Corporate Governance: Conjecture and Modernism

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Corporate Governance: Conjecture and Modernism

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Abstract

This paper examines on corporate governance theories is provided, including economic/market-based stakeholder, stewardship, and political models of corporate governance. This paper also discussed on the practice of corporate governance worldwide, and briefly considers corporate governance in developing countries.

Keywords: Corporate Governance, Conjecture, Modernism, Theory, Practice.

Introduction

The foundations of modern corporations can be traced back to the 19th century when entrepreneurs, encouraged by new legislation defining corporations, founded some great companies. The key concept of this legislation was the creation of an entity with its own legal base (Mallin, 2000), being regarded as separate from the owners, yet holding many legal property rights, such as the ability to sign contracts, to sue and be sued, to own property, and to employ.

The consequence as the spectacular growth of business, and the development of ideas regarding the proper management of these corporations. In this respect, there are indications that while management theories regarding what to do have developed, strategies on how to render managerial duties in a way that ensures the best interest of all the concerned parties, have been lacking. Researchers have placed importance in management and organization theories with a lesser focus on actual roles, behavior and accountability of managers. In all senses, the issue of corporate governance has been ignored until comparatively recently.

However, recent developments in the business and financial sectors have brought this issue into focus 4, and evidence for a relationship between sound governance and economic potential has been demonstrated by several researchers (Feinberg, 1998; Johnson and Neave,
1991). It is, therefore, appropriate to consider what the term 'Corporate Governance' actually means, and this is considered in the following section.

2. Research Objectives

- To justify the gap between the theory and practice of Corporate Governance.
- To discussed different models of corporate governance.
- To discussed corporate governance: International Principles and Practices.
- To explored Corporate Governance Issues in Developing Countries.

3. Research Methodology

Having decided any particular research issue, it is necessary to establish the research approach (Punch, 1998). Researchers around the world mainly employ two different types of research approaches, namely, the qualitative research methods. Qualitative methodology takes a descriptive, non-numerical approach to collect and interpret information, aiming at understanding the phenomenon. Kvale (1996) suggests that the qualitative approach entails alternative conceptions of social knowledge, of meaning, reality, and truth in social science research. Researchers attribute various advantages to using a qualitative approach. Berg (2001) hints that it provides greater depth of understanding. The author also claims that this procedure provides a means of accessing unquantifiable facts and seeks answers to questions by examining various social settings and those individuals who inhibit the settings.

4. Data Analysis

4.1 Corporate Governance: The Concept

Corporate governance is a practice that deals with concerns that one or more parties involved with organizational decision-making may not behave in the best interest of the organization and associated parties. Over two centuries ago, probably without using the term 'corporate governance', Adam Smith (1776) expressed worries that the level and quality of vigilance demonstrated by managers would be far less than displayed by the partners of a firm. However, it is Berle and Means (1932), whose ideas evolved around the growing separation of power between the executive management of the major public companies and their shareholders, who are considered to be the pioneers in the contemporary thinking about corporate governance.

Indeed, control of company affairs has dominated the thoughts of various scholars in their attempts to define corporate governance. Monks and Minnow (1995) argue that corporate governance seeks to deal with mechanisms of exercising power and control over the corporation's direction and behavior; Turnbull (1997) asserts that corporate governance is the set of all influences affecting the institutional processes involved in organizing production and sale; and Cadbury (1992) considers it to be the whole system of controls, both financial and otherwise, which enables a company to be directed in right way to the right direction. The OECD (1999) defines corporate governance as asset of relationships between company’s board, its shareholder
and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Another central theme of corporate governance revolves around how investors in a firm can ensure they get fair return on their invested funds. As noted by Shleifer and Vishny (1997), it deals with the ways in which suppliers of finance to corporations make sure that they will receive a return on their investment. Whenever ownership of a fund/company is separated from its management, issues regarding how to manage the entity/funds in the best interest of the owners emerge, and that is the focus of corporate governance.

4.2 Corporate Governance: From Different Theoretical Angles

In the wake of turbulent corporate events already documented, the issue of corporate governance has been generating concern among researchers, and several theoretical approaches have been developed in the recent past. In this respect, Hawley and Williams (1996) have identified four models of corporate governance, these being:

a) The Simple Finance Model,
b) The Stakeholder Model,
c) The Stewardship Model, and
d) The Political Model.

