Corporate Governance

Unit 1 Introduction to Corporate Governance

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Unit Overview

The main purposes of Unit 1 are to introduce the basic concepts of corporate governance and examine why interest in corporate governance has exploded around the globe. In studying the unit, you will chart the evolution of corporate structure and learn to describe corporate governance in terms of such issues as capital formation, corporate finance and economic growth.

Learning outcomes

When you have completed your study of this unit and its readings, you will be able to:

- explain the key concepts underpinning the study of corporate governance
- discuss the concept of the corporation, explain why it exists and how it functions
- define corporate governance and discuss reasons for its recent increase in popularity
- evaluate the relationship between corporate governance and the macro economy.

Reading for Unit 1

Aguilera R and R Crespi-Cladera (2016) 'Global corporate governance: on the relevance of firms' ownership structure'. *Journal of World Business*, 51 (1), 50–57.

Hansmann H (2000) 'An analytic framework'. In: *The Ownership of Enterprises*. Cambridge MA, Harvard University Press. pp. 11–23.

Monks RAG and N Minow (2011) 'What is a corporation?' In: *Corporate Governance.* 5th Edition. West Sussex, John Wiley & Sons. pp. 3–100

1.1 Introduction

Concern with governance issues and their focus has increased dramatically in recent years. This module is designed to enable you to gain an in-depth understanding of the key theoretical and practical issues underpinning the study of corporate governance, and how they affect the governance of the modern corporation. A previous knowledge or study of corporate governance is not essential for this module, although a familiarity with recent governance issues will help put your study in context. If you have previously studied subjects such as economics, finance, sociology of organisations, or law, you will find that this module will further contribute to your existing knowledge of these areas.

1.1.1 Ownership and control

Although recent discussion and interest in corporate governance has tended to focus on issues relating to financial crises and such high profile corporate scandals as Enron and WorldCom, corporate governance has in fact been of concern ever since the foundation of the joint-stock company. Much of this concern centred on the separation of ownership from control. Adam Smith, in the eighteenth century, was one of the first economists to express unease over the governance of joint stock companies:

> The directors of such [joint-stock] companies, however, being the managers of other people's money than 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 co-partnery frequently watch over their own. Like the stewards of rich men, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.
>
> Source: Smith ([1776] 1990)

Indeed, the separation of ownership and control was the central topic of Adolf Berle and Gardiner Means' (1932) seminal study, which has underpinned much of the recent debate on corporate governance structures. They proposed that the evolution of the modern corporation was such that it produced a condition where the interests of owners and managers diverged. The consequences were a surrender of investor's control, a breaking of traditional property relations and a demand for a completely new definition framework. Such a framework would need to take account of the fact that persons other than those who controlled wealth could now shape industry and individual corporations. Berle and Means regarded this evolution of economic activity as being underpinned by two developments:

- *The factory system*: this formed the basis of the industrial revolution and was responsible for bringing large numbers of workers under a single management.

- *The modern corporation*: the advent of the modern corporation placed the wealth of many individuals under the same central control.

Authors, such as Eugene Fama (1980), later came to view the separation of ownership as a move from the classical model of an entrepreneur or owner-manager single-mindedly operating the firm to maximise profits, to the development of 'behavioural' and 'managerial' theories that focus on monitoring and control. In this manner, the separation of ownership and control was viewed as an efficient form of organisation. The separation of ownership and control was effectively a separation of decision-making and risk-bearing functions, allowing organisations to benefit from specialising in management and risk bearing.

Separating ownership and control also meant new costs for the firm. These are the monitoring costs associated with aligning the interests of owners and managers. Much of the study of corporate governance is concerned with how to minimise these costs and better align the interests of owners and managers. These costs form the basis of agency theory, which sought to explain the transaction or agency costs associated with reconciling the interests of shareholders as principals and managers as agents.

Review Question 1.1

Berle and Means (1932) were highly sceptical of the separation of ownership and control. However, the literature on organisational form later illustrated the efficiency benefits of separating ownership and control. Organisational theories that viewed the firm as a 'nexus of contracts' provided new insight into how the firm could contract in an efficient manner for the governance issues that arose.

