2 Development of codes of governance and international comparisons

2.1 Introduction

Every organization has its own decision-making processes and structures according to its structure and objectives which may range from formal and sophisticated ones subject to laws and regulations, to informal ones rooted in its organizational culture and values. The world has now realised the importance of harmonised codes of governance and considerable effort has been put into developing such codes. In this chapter we consider the various approaches.

2.2 Systems of governance

It is probably true to say that there is a considerable degree of convergence on a global scale as far as systems of governance are concerned, and this convergence is based on the dominance of the Anglo Saxon model[6] of the state, the market and of civil society. As a consequence there tends to be an unquestioning assumption (see for example Mallin 2004) that discussions concerning governance can assume the Anglo Saxon model as the norm and then consider, if necessary, variations from that norm (see Guillen 2001). It is important however to recognise that there are other models so in this chapter we state that there were historically 3 significant approaches to governance. Each has left its legacy in governance systems around the world. The Anglo Saxon model is important but just one of the 3 models we wish to examine. The other two we have described as the Latin model and the Ottoman model. We start by outlining the salient features of each.

2.2.1 The Anglo Saxon model of governance

The Anglo Saxon model of governance is of course familiar to all readers of this book. It is founded on rules which must be codified and can therefore be subject to a standard interpretation by the appropriate adjudicating body. It has a tendency to be hierarchical and therefore imposed from above; and along with this imposition is an assumption of its efficacy and a lack therefore of considerations of alternatives. In this model therefore the issues of governance, politics and power become inseperably intertwined

The abuses which have been revealed within this system of governance[7] have exposed problems with the lack of separation of politics from governance. This has led to the suggestion that there should be a clear distinction between the two. The argument is that politics is concerned with the processes by which a group of people, with possibly divergent and contradictory opinions can reach a collective decision which is generally regarded as binding on the group, and therefore enforced as common policy. Governance, on the other hand, is concerned with the processes and administrative elements of governing rather than its antagonistic ones (Solomon 2007). This argument of course makes the assumption that it is actually possible to make the separation between politics and administration.

For example both the UK and the USA have governance procedures to make this separation effective for their national governments – and different procedures in each country – but in both countries the division is continually blurred in practice. Many would argue that the division is not possible in practice because the third factor of power is ignored whereas this is more important. Indeed it is our argument that it is the operation of this power in practice that brings about many of the governance problems that exist in practice. We discuss this in greater detail later in the chapter but part of our argument is that theories and systems of governance assume that power relationships, while not necessarily equal, are not too asymmetric. If the relationship is too asymmetric then the safeguards in a governance system do not operate satisfactorily whereas one of the features of globalisation is an increase in such power asymmetries.

The Anglo Saxon model is hierarchical but other forms of governance are allowed and even encouraged to operate within this framework. Thus the market form features prominently in the Anglo Saxon model while the network and consensual forms can also be found. It is therefore apparent that it is not the form of governance which epitomises the Anglo Saxon model; rather it is the dependence on rules and adjudication which distinguishes this system of governance.

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2.2.2 The Latin model of governance

The Latin model[8] of governance tends to be less codified than the Anglo Saxon model and finds less need for procedures for adjudication. This is because it is founded in the context of the family and the local community. In some respects therefore it is the opposite of the Ango Saxon model, being based on a bottom up philosophy 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. And older members of the family are deemed to have more wisdom and therefore assume a leadership role because of the respect accorded them by other family members. As a consequence there is no real need for formal codification of governance procedures and the system of adjudication does not need to be formalised – it works very satisfactorily on an informal basis. Moreover this model is extended from the family to the local community and works on the same basis.

In many ways the network form of governance described in Chapter 1 is based on this Latin model, insofar as it is predicated in informal relationships of mutual interest, and without the need for codification: this need is not required because of the interest of all parties in maintaining the working relationships which exist. Thus tradition can be said to play a part in this model of governance – trust based on tradition because it has worked in the past and can be expected to continue working into the future. The network form however is based on a lack of significant power inequalities whereas the Latin model definitely does have a hierarchy and power is distributed unequally. The power is distributed according to age however and therefore it is acceptable to everyone because they know that they will automatically rise up the hierarchy – thereby acquiring power – as they age. The process is therefore inevitable and deemed to be acceptably fair.

2.2.3 The Ottoman model of governance

The Ottoman Empire existed for 600 years until the early part of the twentieth century. Although the empire itself is well known, few people know too much about it. Throughout Europe, at least, the reality is obscured by the various myths which abound – and were mostly created during the latter part of the nineteenth century – primarily by rival states and for political propaganda purposes. The reality was of course different from the myths and the empire had a distinct model of governance which was sufficiently robust to survive for 600 years, although much modern analysis suggests that the lack of flexibility and willingness to change in the model was one of the principle causes of the failure of the empire. We do not wish to enter into this debate and will restrict ourselves to an analysis of this distinct model of governance.