The finance model also came into discussion in the seminal corporate governance study by Shleifer and Vishny (1997). A survey of from the developed world market economies indicates two major corporate governance systems – the market-based system and the institutionally-based system of governance and control (Prowse, 1994). Learmount (2002) presented two theories of corporate governance, the ‘Economic Approach’ and 'Organizational Approach'.

From these models, two dominant approaches can be identified. The first is the Market Based/Finance model of corporate governance, which can be subsumed under Economic Models, and the second is the Institutional/Stakeholder model of corporate governance, which can be grouped under Organizational Models. The Stewardship Model and the Political Model, prescribed by Hawley and Williams (1996), fall outside the two dominant categories, which will be analyzed in the following section. Important features of various corporate governance theories have been summarized and presented together with their respective generators in Table 1.

2.2.1 Economic/Market Based Theory of Corporate Governance

The economic approach toward corporate governance is based on the financial and/or market mechanism of firms. According to Hawley and Williams (1996), the finance view of corporate governance revolves around the central problem of constructing rules and incentives to align the behavior of agents with the interests of principals. Turnbull (1997) suggests that these rules and incentives of the finance model generally stem from those within the US system of publicly-traded firms. In the early days of American industrialization, companies were managed by the
individuals who established them as private properties. As the companies expanded, and the shareholdings were dispersed away from the exclusive founding families, professionals were needed to manage the enterprises (Berle and Means, 1932). This incident was termed as growing separation of ownership and effective control, and under the changing context, issues relating to rules and incentives gained momentum.

This ownership issue dominated corporate governance research until 1970, thereby influencing the classical economists to view shareholders as company owners (Bratton, 1989). In 1970s, Alchian and Demsetz (1972) and Jensen and Meckling (1976) proposed Agency Theory, which changed the focus of corporate governance from 'managerialism' to the concept of 'firm' itself. According to this theory, the firm is a bundle of contracts amongst individual factors of production (Learmount, 2002). The central theme of agency theory is the separation of management and finance (Shleifer and Vishny, 1997). In an ideal situation, a manager will always do what is mentioned in the contract that outlines what the managers will/can do with funds, but in reality, what the managers do under various circumstances could be totally different from what they are expected to do under ideal circumstances. These occurrences motivate investors and managers to allocate residual control rights that allow decisions to be made in circumstances to fully foreseen by the contract (Grossman and Hart, 1986; Hart and Moore, 1990). Hence, managers possess significant amount of residual control to apportion funds, since the investors themselves lack the qualifications and information to make educated decisions in unforeseen circumstances. In this type of situation, the best an investor can do is to place limits on the management's residual control and authority, when designing the contracts, and as noted by Shleifer and Vishny (1997), corporate governance deals with these limits. In effect, corporate governance attempts to align the behavior of agents towards the benefits of the principals by placing these restrictions upon them and monitoring their actions through various mechanisms.

In many cases, shareholders are individuals and too small in number to exert influence on the managers' conduct. According to Downs (1957), individual investors lose their interest to learn about firms or to participate in governance because of the free rider problem. Such scenarios allow residual control rights and the managerial discretion to use funds, very extensive, and Shleifer and Vishny (1997) suggest that managers may even pocket money in the form of simply taking the cash or in more sophisticated ways such as transfer pricing. Studies by Zingales (1994), Baumol (1959), Marris (1964), Williamson (1964), Jensen (1986), Burrough and Helyar (1990) provide further examples and explanations of how managers use their control rights to pursue projects, which are for their own benefit, rather than that of the investors.

In many cases, attractive incentive packages such as share ownership, stock options, or threat of dismissal if income is low are used by investors to align the behavior of the agents (Ferrani and Moloney, 2005; Jensen and Meckling 1976; Fama, 1980). However, several factors such as managers' risk aversion, the importance of managers' decisions, and their ability to pay for the cash flow ownership, work as determinants in designing the optimal incentive contract (Ross, 1973; Stiglitz, 1975; Mirrlees, 1976. Many studies have outlined a positive relationship between pay and performance and rejected the extreme hypothesis of complete separation of ownership and control.
However, there remains some doubt as to how effective takeovers are in solving the corporate governance-related problems. Shleifer and Vishny (1997) argue that takeovers are so costly that only significant large performance failures are likely to be focused on. Jensen (1983) showed that out of all takeovers in the 1980s in the USA, only a few resulted from management failures, and that most were strategic business decisions. The absence of highly active or liquid capital markets also impedes the takeover’s capacity to discipline managers through ownership change.