Before proceeding further, you might like to take a moment to write down the likely costs for owners associated with monitoring managers, and how you think these costs might be reduced.

You can compare these with your thinking as it develops during your study of the module.

More recently, the expropriation of investors' funds and large-scale corporate and banking failure, as illustrated by the collapse of Enron and the recent Global Financial Crisis, has resulted in a greater focus not just on shareholder-value, but also the effects of corporate governance failure on society generally. Corporate governance is now viewed as an important issue both as a criterion for investment and as a method for improving the allocation of rewards in society.

The globalisation of the international economy has also provided challenges for corporate governance structures. The global repercussions of the recent Global Financial Crisis are a case in point. Large multi-national financial institutions increasingly rely on more complex external and international methods of financing. This results in a growing informational distance between shareholders and management. Large banks and financial institutions have become simultaneously more complex and vulnerable to economic shocks, and the effects of their collapse tend to be felt far beyond their shareholders. This has once again raised questions over whether the separation of ownership and control, with its emphasis on the relationship between the board of directors and shareholders, really is the optimal form of governance. Many argue that instead of being an efficient organisational form, it has instead encouraged excessive risk taking in order to maximise shareholder value, while the costs of failure are borne not necessarily by the board of directors, but rather by society as a whole.

Along with these developments there has been an increasing tendency for governments, regulators and other international organisations to involve themselves in governance issues. The Global Financial Crisis not only witnessed an increasing effort by governments and regulators to design more efficient monitoring and regulatory structures, but in some cases witnessed states once again becoming major shareholders in large banks and corporations. While the latter had the effect of preventing a complete collapse of large financial institutions, from a corporate governance perspective it also suggested that many financial institutions had become so interconnected that the likely contagion from their collapse meant that they had become in effect 'too big to fail'.

1.1.2 Systems of corporate governance

Just as in other disciplines, strong divisions have marked the study of corporate governance over different approaches. One of the main areas of contention concerns the main corporate governance systems. The governance literature has largely focused on two main systems:

- *The dispersed or outsider system of governance*, which is characterised by dispersed ownership and shareholder protection and is associated with the UK and US.
- *The concentrated or insider system*, on the other hand, which is characterised by concentrated ownership and weaker shareholder protection, and is associated with European systems of governance.

In this module we also consider a third system of governance – the *family-based system*, which tends to be associated with East Asian countries.

While these systems tend to dominate the core governance literature, we would also like you to understand that these systems are not rigid. Recent developments have seen the emergence of 'unconventional' governance structures in response to changes in the market place. The emergence of human-capital intensive firms, typically associated with Silicon Valley, is one example of this. For these firms, it is human capital rather than physical assets that need to be contracted for. The new challenge is therefore 'to explain what happens when there are no physical assets involved or when the assets are simple commodities and easily replaceable' (Zingales, 2000: p. 31). Similarly, employee ownership, convergence of governance systems and the upward (or downward) devolution of monitoring challenge traditional theories of the firm.

One of often-overlooked characteristics of the corporate form is its ability to adapt. A rigid interpretation of governance systems could lead to a very pessimistic view of the prospects of governance reform, particularly for developing and transition economies. A key feature of recent developments in corporate governance has been the increasing tendency of countries with weak governance institutions to converge towards better practice.

From this brief introduction to corporate governance, you should begin to understand how the study and practice of corporate governance continues to evolve and respond to new developments. The following sections outline the key concepts, definitions and implications of corporate governance. Please note that these definitions and examples are not exhaustive, and you should feel free to reconcile them with your own knowledge and experience.

Reading 1.1 and 1.2

You should now read Sections 1 and 2 (pages 50–53) of the article by Ruth Aguilera and Rafel Crespi-Cladera (2016) on the relevance of firms' ownership structure. You will revisit the issue of ownership in Unit 2 and study the remainder of this article in Unit 3 when we look at comparative systems of corporate governance and the question of convergence.

When you have finished reading the article sections note the evolution of studies globally on the relationship between ownership structure and corporate governance.

