Seminar in Corporate Governance

Government v Governance
History & Evolution of Corporate Governance

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What is the difference between government and governance?

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Democratic values include:

- Life
- Liberty
- Political Equality
- Legal Equality
- Justice
- Pursuit of happiness

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Constitutional Government:

- The rule of law:
  - *Government is subject to the same laws as the citizenry and much make decisions and take actions according to the established laws rather than arbitrary decree*

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Constitutional Government:

- Separation of powers:
  - *Legislative, executive and judicial powers should be exercised by different institutions with the power distributed between a federal government, state government and the people*

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Constitutional Government:

- Majority rule
  - *Citizens have the right to place their vote, that their vote be counted equally and that the majority of those votes will win*

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Constitutional Government:

- Minority rights
  - *Decisions made in accordance with the principle of majority rule should not unreasonably and unfairly infringe upon the rights of minorities*

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Constitutional Government:

- Consent of the governed
  - *Citizens are the sovereign rulers and give implicit consent by accepting the laws and services of the government and nation*

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Government and Governance

The Independent Institute…Government and Governance

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Government and Governance

Policy debates typically center around the role of markets versus the role of governments…but this is a misleading distinction…

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…a central question is not whether the market or government can best accomplish some task, but whether the governance shall be voluntary or coercive.

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The prevailing [market-failure doctrine] asserts that while markets might provide private goods efficiently in a competitive economy, markets fail to provide the collective goods that people want.

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Two basic reasons why market is not sufficient:

1) Markets can easily determine the demand for private goods, but how can we tell how much each individual wants of a collective good?

2) Free riders also are a problem.

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- *A private good is individually consumed in quantity, whether provided by government or by a market*
- *A public good is collectively used, whether provided by the private or the public sector*

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Economists who study institutions recognize the importance of private governance…for example, Oliver Williamson's work on industrial organization concludes that when…

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1. *Assets are specific to certain uses;*
2. *Opportunism is possible;*
3. *Transactions recur frequently*
4. *Transaction costs would be large with many small units…*

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…governance within an institution is more effective than transactions among firms.

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Corporate Governance History

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'Accountability is a means of concretizing relations between institutions, delineating responsibilities, controlling power, enhancing legitimacy, and ultimately promoting democracy'…

The aim of devising accountability is creating trust in governance institutions.

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Accountability is 'a relationship in which an individual or agency is held to answer for performance that involves some delegation of authority to act… accountability does not necessarily imply the existence of democracy; rather, it suggests any form of governance conducted through some delegation of authority.'

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Accountability may be held as the trademark of corporate governance, and particularly of the two descendants of this field of study: agency theory and stakeholder theory.

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Milestones on the Road to Accountability:

1. Adam Smith and the emergence of the corporation

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less in the management of the affairs of such a company

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Milestones on the Road to Accountability:

2. Pre-contemporary evidence: the birth of managerial accountability

In 1919, a seminal ruling in the Michigan courts, *Dodge v. Ford Motor Company, set the legal tone for management responsibility and corporate governance. The court ruled that: "A business corporation is organized and carried on primarily for the profit of the shareholders."*

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Milestones on the Road to Accountability:

2. Pre-contemporary evidence: the birth of managerial accountability

Berle and Means (1932) focused on the…separation of ownership and control
nexus of contracts theorists argued that due to the incomplete nature of contracts problems of expropriation arise…the *agent theoretic model* focused on the behavioural motivations of conflicts of interest.

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Milestones on the Road to Accountability:

3. Jensen & Meckling (1976): the fathers of scientific corporate governance

Two problems exist in agency relationships. First, the agent and the principal might have conflicting goals, and it is difficult and/or expensive for the principal to verify the agent's activities. Second, the principal and the agent have different propensities to accept risk.

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Milestones on the Road to Accountability:

3. Jensen & Meckling (1976): the fathers of scientific corporate governance

Potential shareholders, possessing rational expectations, recognize that the owner-manager will engage in more on-the-job consumption of various sorts, once he is no longer the firm's sole owner, because the costs of such consumption are now shared with the new owners.

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Milestones on the Road to Accountability:

4. Stakeholder theory and business ethics

Donaldson and Preston (1995, quoted in Jones, 1995, and in Pesqueux & Damak-Ayadi, 2005) argued that stakeholder theory explicitly or implicitly contains theory of three different types – descriptive/empirical, instrumental, and normative.