Ownership structure exerts significant influence on agency cost. Turnbull (1997) argues that the 'Agency Problem' is very intense in Anglo-Saxon cultures with a dispersed shareholding scenario, since there is an absence of supervising boards, or 'relationship investors' as described by Monks (1994)”. Individual or small investors lack the time and information to monitor management activities, and sometimes the law impedes the ability of shareholders in Anglo-Saxon countries to form a large voting block or to obtain a firm's internal activity-related information that might reveal inappropriate managerial conduct.

Clearly, in the above discussions, the theoretical underpinnings conceive the firm as an economic mechanism, and stressed that corporate governance is mainly concerned with the shareholders control of the firm's managers. The emergence of large institutional shareholders as reinforced this view (Learmount, 2002; Hill and Duffield, 2001), since the increasing number of powerful institutional investors provides both the ability and the incentive to monitor and discipline company managers. Indeed, it is very typical for corporations, as pointed out by Shleifer and Vishny (1997), to have large shareholders as controlling owners, who are often also the founders. In this connection, Franks and Mayer (1994) showed that large shareholders are associated with a higher turnover of directors, and a study by Gorton and Schmidt (1996) presented evidence demonstrating that block holders improve the performance of German companies. Additionally, two studies by Kaplan and Minton (1994), and show that firms with large shareholders are more likely to replace managers for sub-standard performance compared to those firms without large investors

4.2.2 Institutional/Organizational/Stakeholder Theories of Corporate Governance

Changing scenarios in the corporate sector have brought stakeholders of firms into focus in theorizing corporate governance. According to stakeholder theory, a firm should be run in the best interest of all its stakeholders rather than just the shareholders. Clarkson (1994) states that a firm is a system of stakeholders operating within the larger system of the host society, and support for Clarkson's view can be found in Blair’s (1995) suggestion that the goal of directors and management should be to maximize total wealth creation while aligning the interest of critical stakeholders with that of shareholders”. Allen (2005) and Crainer (1995) claims that many stakeholders have the right to decide what happens within a firm, rather than this being the entitlement of the owners only. However, in order to uphold these various interests, one needs to know who a stakeholder is in the context of firms.

Stakeholders are, as Donaldson and Preston (1995) argue, identified through the actual or potential harm and benefits that they experience as a result of a firm’s action or inaction. The
development of stakeholder theory is often credited to Freeman, who defined stakeholders as those individuals whose support is essential for the continuation of the firm's existence.

Many recent studies have associated stakeholders with the success of firms, for instance, the American Law Institute (1992) highlighted the importance of the interdependence between a firm and its stakeholders, and Porter (1992) emphasized the need to promote long-term employee ownership and appropriate board representation by various stakeholders. Nevertheless, some scholars have expressed different viewpoints, Williamson (1985) arguing that instead of including large groups of stakeholders board membership should remain restricted to informational participants. Both Goyder (1998) and Sternberg (1997 and 1998), however, argue that stakeholder theory replaces the accountability of business to shareholders with an accountability to everyone. Sternberg's (1997, 1998) opinion has much to do with the inclusion of universality in her definition since by using the term 'everyone' and balancing stakeholder benefits, she creates a situation where balanced benefits are supposedly impossible. However, Vinten (2001) observes that Sternberg's position does not match the reality as over the past decade the balancing approach has been very effective in making business strategies successful, as noticed by the fact that customer satisfaction and employee morale are given the same importance as traditional financial measures, as drivers of long-term economic value. Mahoney (1995) considered the stakeholder approach to be positive in terms of extending its focus beyond shareholders.

Sternberg's second disagreement with stakeholder theory is its incompatibility with corporate governance, since it denies that corporations should be accountable to their owners, resulting in no common and effective standard against which corporate agents can be judged. However, Vinten (1991 and 2001) argues that balanced stakeholder theory is attentive to prior claims of the owners, and Hill and Jones (1992) have demonstrated how the principal-agent relationship of agency theory is merely a sub-set off the more general stakeholder-agent relationship.

Various corporate governance studies have expressed explicit and implicit support for the stakeholder view. The famous Cadbury Report (1992) for instance, suggests that while the Directors' Report is addressed to the shareholders, it is also important to a wider audience including employees, and The Royal Society of Arts Report (1995) presented evidence of companies that have achieved competitive advantage through the stakeholder approach. Several other corporate reports have also extended support to the concept.