You should also read pages 11–16 of Henry Hansmann's *The Ownership of Enterprises* in order to familiarise yourself with the concept of ownership and control. These concepts are essential to the understanding of corporate governance. You should note the various forms of ownership that Hansmann identifies.

When you have finished reading, please answer the following questions.

- How does ownership differ from control?
- Why does *formal* control not always mean *effective* control?

Aguilera and Crespi-Cladera (2016) 'Global corporate governance: on the relevance of firms' ownership structure'. *Journal of World Business*

Hansmann (2000) Chapter 1 'An analytic framework' from *The Ownership of Enterprises.*

1.1.3 Key conceptual issues

As a subject, corporate governance transcends and encapsulates many different disciplines. Accountants have typically been concerned with the regulatory and compliance aspects of corporate governance. Economists tend to be concerned about how to align the interests of shareholders and managers in order to minimise the costs associated with organisation. More recently, the legal discipline has become increasingly concerned with governance issues.

You should not, however, be overwhelmed by this. The next section will examine some of the key concepts that will help you approach the study of corporate governance. First, the alternative approaches to governance issues are examined; second, the section looks at the nature of the corporation, and thirdly, it defines corporate governance.

1.2 Approaches to Corporate Governance

There are two main traditional approaches to the study of corporate governance: institutional and functional.

An *institutional* approach to corporate governance involves examining the existing institutions to see how they can produce the services they offer more efficiently. In corporate governance, institutions generally refer to the regulatory, legal and financial framework that underpins the governance system. An institutional approach would therefore look at each of these areas and see how they could be improved upon in order to improve governance generally. More recently, there has been increasing focus on legal institutions to see how they can be strengthened to protect investors against corporate fraud.

A *functional* approach looks at how different institutional arrangements can function in different ways. This type of approach takes the view that there are different ways to address similar governance concerns. It implies a more open-minded approach to examining different possibilities. The core function is to facilitate investment. However, there are many different ways by which investment can be facilitated.

As you study different units of this module, you will become more aware of the various institutional arrangements that facilitate investment. This will be apparent both in terms of different countries and different theoretical approaches.

1.2.1 What is a corporation?

As its name suggests, corporate governance is primarily concerned with the study of the governance of corporations. However, there are many alternative definitions of what exactly a corporation is. In this manner, corporations mean different things to different people. Here are some definitions presented by Monks and Minow (2004: p. 9):

- 'An ingenious device for obtaining individual profit without individual responsibility' Ambrose Bierce, *The Devil's Dictionary*.
- '… one person in law – a person that never dies: in like manner as the River Thames is still the same river, though the parts which compose it are changing every instant' *Blackstone*.
- 'A mechanism established to allow different parties to contribute capital, expertise, and labour, for the maximum benefit of all of them.'

None of these definitions is necessarily better than the others. What you understand at this stage is that the diversity of definitions is illustrative of the many different perspectives and approaches to the corporation. For example, economists have typically viewed the corporation as a 'nexus' or collection of contracts. Those from the management discipline may, however, prefer to see it as a series of complex business relationships.

Another example illustrates how the corporation is viewed by different classes of stakeholders. Take the case of investors, managers and workers:

- Investors are mainly concerned with access to the corporation's profits. They have no responsibility for operational matters. This responsibility is delegated to managers.
- Managers run the company on behalf of investors. They have no responsibility for personally providing funds. Providing funds is the responsibility of investors.
- For workers, the corporation represents a job opportunity and a wage. They have no responsibility for providing funds or for running the business.

Review Question 1.2

The distinction between the roles and responsibilities of investors, managers and workers is not a rigid one. Recent developments in corporate governance have challenged the conventional understanding of the corporation. Many corporations now provide management with share options, thereby making them investors. You will already know from your reading that there exist many different forms of corporate structure. Worker representatives on the board of directors are common under some governance systems. Worker-owned cooperatives are common in such countries as Spain and Italy. These developments will be examined in greater detail in the following units. However, for the moment, you should consider the fact that one characteristic of a corporation that is often neglected is its ability to adapt.

- How important do you think the ability of the corporation to adapt is in the modern business environment?
- Can you think of examples?

