

# 3 The principles of corporate governance

## 3.1 Introduction

We have considered the need for governance for all organisations. In the last chapter we considered the various forms of governance and the codes which have been created. In this chapter we want to look in more detail into the principles – firstly of governance generally and then as applied to corporations.

## 3.2 The principles of governance

There are 8 principles which underpin every system of governance:

### 3.2.1 Transparency

Transparency, as a principle, necessitates that information is freely available and directly accessible to those who will be affected by such decisions and their enforcement. Transparency is of particular importance to external users of such information as these users lack the background details and knowledge available to internal users of such information. Equally therefore the decisions which are taken and their enforcement must be done in a manner that follows rules and regulations. Transparency therefore can be seen to be a part of the process of recognition of responsibility on the part of the organisation for the external effects of its actions and equally part of the process of redistributing power more equitably to all stakeholders.

Here is where another issue arises which is conflict of interests. So it should be noticed that transparency doesn't mean to reveal proprietary information, which belong and are owned only by the organisation. This is the right of a company to compete in a healthy environment so it can freely keep such information as confidential.

As a whole any kind of privileged information or that which would breach legal, commercial, security or personal privacy obligations should not be considered as requiring to be transparent. However, it is also important for citizens and civil society organisations to have public information available, so that they can ask questions, raise issues, and if needed challenge the information itself. Therefore an enterprise should reveal information related to such matters as its objectives, missions and visions, relationships and authorities, responsibilities, revenues, and its rules and standards.

### 3.2.2 Rule of law

This is a corollary of the transparency principle. It is apparent that good governance requires a fair framework of rules of operation. Moreover these rules must be enforced impartially, without regard for power relationships. Thus the rights of minorities must be protected<sup>10</sup>. Additionally there must be appeal to an independent body as a means of conflict resolution, and this right of appeal must be known to all stakeholders.<sup>11</sup>

It means that an enterprise should obey all the related rules and regulations already in force in the community. The scale of this community depends on the diversity and breadth of a company's activities. So it can be a district, a city, a region, a

country or the world. Although very easy to say, this is actually a very disputable principle. Not all the regulations already devised and in force are necessarily conforming to the requirements of good governance. And abiding by such rules does not always mean to be socially responsible.

Such conflict can arise from the reluctance or inability of some countries to abide by the internationally agreed principles such as those of human rights, labor practice, etc.. This is due to nonconformities related to religion, culture, power concerns, and the like. So a powerful country claiming to govern the world resists adopting environmental agreements, and the other ever-developing avoids laws regarding child labour; whereas the other heralding the world to entail prescriptions for the world's prosperity oppresses its nation according to its religious laws not conforming the human rights. Therefore despite the emphasis of ISO 26000, it is not always easy to both comply with legal requirements and to be socially responsible.

### 3.2.3 Participation

Although participation by all stakeholders is of course desirable, this is not an essential principle of good governance. The ability of all to participate if so desired is however an essential principle. Participation of course includes the freedom of association and of expression that goes along with this. Depending upon the size and structure of the organisation, participation can be either direct or through legitimate intermediate institutions or representatives, as in the case of a national government (ie Parliament). Participation of course would involve everyone, or at least all adults both male and female.

### 3.2.4 Responsiveness

This is a corollary of the participation principle and the transparency principle. Responsiveness implies that the governance regulations enable the institutions and processes of governance to be able to serve all stakeholders within a reasonable timeframe.

### 3.2.5 Equity

This principle involves ensuring that all members of society feel that they have a stake in it and do not feel excluded from the mainstream. This particularly applies to ensuring that the views of minorities are taken into account and that the voices of the most vulnerable in society are heard in decision-making. This requires mechanisms to ensure that all stakeholder groups have the opportunity to maintain or improve their well being.

### 3.2.6 Efficiency and Effectiveness

Efficiency of course implies the transaction cost minimisation whereas effectiveness must be interpreted in the context of achievement of the desired purpose. Thus for effectiveness it is necessary that the processes and institutions produce results that meet the needs of the organisation while making the best use of resources at their disposal. Naturally this also means sustainable use of natural resources and the protection of the environment.