4.2.3 The Stewardship Theory of Corporate Governance

The stewardship theory advocates the value of self-motivation towards what is good, assuming that managers, or the board of a firm are self-motivated to serve the best interest of firm and its owners. Donaldson and Davis (1994) argue that manager’s are good stewards of corporations who, being motivated by their own achievement and responsibility needs, will work hard to increase shareholders’ wealth. The authors continue to assert that, since the managers themselves feel the need for responsible activities, corporations will be better served if the managers are free of subservience to non-executive directors. According to this theory, the economic performance
of a firm will improve if power and authority are concentrated in a single executive who is both CEO and Chairman. Depth of knowledge, commitment, access to current operating information and technical expertise are vital to run a company efficiently, and CEOs, who are deemed to possess these advantages, will be able to provide more effective leadership if they also hold the Chair's position on the Board. Confirming these ideas, Muth and Donaldson (1998) produced results from their empirical study on the boards of 145 companies listed on the Australian Stock Exchange, which showed that the more independent the Board, and a split of CEO-Chairman, the lower the returns for the shareholders and the rate of growth.

The idea of trusteeship echoes the stewardship theory in many ways, since it puts emphasis on the concept that managers have numerous motivations other than simply maximizing their own benefits earlier, Etzioni argued that managers, when faced with a situation which brings no direct personal advantage, may still basset their job on a sense of duty.

Commenting on the stewardship theory's urge for having less influence by nonexecutive directors, Hawley and Williams (1996) claim this would lead to a situation where there were mainly executive-dominated boards or no boards at all. But Donaldson and Davis (1994) argue that a non-executive board of directors is an ineffective control device. Turnbull (1997) suggests that boards can be redundant with the presence of a dominant active shareholder, particularly when the shareholder is a family or government'. According to Tricker (1996), company law imposes a fiduciary duty upon managers, towards the shareholders, and hence, managers can be easily trusted with the stewardship of the company assets. In short, the stewardship theory of corporate governance thrives on the concept of managers being self-motivated towards working for the best interest of the company and other related parties.

4.2.4 Political Model of Corporate Governance

The political model, according to Hawley and Williams (1996), has been very influential on corporate governance development in the recent past. Turnbull (1997) suggests that this model acknowledges the fact that government has much to do in determining how corporate power, privileges, and profits are allocated between owners, managers and other stakeholders. The macro framework affects the ability of the corporate stakeholders to influence the allocations between themselves at the micro level, and the macro framework is interactively subjected to the influence of the corporate sector.

While focusing on the micro level in the political arena, Pound (1993a, 1993b) says that active investors rely on developing voting support from widely-spread shareholders instead of purchasing voting power or control which falls under the economic approach. Gundfest (1993) argues that one must understand the political marketplace to appreciate the role played by capital market mechanisms in ensuring corporate governance, and support for this view emerges in a study by Gordon and Pound (1991). Monks and Minow (1996) suggest that the political model is concerned with the related issues of trading off investor voice to investment exit, and institutional agents monitoring corporate agents, while Coffee (1991) indicates that the current political model focuses on contemporary issues such as the US proclivity for market liquidity over institutional control. The political model underpins the governance framework where
corporation and governments/regulators and politics play a crucial role in sketching the corporate governance framework in a broader political context.

Table 1: A Summary of Corporate Governance Theories

<table>
<thead>
<tr>
<th>Corporate Governance Theory</th>
<th>Key Issues</th>
<th>Author(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The economic/Market Based Theory</td>
<td>Aligning the behavior and goals of managers with the interests of shareholders</td>
<td>Hawley &amp; Williams (1996)</td>
</tr>
<tr>
<td></td>
<td>Construct rules and incentives in the form of explicit or implicit contracts to align managerial behavior</td>
<td>Turnbull (1997)</td>
</tr>
<tr>
<td></td>
<td>Views shareholders as only owners of firms and concerned with what goes on in the market</td>
<td>Berle and Means (1932)</td>
</tr>
<tr>
<td></td>
<td>Recognizes the Agency Problem which views firm as a bundle of contracts among individual Factors of production and is more concerned about what goes on inside the firm</td>
<td>Alchian and Demestz (1972)</td>
</tr>
<tr>
<td></td>
<td>Placing limits on residual control and authority Of managers and monitoring them</td>
<td>Shleifer and Vishny (1997)</td>
</tr>
<tr>
<td></td>
<td>Incentives such as financial or threat of dismissal are helpful in aligning managerial behavior and motives</td>
<td>Jension and Meckling (1976)</td>
</tr>
<tr>
<td></td>
<td>Market mechanisms such as market for corporate control, takeovers work as disciplinary market forces in aligning managerial motives with shareholders</td>
<td>Franks and Mayer (1990)</td>
</tr>
<tr>
<td>Organizational/ Stakeholder Theory</td>
<td>Firms must be run for the best interest of all stakeholders, rather than shareholders only</td>
<td>Freeman (19984), Blair (1995)</td>
</tr>
<tr>
<td></td>
<td>Firms must maintain a balancing approach to all stakeholders benefits</td>
<td>Vinten (2001)</td>
</tr>
<tr>
<td></td>
<td>Principal-Agent theory is a sub-set of general</td>
<td>Hill and Jones (1992)</td>
</tr>
</tbody>
</table>
Due to investment of human capital in firms, employees all have a residual risk in firms and require a governance role. A systematic stakeholder view theorizing corporate governance is yet to develop. 