1.2.2 Essential characteristics of the corporate form

This section examines essential characteristics of the corporation:

- limited liability
- transferability of investor interests
- legal personality
- centralised management.

Limited liability

One of the key features of the modern corporation is limited liability. Limited liability has its origins in the separation of ownership and control. The corporation is separate from its owners and employees. If a corporation goes bankrupt, its individual members are not individually liable.

This is important for investors, as whatever happens, the risk of loss is limited to the amount of their investment. The downside of limited liability is that it comes with limited control. Remember how we noted in the introduction that the separation of ownership and control led to a specialisation in risk bearing and management. Limited liability comes with limited authority: shareholders' low-level risk corresponds to the low-level control by shareholders.

Review Question 1.3

Under limited liability, the liability of shareholders is limited to the amount they invest. Risk is spread across individual investors, depending on the size of investment. While this lessens the risk to individual shareholders, it also lessens their control over the corporation. Now consider the following and make note of your answers:

- Compare the limited liability corporation form with partnership form. Adam Smith argued that the partners in a private co-partnery could watch over their investments with much greater vigilance than the owners of joint stock corporations. Why do you think this is?
- What are the advantages of the limited company over an unlimited company? Why do we need limited liability?
- A final question you might consider is whether there is a social cost to limited liability? This is because limited liability is a privilege granted by society that also comes with obligations. We will return to this question when we consider executive remuneration in Unit 6.

Transferability of investor interests

A second important characteristic of the corporate form is the ability of the investor to exit the company with ease. In listed corporations, stock is almost as liquid as cash. In other words, investors can easily sell their investment for cash. Because of this, shareholders possess *exit rights*: they can 'vote with their feet' and sell their shares.

Legal personality

Not only is the corporation separate from its owners and employees, it also has a legal entity of its own. The following points are important:

- A corporation lives on for as long as it has capital.
- Corporate structure protects its individual participants from direct legal responsibility in its business operation.
- 'Shareholders own shares, not the corporation': this enables limited collective control by shareholders.
- A corporation owns its own assets and property.

To help you answer the next set of questions, please read the following citation from Douglass Bandow, a former aide of US President Ronald Reagan:

> Corporations are specialized institutions created for a specific purpose. They are only one form of enterprise in a very diverse society with lots of different organizations. Churches exist to help people fulfil their responsibilities toward God in community with one another. Governments are instituted most basically to prevent people from violating the rights of others. Philanthropic institutions are created to do good works. Community associations are to promote one or another shared goal. And businesses are established to make a profit by meeting people's needs and wants.

> Shouldn't business nevertheless 'serve' society? Yes, but the way it best does so is by satisfying people's desires in an efficient manner… Does this mean that firms have no responsibilities other than making money? Of course not, just as individuals have obligations other than making money. But while firms have duty to respect the rights of others, they are under no obligation to promote the interest of others. The distinction is important.
>
> Source: Bandow (1992) p. 95

Review Question 1.4

- The corporation is a legal person but is it also a *moral person*? What is the extent of the social responsibility of corporations?
- Is there a trade-off/balance between profits and social goals?

Centralised management

In partnerships, each partner has an equal say in the management of the company. In a corporation, shareholders delegate this responsibility to the board of directors and management. It would be difficult, if not logistically impossible, to find consensus among dispersed individual shareholders on issues concerning the day-to-day affairs of the corporation. Delegation of responsibility works in the following manner:

- The power to determine the company's overall direction is given to the board of directors.
- The power to control the company's day-to-day operation is given to the managers.
- In order to allow the company to operate with maximum efficiency, the shareholders give up the right to make decisions on all but the most general issues facing the company.

Reading 1.3

Monks & Minow (2011) *Corporate Governance,* Chapter 1 'What is a Corporation?

Please read the first chapter of *Corporate Governance* by Monks and Minow.

While reading, you should study carefully and take notes on the following issues:

- the evolution and features of the corporation (pages 5–9)
- the corporation as 'a person', 'complex adaptive system' and 'moral' decision taker (pages 12–15)
- the corporation's responsibility to society (pages 16–17).