According to the fifteenth century statesman, Tursun Beg, it is only statecraft which enables the harmonious living together of people in society and in the Ottoman empire there were two aspects to this statecraft – the power and authority of the rule (the Sultan) and the divine reason of Sharia (via the Caliph) (Inalcik 1968). In the Ottoman Empire these two were combined in one person. The Ottoman Empire was of course Islamic, but notable for its tolerance of other religions. It has been argued (Cone, 2003), that the Islamic understanding of governance and corporate responsibility shares some fundamental similarities with the Rawlsian concept of social justice as mutual agreement among equals (motivated by self interest). All parties must be fully aware of the risks attendant on a particular course of action and be accepting of equal liability for the outcomes, good or bad.

Muslims see Islam as the religion of trade and business, making no distinction between men and women and seeing no contradiction between profit and moral acts (Rizk 2005). The governance system was effectively a form of patronage which operated in a hierarchical manner but with the systems and procedures being delegated in return for the benefits being shared in an equitable manner. This enabled a very devolved form of governance to operate effectively for so long over such a large area of Asia, Europe and Africa. It is alien to the Anglo Saxon view because the systems involved payment for favours in a way that the Anglo Saxon model would interpret as corrupt but which the Ottoman model interprets simply as a way of devolving governance. It is interesting to observe therefore that the problems with failure of governance in the current era could not have occurred within the Ottoman model because there was no space left for the necessary secrecy and abuse of power.

2.3   Developing a framework for corporate governance

The first report which set out a framework for corporate governance was the Cadbury Report which was published in 1992 in the UK. Since then there have been a succession of codes on corporate governance each making amendments from the previous version. Currently all companies reporting on the London Stock Exchange are required to comply with the Combined Code on Corporate Governance, which came into effect in 2003. It was revised in 2006 and became the UK Corporate Governance Code in 2010. It might be thought therefore that a framework for corporate governance has already been developed but the code in the UK has been continually revised while problems associated with bad governance have not disappeared. So clearly a framework has not been established in the UK, and an international framework looks even more remote.

One of the problems with developing such a framework is the continual rules versus principles debate. The American approach tends to be rules based while the European approach is more based on the development of principles – a slower process. In general rules are considered to be simpler to follow than principles, demarcating a clear line between acceptable and unacceptable behaviour. Rules also reduce discretion on the part of individual managers or auditors. In practice however rules can be more complex than principles. They may be ill-equipped to deal with new types of transactions not covered by the code. Moreover, even if clear rules are followed, one can still find a way to circumvent their underlying purpose - this is harder to achieve if one is bound by a broader principle.

There are of course many different models of corporate governance around the world. These differ according to the nature of the system of capitalism in which they are embedded. The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model, which is normally found in Continental Europe and in Japan, recognises in addition the interests of workers, managers, suppliers, customers, and the community. Both models have distinct competitive advantages, but in different ways. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition. However there are important differences between the recent approach to governance issues taken in the USA and what has happened in the UK.

2.4 Company management

In the USA a corporation is governed by a board of directors, which has the power to choose an executive officer, usually known as the chief executive officer (CEO). The CEO has broad power to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his / her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board may include policy setting, decision making, monitoring management's performance, or corporate control.

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The board of directors is nominally selected by and responsible to the shareholders, but the articles of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board. Normally individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubberstamp the nominees of the sitting board. Perverse incentives have pervaded many corporate boards in the developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Frequently, members of the boards of directors are CEOs of other corporations – in interlocking relationships, which many people see as posing a potential conflict of interest.

The UK on the other hand has developed a flexible model of regulation of corporate governance, known as the "comply or explain" code of governance. This is a principle based code that lists a number of recommended practices, such as:

- the separation of CEO and Chairman of the Board,
- the introduction of a time limit for CEOs' contracts,
- the introduction of a minimum number of non-executives Directors, and of independent directors,
- the designation of a senior non executive director,
- the formation and composition of remuneration, audit and nomination committees.

Publicly listed companies in the UK have to either apply those principles or, if they choose not to, to explain in a designated part of their annual reports why they decided not to do so. The monitoring of those explanations is left to shareholders themselves. The basic idea of the Code is that one size does not fit all in matters of corporate governance and that instead of a statutory regime like the Sarbanes-Oxley Act in the U.S., it is best to leave some flexibility to companies so that they can make choices most adapted to their circumstances. If they have good reasons to deviate from the sound rule, they should be able to convincingly explain those to their shareholders. A form of the code has been in existence since 1992 and has had drastic effects on the way firms are governed in the UK. A recent study shows that in 1993, about 10% of the FTSE 350 companies were fully compliant with all dimensions of the code while by 2003 more than 60% were fully compliant.