**Stewardship Theory**

Managers or boards are self-motivated to work for the best interest of firms and owners. Better economic performance if the same executive is trusted with the power and authority of both CEO and board chair. Does not support CEO/Chair duality. Managers act as trustees who preserve and enhance the assets under their control.

**Political theory**

Government has vital role in determining how corporate power and assists are allocated between owners and managers. Corporate world exerts significant influence in the design of law and regulations affecting corporations. Firm/ Micro level politics greatly affects governance of firms.


Learmount (2002)

Donaldson and Davis (1994)

Muth and Donaldson (1998)

Kay and Silberstone (1995)

Hawley and William (1996)

Monks (1996)

Pound (1993)

Source: Researcher’s own compilation based on the literature reviewed in Chapter Two.

### 4.3 Corporate Governance: International Principles and Practices

There is no universal model of corporate governance, but events in the corporate world such as the collapse of many giant corporations, the changing pattern of share ownership, and the internationalization of cross-border portfolios, have led various countries and international organizations to develop some principles of corporate governance which may be followed in the context of different countries (Hussain and Mallin, 2002). Among them, the UK Cadbury Report (1992), and the OECD Principles of Corporate Governance (1999) have been widely accepted. The principles are presented in Table 2.

Amidst growing recognition of sound governance, different countries are addressing the issue of corporate governance from varying angles. A system of corporate governance refers to a country-specific framework of legal, institutional, and cultural factors through which
stockholders and stakeholders can influence managerial behavior and there are several such country-specific systems that work as determinants of corporate governance practices around the world. Scholars such as Scott (1985), DeJong (1989), Moerland (1995), Weimer (1995), Weimer and Pape (1999) have all echoed their voice for four systems of corporate governance, which originate from relatively rich, industrialized countries. These four systems are:

- Anglo-Saxon System (USA, UK, Canada, Australia)
- Germanic System (Germany, Netherlands, Switzerland, Sweden, Austria, Denmark, Norway, Finland)
- Latin System (France, Italy, Spain, Belgium)
- Japanese System

### 4.3.1 Anglo-Saxon System of Corporate Governance

The Anglo-Saxon system mainly stems from the governance practices of the United States and the United Kingdom. And English-speaking countries such as Canada, Australia etc. According to Weimer and Pape (1999), firms in these countries must commit themselves to the priority objective of maximizing shareholders' wealth, and they have strong legal backing to protect shareholders' interest through laws that give rise to the principle of 'one share one vote.

Corporations in countries which follow the Anglo-Saxon model are usually governed by one single board of directors comprising both internal and external members (Weimer and Pape, 1999). The external or non-executive directors supervise and advise the managerial directors on major policy decisions in line with the best interest of the shareholders.

The Anglo-Saxon countries have an active market for corporate control, referred to as a Takeover Market with common takeover techniques such as mergers, tender offers, proxy fights and leveraged buy-outs (Weimer and Pape, 1999). Ownership concentration is very low in these countries, showing a widely-held interest (Weimerand Pape, 1999). According to an estimate by the OECD (1997), the largest five shareholders in the UK and USA hold an average of 20-25 per cent of the outstanding shares. Individuals own about 51.4 per cent of the publicly-listed US companies 'shares, and 17.7 per cent of those in the UK (OECD, 1997). Abowd and Bognanno (1995) hint that in the USA, performance-based remuneration is an important part of the total managerial compensation, accounting for one third of total compensation of CEOs in 1992. They also suggested that such systems are becoming increasingly important in the UK and Canada.