To help you understand these issues, Monks and Minow have provided a number of interesting case studies that you should read. In particular, the cases of Wrigley Corporation (pages 15–16) and Stride Rite (pages 59–60) provide useful examples of the dilemmas faced by corporations. When reading these cases, you should make notes on the trade-off between social responsibility and profit faced by corporations.

1.2.3 What is corporate governance?

At its most basic, corporate governance refers to 'the ways suppliers of finance to corporations assure themselves of getting return on their investment' (Shleifer and Vishny, 1997: p. 736). However, just like the corporation, corporate governance can be defined or interpreted in numerous ways. Traditionally, corporate governance has focused on the shareholder/management relationship. This concerns mainly the internal governance relationships.

> Corporate governance refers to the systems, processes, and responsibilities involved in running and building value in a firm or organisation, and the way in which these are organised and directed at board level.
>
> Source: CMI. (n.d.)

More recently, corporate governance has been used to describe a much broader relationship between institutions and stakeholders.

> Corporate Governance is concerned with the systems of laws, regulations, and practices which will promote enterprise, ensure accountability and trigger performance.
>
> Source: World Council for Corporate Governance (n.d.)

Today, corporate governance is increasingly concerned with the role of stakeholders, and its impact on the collective welfare of society. For example, the OECD views the role of corporate governance as twofold:

- firstly, it covers the manner in which shareholders, managers, employees, creditors, customers and other stakeholders interact with one another in shaping corporate strategies
- secondly, it relates to public policy, and an adequate legal regulatory framework, which are essential for the development of good systems of governance.

Taking these points into account, corporate governance is viewed as a key element in improving the microeconomic efficiency of a firm, affecting the functioning of capital markets and influencing resource allocation. Megginson and Netter (2001) thus defines corporate governance as a nation's 'set of laws, institutions, practices and regulations that determine how limited liability companies will be run and in whose interest' (Megginson & Netter, 2001: p. 377).

From an academic perspective, a corporate governance system is the complex set of socially defined constraints that affect expectations for how authority in firms will be exercised or how the system affects the willingness to make investments in corporations in exchange for promises (e.g. Williamson, 1985).

- A 'good' governance system supports a continual process of mobilising scarce resources to their most promising uses.
- The major components of the governance system are the legal, political, economic and social institutions that either constrain or enable the corporation. According to Holmstrom (1999), under this set-up the firm is viewed as a 'sub-economy', and is dependent on the macro environment.

- There is no perfect corporate governance structure that is able to provide optimal solutions to all trade-offs.

Less academically defined, corporate governance encompasses the combination of laws, regulations, listing rules and voluntary private sector practices that enable the corporation to:

- attract capital
- perform efficiently
- achieve the corporate objective
- meet both legal and obligations and general societal expectations.

Narrowly defined, corporate governance concerns the interactive relationships between corporate managers, directors and the providers of equity capital. However, such a narrow interpretation is not enough to take account of the complex relationships between the corporation and its various stakeholders. Stakeholders include workers, suppliers, creditors and investors. In fact, stakeholders can, in a broad sense, refer to anyone whose life is affected in one way or another by the existence of the corporation.

A more constructive or long-term approach to defining corporate governance should therefore take account of the relationship of the corporation to stakeholders and society. Such an approach should take account of the interests of both shareholders and stakeholders. Viewed in this manner, stakeholder interests (societal expectation) and shareholder interests are not mutually exclusive. Instead, they would appear to be dependent on each other in the long-term.

> Corporate governance deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders. How well companies are run affects market confidence as well as company performance. Good corporate governance is therefore essential for companies that want access to capital and for countries that want to stimulate private sector investment. If companies are well run, they will prosper. This, in turn, will enable them to attract investors whose support can help to finance faster growth. Poor corporate governance, on the other hand, weakens a company's potential and, at worst, can pave the way for financial difficulties and even fraud.
>
> Source: McGill and Patel (2008) p. 174

1.2.4 Why has interest in governance issues exploded?

Scandal certainly arouses interest, and the following quotation gives one answer to this question:

> Spectacular business failures, the build-up of huge excess capacities, unscrupulous managers expropriating shareholders by paying themselves fantastic salaries, and the roles played by the market for corporate control and institutional investors in generating apparently short-term investment objectives has led to a renewed interest in corporate governance.
>
> Source: Gugler (2001) p. 6

You will probably be aware of the controversy surrounding recent high profile corporate scandals. There is little doubt that these have contributed to the increased focus on governance issues. There are a number of important factors underpinning the recent rise in interest in the subject of corporate governance. The following text cites some of the factors that you should note.