Now compliance is more or less 100%. Of course all firms reporting on the London Stock Exchange are required to comply with this code, and so these firms are doing no more than meeting their regulatory obligations. Many companies regard corporate governance as simply a part of investor relationships and do nothing more regarding such governance except to identify that it is important for investors / potential investors and to flag up that they have such governance policies. The more enlightened recognise that there is a clear link between governance and corporate social responsibility and make efforts to link the two. Often this is no more than making a claim that good governance is a part of their CSR policy as well as a part of their relationship with shareholders. Clearly the code is not yet fully complete – hence the continued revisions – and has not succeeded in eliminating all of the problems. Indeed governance issues have been considered to be one source of the recent crisis.

The same success was not achieved when looking at the explanation part for non compliant companies. Many deviations are simply not explained and a large majority of explanations fail to identify specific circumstances justifying those deviations. Still, the overall view is that the U.K.'s system works fairly well and in fact is often considered to be a benchmark, and therefore followed by a number of other countries. Nevertheless it still shows that there is more to be done to develop a global framework of corporate governance.

In East Asian countries, the family-owned company tends to dominate. In countries such as Pakistan, Indonesia and the Philippines for example, the top 15 families control over 50% of publicly owned corporations through a system of family cross-holdings, thus dominating the capital markets. Family-owned companies also dominate the Latin model of corporate governance, that is companies in Mexico, Italy, Spain, France (to a certain extent), Brazil, Argentina, and other countries in South America.

Corporate governance principles and codes have been developed in different countries and have been issued by stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers with the support of governments and international organizations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes which are linked to stock exchange listing requirements[9] will tend to have a coercive effect. Thus, for example, companies quoted on the London and Toronto Stock Exchanges formally need not follow the recommendations of their respective national codes, but they must disclose whether they follow the recommendations in those documents and, where not, they should provide explanations concerning divergent practices. Such disclosure requirements exert a significant pressure on listed companies for compliance.

2.5   References

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2.6   Further reading

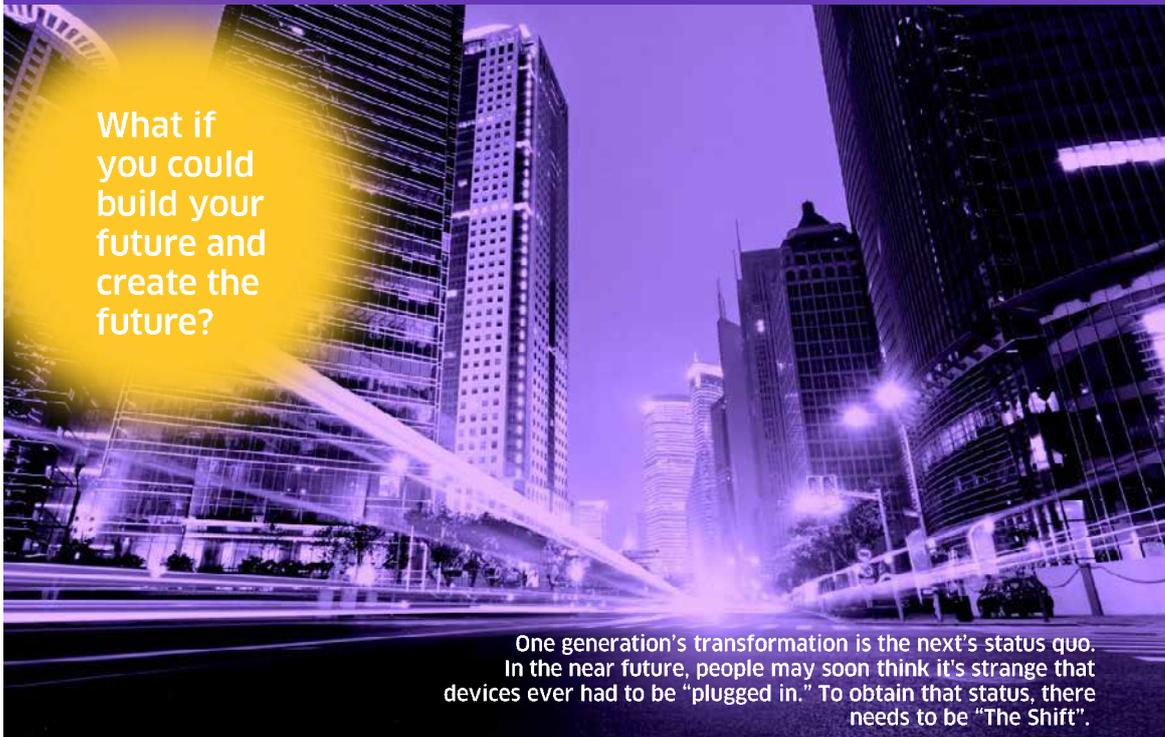Aras G & Crowther D (2008); Culture and Corporate Governance; SRRNet, Leicester

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2.7   Self-test questions

1. When did the UK Combined code come into effect

2. What is the requirement regarding compliance in the UK?

3. Explain the difference between the Anglo Saxon approach and the Latin approach.

4. What is the role of the Board of Directors?

5. Outline the main difference between the 3 forms of governance

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