**Table 2: International Principles of Corporate Governance**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Shareholders’ right obligations and Implicitly Assumed in the overall theme of the guidelines</td>
<td>Corporate Governance framework should protect shareholders rights. 1 share, 1 vote; Sufficient and relevant information from</td>
<td></td>
</tr>
<tr>
<td>Treatments</td>
<td>the companies; participate in an general meeting; share in residual profit; protection of minority rights; fairness and transparency of company operation</td>
<td></td>
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<tr>
<td>-----------</td>
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</tr>
</tbody>
</table>
|           | • Obligation: use voting rights  
• Corporate Governance Framework should ensure equitable treatment of all shareholders, including minority and foreign shareholders  
• Same voting rights  
• All shareholders of same class should be treated equally |

| Stakeholder ‘Role | Implicitly Assumed | Corporate Governance framework should ensure the rights of stakeholders, are protected by law and that these rights are respected  
• Effective redress for violation of rights  
• Encourage the role of stakeholders in corporation in a manner that enhances the performance of the corporation and the market  
• Provision for disclosure of information and relevant to interests of stakeholders |

| Board | There should be at least three independent non-executive directors - board balance should include a balance of executives/non-executive directors so that no individual can dominate the board’s decision-making | Corporate governance framework should ensure that strategic leadership of corporation, the efficient monitoring of management by the board of directors; accountability of board to its corporation and shareholder.  
• Meeting, for example one a month; process; Chair/CEO off(separation of duties and responsibility) etc.  
• Non-Executive members of boards should form independent judgment’s, especially with respect to corporation’s strategy, performance, asset management and appoint management.  
• Non-Executive members should be independent from executive members of board (no family relation) and have no business relation with the corporation or other commercial involvement that may affect their judgments.  
• Interlocking directorship(should be avoided) |
| Executive Management, Performance, Compensation | Simply awards more discretion to executives in ruining the business. However also calls for inclusion of at least three independent directors in board to monitor executive decision making. | • Good practice that management compensation be tied to corporation’s general level of profitability and overall performance.  
• Total compensation should be disclosed in financial statements.  
• Procedures for compensation should be disclosed.  
• Remuneration committee (or review Committee) |
| --- | --- | --- |
| Transparency | Urges for greater transparency through board committees as the principles suggest companies should establish key board committees: audit-composed of non-executive directors responsible to the board for recommending remuneration of directors, nomination-as formal and transparent procedure for the appointment of new directors of the board. | • Corporate Governance framework should ensure fill, timely and detailed disclosure of information on all material, including its financial situation, performance, ownership structure and governance of the corporation.  
• Includes establishment of (internal) audit committees  
• Transparency/disclosure of information on  
  ➢ Financial/operating results  
  ➢ Ownership Structure  
  ➢ Member of board of directors and management  
  ➢ Governance structure and policies  
  ➢ Corporate targets and prospects |
| Control | Urges for splitting the control as the principles suggest separation of roles of Chair (running of the board) and CEO (executive responsible for running the business) | • Does not address the issue explicitly or implicitly. |


The lengths of economic relationships mark another characteristic of corporate governance systems, and according to Weimer and Pape (1999) these relationships are short term in the
Anglo-Saxon system. Such short-term and unstable relationships result from unrestricted markets for capital, labor, goods and services which ensure rapid adjustment to changing circumstances.

### 4.3.4 Japanese System of Corporate Governance

Amongst all systems of firm governance, the Japanese system is more driven by the cultural dimension of the corporate governance and it is argued that 'family values' encompass all characteristics of the Japanese governance system. In legal aspects, the ICMG (1995) suggests that little emphasis is placed on litigation in Japan.

The board structure of Japanese firms is comprised of a board of directors, an office of representative directors and an office of auditors. Aoki (1984) and Corbett (1994) claim that Japanese firms often set up an informal sub-structure of the board of directors which results in the inclusion of both inside and outside members.

In the Japanese model, employees and shareholders exert much influence on managerial decisions. Aoki's (1984) study presents a model which views Japanese firms as a coalition of the body of employees and the body of shareholders, integrated and mediated by the management. Japanese commercial codes view shareholders as important stakeholders but for cultural reasons their role is different from those in the other governance systems. Zielinski and Holloway (1991) suggest that sometimes the shareholders old shares for symbolic reasons since they are considered as a ticket of admission to the corporate network.

Japanese banks are believed to be salient influential stakeholders in the Japanese system and the Japanese stock market is the oldest in Asia, playing a very active role in the economy. As takeovers are frowned upon, there is no active market for corporate control in Japan. The ownership structure is marked by stable crossholdings between financial and non-financial companies, and as a result, ownership is more widely dispersed than in the Germanic system but the concentration is still higher than the USA (Weimer and Pape, 1999). According to the OECD Report (1997), the average holding by the largest five shareholders in Japan is 33 per cent.