The international economy

The global expansion of the market economy has meant that many large corporations now operate in an international environment, which is often very different from the domestic market. The transition of former centrally planned economies has also created significant opportunities for further expansion. Consequently, corporations are much more exposed to the institutional structures and practices of the international economy.

The growth of corporations

Some of multi-nationals have a global reach and economic and political power that transcend the reach and power of governments. Corporations can use this political power to influence regulators and governments.

Deregulation and globalisation

The deregulation of markets has meant that corporations can now compete across borders with much greater ease. Deeper and broader cross-border business relationships between nations signal significant changes to all aspects of society. Establishing international business relationships means corporations must exhibit a greater understanding of international governance systems and practices. Corporations can also raise funds on international capital markets. This provides the corporation with more diverse funding opportunities, but also increases the distance between shareholders and directors.

Shareholder activism

One of the features of recent developments in corporate governance has been the rise of institutional investors. Institutional investors have more influence than small shareholders, as they tend to control larger shareholdings. Emerging trends suggest that institutional investors see a link between sound corporate governance and lower investment risk. Smaller shareholders also have become more active in voting against executive compensation of their Chief Executive Officers (CEOs).

Corporate scandals and financial crises

The systematic failure of investor protection mechanisms, combined with weak capital market regulation, can lead to failure of confidence. As suggested at the beginning of this section, the significant coverage given in the media to such corporate scandals as Enron and WorldCom, and their consequent effect on investor confidence, has effectively raised interest in the issue of corporate governance.

The above issues have propelled corporate governance to the forefront of investment decisions. The strength of this trend can be seen from investors' awareness of and willingness to pay for good governance practice. One noteworthy event is the decision in 2003 of CalPERS, the largest pension fund in the US, to rule out the possibility of investing in China, India and Russia. It also ruled out returning to other emerging markets, including Thailand and Malaysia. CalPERS cited stability and disclosure concerns as the prime reason for rethinking its investment strategy. A 2002 survey by McKinsey, a global consultancy group, found that investors were willing to pay a premium of up to 30% for good corporate governance. More recently, Hermes Asset Management confirmed this trend in a 2016 study of the relationship between investor returns and corporate governance standards. Take a moment to examine some of the findings of Hermes' study in the figures below.

Review Question 1.5

As you study the charts, write down your answers to the following questions:

- Why do you think that investors are willing to pay for good governance?
- In which regions does poor corporate governance have the biggest negative effect on returns?

You might also note that in Japan poor corporate governance did not have a large negative effect on returns (as in other regions). We will return to the issues surrounding corporate governance reform in Japan in Unit 4.

Figure 1.1 Environmental, social and governance value remains strongly influenced by corporate governance concerns

Average monthly dispersion in total returns between companies in top-decile and lowest-decile on environment, social and governance scores from 31st December 2008 to 30th June 2016

