under the Anglo-Saxon model of governance that there could ever be a need for CSR. They would argue that the Cartesian dichotomy is a peculiarly Anglo-Saxon development which led directly to the notion of a free market as a mediating mechanism and the acceptance of the use of power for one's own end, in true utilitarian style. This has led to the loss of a sense of community responsibility which removed any sense of social responsibility from business. This therefore necessitated its reinvention in the form of corporate social responsibility, just as it necessitated the development of codes of corporate governance.

The Latin model of governance however is founded in the context of the family and the local community and is therefore the opposite of the Anglo Saxon model, being based on a bottom up philsophy rather than a hierarchical top down approach. Thus this model is based on the fact that extended families are associated with all other family members and therefore feel obligated. In such a model of governance the sense of social responsibility remains strong and is applied to firms just as much as individuals. This sense of social responsibility has never therefore been really lost and consequently there has been no need for its reinvention.

The Anglo Saxon system of governance is of course the dominant model throughout the world and, as a consequence, the concern with corporate social responsibility has spread to other systems of governance. It would be reasonable therefore to argue that the concept now permeates all business models and all systems of governance, no matter what the antecedents or the necessity might be. Consequently we are able to address global perspectives on the issues of corporate governance and corporate social responsibility in this volume without fear of being regarded as Anglo-centric.

1.5 Relating corporate governance and corporate social responsibility

It is of course no longer questioned that the activities of a corporation impact upon the external environment and that therefore such an organisation should be accountable to a wider audience than simply its shareholders. This is a central tenet of both the concept of corporate governance and the concept of corporate social responsibility. Implicit in this is a concern with the effects of the actions of an organisation on its external environment and there is a recognition that it is not just the owners of the organisation who have a concern with the activities of that organisation. Additionally there are a wide variety of other stakeholders who justifiably have a concern with those activities, and are affected by those activities. Those other stakeholders have not just an interest in the activities of the firm but also a degree of influence over the shaping of those activities. This influence is so significant that it can be argued that the power and influence of these stakeholders is such that it amounts to quasi-ownership of the organisation.

Central to this social contract is a concern for the future which has become manifest through the term sustainability. This term sustainability has become ubiquitous both within the discourse of globalisation and within the discourse of corporate performance. Sustainability is of course a controversial issue and there are many definitions of what is meant by the term. At the broadest definitions sustainability is concerned with the effect which action taken in the present has upon the options available in the future. If resources are utilised in the present then they are no longer available for use in the future, and this is of particular concern if the resources are finite in quantity. Thus raw materials such as coal, iron or oil are finite in quantity and once used are not available for future use. At some point in the future therefore alternatives will be needed to fulfil the functions currently provided by these resources. This may be at some point in the relatively distant future but of more immediate concern is the fact that as resources become depleted then the cost of acquiring the remaining resources tends to increase, and hence the operational costs of organisations tend to increase.

Sustainability therefore implies that society must use no more of a resource than can be regenerated. This can be defined in terms of the carrying capacity of the ecosystem and described with input – output models of resource consumption. Viewing an organisation as part of a wider social and economic system implies that these effects must be taken into account, not just for the measurement of costs and value created in the present but also for the future of the business itself. Such concerns are pertinent at a macro level of society as a whole, or at the level of the nation state but are equally relevant at the micro level of the corporation, the aspect of sustainability with which we are concerned in this book. At this level, measures of sustainability would consider the rate at which resources are consumed by the organisation in relation to the rate at which resources can be regenerated. Unsustainable operations can be accommodated either by developing sustainable operations or by planning for a future lacking in resources currently required. In practice organisations mostly tend to aim towards less unsustainability by increasing efficiency in the way in which resources are utilised. An example would be an energy efficiency programme.

One view of good corporate performance is that of stewardship and thus just as the management of an organisation is concerned with the stewardship of the financial resources of the organisation so too would management of the organisation be concerned with the stewardship of environmental resources. The difference however is that environmental resources are mostly located externally to the organisation. Stewardship in this context therefore is concerned with the resources of society as well as the resources of the organisation. As far as stewardship of external environmental resources is concerned then the central tenet of such stewardship is that of ensuring sustainability. Sustainability is focused on the future and is concerned with ensuring that the choices of resource utilisation in the future are not constrained by decisions taken in the present. This necessarily implies such concepts as generating and utilising renewable resources, minimising pollution and using new techniques of manufacture and distribution. It also implies the acceptance of any costs involved in the present as an investment for the future.

Not only does such sustainable activity however impact upon society in the future; it also impacts upon the organisation itself in the future. Thus good environmental performance by an organisation in the present is in reality an investment in the future of the organisation itself. This is achieved through the ensuring of supplies and production techniques which will enable the organisation to operate in the future in a similar way to its operations in the present and so to undertake value creation activity in the future much as it does in the present. Financial management also however is concerned with the management of the organisation's resources in the present so that management will be possible in a value creation way in the future. Thus the internal management of the firm, from a financial perspective, and its external environmental management coincide in this common concern for management for the future. Good performance in the financial dimension leads to good future performance in the environmental dimension and vice versa. Thus there is no dichotomy between environmental performance and financial performance and the two concepts conflate into one concern. This concern is of course the management of the future as far as the firm is concerned.

Similarly the creation of value within the firm is followed by the distribution of value to the stakeholders of that firm, whether these stakeholders are shareholders or others. Value however must be taken in its widest definition to include more than economic value as it is possible that economic value can be created at the expense of other constituent components of welfare such as spiritual or emotional welfare. This creation of value by the firm adds to welfare for society at large, although this welfare is targeted at particular members of society rather than treating all as equals. This has led to arguments concerning the distribution of value created and to whether value is created for one set of stakeholders at the expense of others. Nevertheless if, when summed, value is created then this adds to welfare for society at large, however distributed. Similarly good environmental performance leads to increased welfare for society at large, although this will tend to be expressed in emotional and community terms rather than being capable of being expressed in quantitative terms. This will be expressed in a feeling of wellbeing, which will of course lead to increased motivation. Such increased motivation will inevitably lead to increased productivity, some of which will benefit the organisations, and also a desire to maintain the pleasant environment which will in turn lead to a further enhanced environment, a further increase in welfare and the reduction of destructive aspects of societal engagement by individuals.

1.6 References

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1.7 Further reading

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1.8 Self-test questions

1. What is meant by governance?
2. What is meant by corporate governance?
3. Which is the dominant model of governance?
4. What is the relationship between corporate governance and corporate social responsibility?
5. What has caused the current interest in corporate governance?