A study by Abowd and Bognanno (1995) suggests that performance-based pay is not very common in Japan, and the ICMG (1995) indicates that the issue of managerial remuneration is of much less interest to stakeholders than in many other countries. According to Weimer and Pape (1999), the presence of keiretsu and the concept of long-term employment together with 'familysim' indicate long-term and stable economic relationships in the Japanese governance system.

### 4.4 Corporate Governance Issues in Developing Countries

Corporate governance in developing economies has only recently attracted attention (Oman, 2001; Lin, 2001), as the East Asian crises, along with debacles in Russia and Brazil, exposed the problems of poor corporate governance in developing as well as emerging markets. Yet the growth in international capital flows to developing countries stresses the importance of improved corporate governance. And sound corporate governance also enhances the liquidity in any economy, and studies indicate that liquidity of equity markets exerts more influence on economic growth than size of those markets.
The attention to the developing world's corporate governance becomes more necessary when it is realized that the success of ongoing economic reforms largely depend on the quality of corporate governance and has stressed the importance of implementing sound corporate governance for the sake of development, suggesting its presence in order to increase the flow, and decrease the cost, of financial capital and to stimulate productivity growth. Developing countries are constantly seeking investment, particularly foreign investment, into trade and industry, and corporate governance plays an important role in tapping investment by boosting investor confidence.

The deregulation and privatization wave has created scores of new firms with millions of new investors, ranging from shareholder-suppliers of equity finance, to creditor suppliers of debt finance, to employee-suppliers of human capital. It is important to implement sound governance within firms to safeguard the investments as well as to build confidence to raise capital, both financial and human, in order to support the growing businesses under a deregulated environment.

In a seminal World Bank study that outlines the corporate governance agenda for developing nations, Nenova (2004) argues that developing countries face challenges in various areas in terms of sound corporate governance. The author argues that the main governance problem in low-income countries is value transfer from non-controlling shareholders or stakeholders to that of dominant large shareholders. Such abuse becomes easier with concentrated ownership, often at the hands of a few families, ineffective disclosure practices, a weak legal framework and enforcement, and problems in the audit environment.

In a report in the Economic Times (1997), a study of the boards of the top 100 listed companies in India is reported, which reveals that most of those companies are dominated by executives or inside directors along with their family members and well-wisher. In terms of audit, the Economic Times (2002) gave the example of the study conducted by Global Data Services which disclosed that a large number of Indian companies overstated their profits while reporting their accounts for the year 2000-2001. Clearly, the need for a credible and strong regulatory mechanism is as the current situation is far from satisfactory.

The inefficiency of the FSU states' capital markets exacerbated the corporate governance problems by inhibiting the takeover mechanisms. In many countries, outside ownership was obstructed; there was large entrenchment by management in terms of purchasing shares from employees, and resistance to takeover by outsiders. And despite the official endorsement of relevant accounting legislation, there have been serious problems in its enforcement for financial reporting purposes in FSU states. This problem is more severe in private companies where there are pervasive effort to hide profit where the practice of tunneling may imply that assets are transferred out of firms by controlling owners without other owners being aware where reported asset value could be fictitious and where only a board seat may enable one to acquire necessary information. Due to lax local accounting standards, the absence of standardized accounting procedure for listed companies, and the opportunity to shift between local and international standards transparency has been inadequate and questionable in FSU states.
A recent report by the World Bank (2003) sheds light on the practice of corporate governance in Chile. The Chilean system attempts to ensure shareholders’ rights through formal ownership registration and disclosure of various information to shareholders. However, taking the advantage of concentrated ownership; many controllers maintain control at 67 per cent in order to make fundamental corporate decisions, thereby ignoring small and outside shareholders. Chilean corporate law restricts cross-holdings, but dual class shares with restrictive/preferential rights to appoint directors are allowed. Firms in Chile must disclose the identities of their 12 largest shareholders. However, it is possible that conglomerates may be controlled through private holding companies and therefore, in reality, it can be difficult to ascertain a firm's controller.