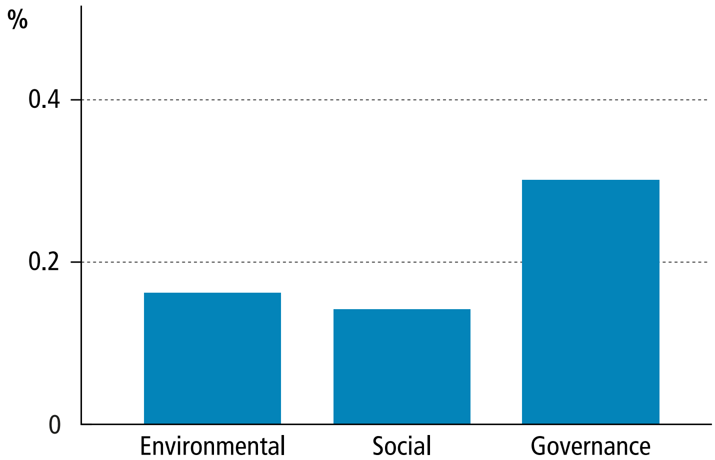
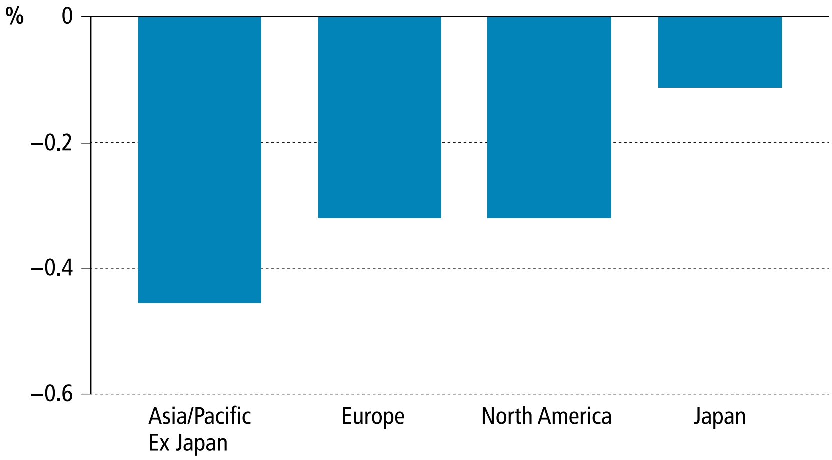


Figure 1.2 Relative returns of the most poorly governed companies by region

The average monthly return of stocks in the lowest governance decile relative to the return of the average company in the MSCI World, from 31st December 2008 to 30th June 2016



Source: Hermes Investment Management (2016) pp. 3–4

1.3 The Evolution of Corporate Structure

Until now, you have mainly examined contemporary issues in corporate governance. But where did it all start? This section addresses the history of the corporation, which will allow you to put the current structure in a historical context.

1.3.1 The first corporations in the Middle Ages

In the Middle Ages, corporations were more like municipalities than business. They included towns, universities and monastic orders. They existed as a form of collective organisation, and they represented a way to create a source of wealth and power that was free from royal domination. In this sense, they provided their members with a structure that protected them from the centralised power of autocrats.

A key feature of the first corporations was that all assets and holdings belonged to the corporation itself, independently of any particular membership. This was facilitated by the development of double-entry bookkeeping, which represented a key technique to separate a man's business from his private life.

1.3.2 The first joint-stock companies and the Bubbles Act

In response to the rapidly expanding markets of the East Indies and West Indies, British East India Company was granted a royal Charter in 1600 and Dutch East India Company was established in 1602. Chartered companies could issue shares with unlimited duration.

Unchartered companies followed suit for 120 years without any regulation. The Bubbles Act of 1720 was a response to excessive speculation in the shares of these companies, which resulted in the crash of the South Sea

Bubble. The Act forbade unchartered companies to issue shares and established a certificate of incorporation.

Although corporate power in the beginning was a threat to the power and wealth of monarchy and church, the corporate form soon emerged as the government's ally. Why was this? If the state permits private property, then society needs the government to protect citizens in the useful enjoyment of that property. The rise of the joint stock company necessitated a greater role for the state in regulation and legislating for its operation.

Study Note 1.1

Specialisation and the corporate structure

The emergence of the corporate structure is as important in transforming commerce as the assembly line is in mass production. Both are based on 'specialisation'. Specialisation is at the core of the corporate form. For example, you don't need to know how to make a complete chair to work in a chair factory – your job is likely to be simply to put the chair leg into the seat. You don't need to know how to make a chair to invest in a chair company. All you need to do is to buy some shares. The corporation form – in particular, the joint-stock company – is necessary for the efficient organisation of talent, money and other factors and energies in the pursuit of technological and industrial progress.

The practical and theoretical considerations underpinning the rise of the modern corporation will be examined in greater detail in Units 2 and 3.