### 3.2.7 Sustainability

This of course requires a long-term perspective for sustainable human development and how to achieve the goals of such development. A growing number of writers over the last quarter of a century have recognised that the activities of an organisation impact upon the external environment. These other stakeholders have not just an interest in the activities of the organisation 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 is a concern for the future which has become manifest through the term sustainability. This term sustainability has become ubiquitous both within the discourse 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 (Crowther 2002). 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 of an extractive nature, 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 (Aras & Crowther 2007a).<sup>12</sup>

Sustainability therefore implies that society must use no more of a resource than can be regenerated (Aras & Crowther 2007b). This can be defined in terms of the carrying capacity of the ecosystem (Hawken 1993) and described with input – output models of resource consumption. We will consider this principle in detail in chapter 5.



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### 3.2.8 Accountability

Accountability is concerned with an organisation recognising that its actions affect the external environment, and therefore assuming responsibility for the effects of its actions. This concept therefore implies a recognition that the organisation is part of a wider societal network and has responsibilities to all of that network rather than just to the owners of the organisation. Alongside this acceptance of responsibility there must be a recognition that those external stakeholders have the power to affect the way in which those actions of the organisation are taken and a role in deciding whether or not such actions can be justified, and if so at what cost to the organisation and to other stakeholders.

It is inevitable therefore that there is a need for some form of mediation of the different interests in society in order to be able to reach a broad consensus in that society on what is in the best interest of the whole community and how this can be achieved. As a general statement we can state that all organisations and institutions are accountable to those who will be affected by decisions or actions, and that this must be recognised within the governance mechanisms. This accountability must extend to all organisations – both governmental institutions as well those as the private sector and also to civil society organisations – which must all recognise that they are accountable to the public and to their various stakeholders. One significant purpose of this is to ensure that any corruption is eliminated, or at the very least minimised.

According to ISO 26000, accountability is the state of being answerable for decisions and activities to the organization's governing bodies, legal authorities and, more broadly, its stakeholders. To make it more clear, to be accountable means to provide proof (e.g. reports) on what you are responsible for. Accountability explains that a company is not isolated from its environment and that it is a part of a wider societal network and has responsibilities to all of that network rather than just to the owners of the organisation.

A company has to be accountable both for the consequences of its activities and also for not repeating any negative activity. So it follows from the principle of transparency in that transparency needs to reveal relevant information to stakeholders and accountability is the means to reveal such information. There has not been a consensus generally on how to deal with this necessity. Is it always possible to rely on a company's self declaration? Or should there be third parties to scrutinize on behalf of all the stakeholders? The reluctance of some countries representing their national industries and companies to respect principles of social responsibility, including accountability, and the efforts to lobby against an international standard has impacted the strength of such a document to be implemented. This fact is observable in different parts of ISO 26000.

## 3.3 Good governance and corporate behaviour

Good governance is of course important in every sphere of society whether it be the corporate environment or general society or the political environment. Good governance can, for example, improve public faith and confidence in the political environment. When the resources are too limited to meet the minimum expectations of the people, it is a good governance level that can help to promote the welfare of society. And of course a concern with governance is at least as prevalent in the corporate world.

Good governance is essential for good corporate performance and 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.

A great deal of concern has been expressed all over the world about shortcomings in the systems of corporate governance in operation, and its organisation has been exercising the minds of business managers, academics and government officials all over the world. 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 firms' 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. Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituents of society – that is the stakeholders, including government; the general public etc; professional / service providers – and the corporate sector.

Of equal concern is the question of corporate social responsibility – what this means and how it can be operationalised. Although there is an accepted link between good corporate governance and corporate social responsibility the relationship between the two is not clearly defined and understood. Thus many firms consider that their governance is adequate because they comply with The UK Corporate Governance Code, which came into effect in 2010. Of course, as we have previously stated, 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. Although many companies regard corporate governance as simply a part of investor relationships, 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.

It is recognised that these are issues which are significant in all parts of the world and a lot of attention is devoted to this global understanding. Most analysis however is too simplistic to be helpful as it normally resolves itself into simple dualities: rules based v principles based or Anglo-Saxon v Continental. Our argument is that this is not helpful as the reality is far more complex. It cannot be understood without taking geographical, cultural and historical factors into account in order to understand the similarities, differences and concerns relating to people of different parts of the world.