Chile has a market for corporate control to a limited extent. Abuse of corporate assets and abuse in connected party transactions remain a recurrent problem in Chile. The corporate governance system requires companies to disclose information such as financial statements, directors' and auditors' reports, board members ‘compensations purchase of shares and sale of company securities and any related party transactions etc., yet despite these requirements, there are no obligations on the firms to disclose some very important information such as changes in equity, company objectives, material foreseeable risk factors, internal control, and material issues regarding stakeholders and governance structures and policies. Moreover, the accounting and audit standard followed in the Chilean corporate sector falls far behind the international accounting and audit standards.

Concerns are increasing, particularly in the small to medium size Chilean firms, regarding the quality, qualification and commitment of the board members. In listed firms belonging to conglomerates, directors sat on an average of two boards, with 1 per cent sitting on two or more boards of firms controlled by different groups. This indicates that even those who might be considered ‘independent directors ‘are often the controller's employees or otherwise connected. Table 3 presents a brief summary of various corporate governance systems followed around the world.

Table 3: Features of various Corporate Governance Systems around the World

<table>
<thead>
<tr>
<th>Corporate Governance Features</th>
<th>Anglo-Saxon System</th>
<th>Japanese System</th>
<th>Developing Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concept of Firm</td>
<td>Stockholder benefit oriented firms with strong legal backing to upholders’ rights</td>
<td>Institutional concept of firm exists where everyone within firm considered as ‘one family’</td>
<td>Mostly oriented to large shareholder benefits including families</td>
</tr>
<tr>
<td>Board System</td>
<td>Single boards with both executive and non-executive directors with the latter mainly</td>
<td>Similar to one-tier boards. However boards are complex with informal sub-</td>
<td>Single boards dominated by founders of firms</td>
</tr>
<tr>
<td>Shareholder’s ability to exert influence</td>
<td>Executive holding shares, large block holders particularly institutional owners possess strong influence</td>
<td>Employees have considerable influence on decision-making as well as banks who are providers of large debts</td>
<td>Most influence lies with founding owners, executives and families</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Role of Stock Market in National Economy</td>
<td>Very strong, in fact, strongest among all systems</td>
<td>Very active stock market</td>
<td>Mixed across various countries. However mostly inefficient in countries where role is active.</td>
</tr>
<tr>
<td>Existence of market for Corporate Control</td>
<td>Extremely active market for corporate control</td>
<td>No market for corporate control</td>
<td>No market for corporate control</td>
</tr>
<tr>
<td>Ownership structure</td>
<td>Widely-held firms implying dispersed shareholding</td>
<td>More concentrated with cross-shareholding very common between financial and non-financial firms</td>
<td>Concentrated in the hands of mostly families, government</td>
</tr>
<tr>
<td>Performance based executive compensation</td>
<td>Executive remunerations is mostly performance based</td>
<td>Performance-based compensation not common</td>
<td>Not common</td>
</tr>
<tr>
<td>Time Horizon of Economic Relationship</td>
<td>Short Term</td>
<td>Long Term</td>
<td>Not Clear</td>
</tr>
</tbody>
</table>


### 5. Conclusion

The issue of corporate governance has gained momentum since the early 20th century. In the context of growing separation of ownership and control, issues such as economic performance and corporate sustainability have provided the impetus for an added focus on corporate governance. As illustrated in Table 1, researchers have investigated the issue from various perspectives such as market, organization, politics etc. Contracts involving rules and incentives to align managerial behavior with shareholders' goals have dominated the Economic/Market-
based theory of corporate governance for a long time, but more recently, the Stakeholder theory has challenged the exclusive concentration on shareholders' interest by the Economic theory. The proponents of this view recognize the important contribution made by vital firm stakeholders such as employees and creditors. Besides these dominant theories, Stewardship and Political approaches toward corporate governance highlight the natural responsible behavior of agents and the role of politics in aligning the agents' interest with that of the principals.

The discussion on international principles and practices of corporate governance clearly indicates that there is no single governance style followed around the world, but it can be seen that four divergent systems have emerged, based on common core principles, and these are summarised in Table 3. However, as is evident in Table 3, the developing economies are clearly less advanced in the area of corporate governance and need a more stringent focus on their practices as their corporate sector characteristics greatly differ from those in the industrial world. Hence, it is not wise to completely replicate western governance practices in the developing countries. Rather, a detailed picture of their corporate governance scenario would pave way to develop a prudent governance framework by identifying the underlying problem areas. The demand for such immediate attention is particularly pressing for the banking sectors of developing economies due to their dominant role in providing finance, and facilitating economic transactions, as well their duty to provide safety for depositors.

References

Fiduciary Capitalism. Working Paper, St. Mary's College of California, School of Economics and Business Administration.