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Milestones on the Road to Accountability:

4. Stakeholder theory and business ethics

Briefly summarized, descriptive/empirical, instrumental, and normative theories address the questions: what happens? what happens if? and what should happen?, respectively (Jones, 1995).

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Milestones on the Road to Accountability:

5. The creation of corporate governance codes

(a) Creative accounting, the direct consequence of multiple accounting options and policies the managers could use as a detour from the 'true and fair view';

(b) The financial scandals and famous bankruptcies – in particular of British firms – that had drawn attention to the failures of corporate governance institutions and piled up criticisms of the reporting and audit systems;

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Milestones on the Road to Accountability:

5. The creation of corporate governance codes

(c) Directors' remuneration schemes, which had come to be seen as an oversized expense directly extracted from investors' yield, without a fully justifiable connection to performance;

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Milestones on the Road to Accountability:

5. The creation of corporate governance codes

(d) The directors' short-termism, a major distraction from sustainable performance – which in turn is the perfect trigger for opportunistic takeovers, erroneously considered to be the most efficient way of disciplining corporate executives.

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Milestones on the Road to Accountability:

6. European policy concerning corporate governance

Companies whose securities are admitted to trading on a regulated market and which have their registered office in the Community should be obliged to disclose an annual corporate governance statement as a specific and clearly identifiable section of the annual report. […]

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Milestones on the Road to Accountability:

6. European policy concerning corporate governance

The corporate governance statement should make clear whether the company applies any provisions on corporate governance other than those provided for in national law, regardless of whether those provisions are directly laid down in a corporate governance code to which the company is subject or in any corporate governance code which the company may have decided to apply' – para. 10.

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Milestones on the Road to Accountability:

7. The U.S. business scandals and the Enron case

What happened?' asks William J. McDonough, president of the Federal Reserve Bank of New York. Speaking at Trinity Church in New York on September 11, 2002, he said, 'Sadly, all too many members of the inner circle of the business elite participated in the overexpansion of executive compensation...

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Milestones on the Road to Accountability:

7. The U.S. business scandals and the Enron case

The policy of vastly increasing executive compensation was also, at least with the brilliant vision of hindsight, terribly bad social policy and perhaps even bad morals'. (Vogl, 2004, quotes McDonough).

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Milestones on the Road to Accountability:

8. The fall of Arthur Anderson

A public accounting firm's responsibility is to ensure that the financial statements fairly present a company's financial position and operations in order for users to make decisions.

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Milestones on the Road to Accountability:

8. The fall of Arthur Anderson

In an unqualified audit report, the firm certifies that the "financial statements present fairly in all material respects, the financial position" of a company and that the audit was conducted in accordance with generally accepted auditing standards (GAAS).

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Milestones on the Road to Accountability:

8. The fall of Arthur Anderson

These standards include independence, specifying that the auditor must be independent in fact (mental attitude) and in appearance (perception by financial statement users) by maintaining objectivity and freedom from bias (Niece & Trompeter, 2004).

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Milestones on the Road to Accountability:

9. The Sarbanes-Oxley Act of 2002

The cornerstone of the…corporate governance reforms is outside independent directors. The reforms increase the role and authority of these directors, as well as tighten the definition of 'independent.' Additionally, the reforms require companies to focus on good corporate governance, and give shareholders more opportunity to monitor and participate in…governance. (Petra, 2006).

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Milestones on the Road to Accountability:

10. OECD Principles and the convergence of governance

The latest version of the *Principles covers six key areas of corporate governance: ensuring the basis for an effective corporate governance framework; the rights of shareholders; the equitable treatment of shareholders; the role of stakeholders in corporate governance; disclosure and transparency; and the responsibilities of the board.*

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Milestones on the Road to Accountability:

The duty of the manager has two main branches: duty towards those under his care, resolvable into *humanity – and duty to his principals (the company), resolvable into economy. Publicity, the* most effectual means of applying the force of moral motives, in a direction tending to strengthen the union between his interest and the *human branch of his duty; by bringing to light, and thus exposing to the censure of the law and of public opinion, every instance of contravention' (Bentham, 1797, quoted in Gallhofer & Haslam, 1995).*

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