### 3.4 Corporate Governance Principles

Since corporate governance can be highly influential for firm performance, firms must know what are the corporate governance principles and how it will improve strategy to apply these principles. In practice there are four principles of good corporate governance, which are:

- Transparency,
- Accountability,
- Responsibility,
- Fairness

All these principles are related with the firm's corporate social responsibility. Corporate governance principles therefore are important for a firm but the real issue is concerned with what corporate governance actually is.

Management can be interpreted as managing a firm for the purpose of creating and maintaining value for shareholders. Corporate governance procedures determine every aspect of the role for management of the firm and try to keep in balance and to develop control mechanisms in order to increase both shareholder value and the satisfaction of other stakeholders. In other words corporate governance is concerned with creating a balance between the economic and social goals of a company including such aspects as the efficient use of resources, accountability in the use of its power, and the behaviour of the corporation in its social environment.

The definition and measurement of good corporate governance is still subject to debate. However, good corporate governance will address all these main points:

- Creating sustainable value
- Ways of achieving the firm's goals
- Increasing shareholders' satisfaction
- Efficient and effective management
- Increasing credibility



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- Ensuring efficient risk management
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- Describing the role of a firm's units
- Developing control and internal auditing
- Keeping a balance between economic and social benefit
- Ensuring efficient use of resources
- Controlling performance
- Distributing responsibility fairly
- Producing all necessary information for stakeholders
- Keeping the board independent from management
- Facilitating sustainable performance

As can be seen, all of these issues have many ramifications and ensuring their compliance must be thought of as a long term procedure. However firms naturally expect some tangible benefit from good governance. So good governance offers some long term benefit for firms, such as:

- Increasing the firm's market value
- Increasing the firm's rating
- Increasing competitive power
- Attracting new investors, shareholders and more equity
- More or higher credibility
- Enhancing flexible borrowing condition/facilities from financial institutions
- Decreasing credit interest rate and cost of capital
- New investment opportunities
- Attracting Better personnel / employees
- Reaching new markets
- Enhanced company image
- Enhanced staff morale

### 3.5 Good Governance and Sustainability

It is clear that all these long term benefits are also directly related to the sustainability of a firm and that firm's success. We can evaluate corporate governance from different perspectives, such as that of the general economy; the company itself; private and institutional investors; or banking and other financial institutions. Some research results show that the quality of the corporate governance system of an economy may be an important determinant of its competitive conditions (Fulgieri and Suominen, 2005). Authors suggest the existence of a relationship between corporate governance and competitiveness and also examined the role of competition in the production of good corporate governance.

Van de Berghe and Levrau (2003) on the other hand investigated good governance from the perspective of companies, investors and banks. From the company's perspective, it can no longer ignore the pressure for good corporate governance from the investor community. Installing proper governance mechanisms may provide a company with a competitive advantage in attracting investors who are prepared to pay a premium for well-governed companies. From an investor's perspective, corporate governance has become an important factor in investment decisions as it is recognised to have an impact on the financial risks of their portfolios. Institutional investors put issues of corporate governance on a par with financial indicators when evaluating investment decisions. From the creditor's perspective, there is a plea for increased attention for corporate governance in a bank's risk measurement methods: a plea which is supported by the new requirements put in place by Basel II and subsequently Basel III.

Bøhren, and Ødegaard (2004) also showed that corporate governance matters for economic performance; insider ownership matters the most while outside ownership concentration destroys market value; direct ownership is superior to indirect; and that performance decreases with increasing board size, leverage, dividend payout, and the fraction of non-voting shares. Black et al (2005) investigated the relationship between governance and firm value. They found evidence that better governed firms pay higher dividends, but no evidence that they report higher accounting profits.

### 3.6 References

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### 3.7 Further reading

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### 3.8 Self-test questions

1. What are the 4 principles of corporate governance?
2. What does the rule of law mean?
3. Explain transparency.
4. What is meant by stewardship?
5. Why will good governance mechanisms create competitive advantage?



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