1.4 Corporate Governance, Capital Formation, Corporate Finance and Economic Growth

Before you proceed to study the following units, it is a good idea to familiarise yourself with the relationship between corporate governance and other aspects of finance and economics. Because corporate governance affects such a broad range of stakeholders, you should consider its impacts on the macro economy. Important questions to consider include the following:

- How does corporate governance affect capital formation?
- How does it affect the financing of corporations?
- How does it impact on economic growth?
- Can we say there is a link between good governance and economic growth?

While it is difficult to establish a direct empirical link between good corporate governance and economic performance, we can look at the consequences of poor corporate governance in terms of financial crises in Asia in 1997–1998 and the Global Financial Crisis in 2007–2009.

The Asian Financial Crisis illustrated how the vital institutional architecture, which underpins investor confidence, simply did not exist. The result was a massive flight of funds from these markets to the relative safety of developed markets. The consequences for developing economies were catastrophic. Currency, bond and equity markets collapsed, large numbers of companies were declared bankrupt and western investors withdrew large quantities of much needed capital. However, it did have the effect of kick-starting a debate in these counties over how best to improve corporate governance.

Just as the Asian Financial Crisis challenged the economic assumptions underpinning that region, the Global Financial Crisis has raised significant questions over whether the Anglo Saxon system offers the optimal solution to corporate governance problems. Although the supposed strength of the Anglo Saxon system was its delegation of control to the board of directors, the Global Financial Crisis exposed a fundamental flaw in the view that the board of directors was best placed to manage risk.

In the rest of this section, you will now consider some of the main lessons from the Asian and Global Financial Crises, and the contribution good governance can make to avoid these problems.

1.4.1 Lessons from the financial crises

The Asian Financial Crisis in 1997/1998 provided the following lessons:

- Weak corporate governance system characterised by cronyism and corruption distorts the efficient allocation of resources.
- It undermines opportunities to compete on a level playing field.
- It leads to failure of confidence, which spreads rapidly from individual companies to entire economies.
- It ultimately hinders investment and economic development.

Although the long term implications of the Global Financial Crisis have yet to be fully understood, some early lessons that might be considered include the following:

- Increasing complexity and interconnectedness of financial institutions meant that they became in effect 'too big to fail'.
- Increasing complexity also meant that regulators were willing to tolerate a certain amount of moral hazard in financial regulation. A moral hazard is typically understood as one where a responsible party, such as a bank making a loan, has an incentive to put their own interests above those of other stakeholders. Because the bank is 'too big to fail', moral hazard is said to lead to excessive risk taking. It was assumed that banks and their boards were best placed to manage this risk.
- Incentives within the financial system were distorted at both the individual and institutional levels. At both levels private rewards and social returns were misaligned (Stiglitz, 2010).
- Firms with more independent directors and greater institutional ownership, features often regarded as the cornerstone of good corporate governance under the Anglo Saxon system, did not necessarily perform any better than those that did not meet these criteria (Erkens *et al*, 2012).

- Boards of directors and shareholders may have placed too much emphasis on maximising shareholder returns which in turn led to excessive risk taking, while the importance of corporate culture, ethics and professionalism were routinely overlooked as valuable characteristics of corporate governance.

We will examine the implications of the recent financial crisis on areas such as executive compensation and global reforms in later units.

1.4.2 The contribution of effective corporate governance

How does good governance practice overcome these problems? Just like any approach, there are limits to what better corporate governance can achieve in the absence of a credible institutional structure. However, there are a number of ways in which we believe better corporate governance can contribute to economic improvements. These include the following:

- Good corporate governance promotes the efficient use of resources both within the company and the economy.
- It helps debt and equity capital flow to the most efficient users.
- It is capable of the timely replacing of those managers who do not put scarce resources to efficient use, or are incompetent, or corrupt.
- It helps to boost both domestic and international investors' confidence, and thus assists companies (and economies) to attract lower-cost investment capital (both debt and equity).
- It provides incentives to the board to ensure compliance with the laws, regulations and societal expectations.

Although better governance does not guarantee improved performance at the individual firm level, it makes companies more actively respond to changes in business environment. It is a check on the power of the relatively few individuals within the corporation who control large amount of other people's money, thus reducing the likelihood of corrupt behaviour.

Reading 1.4

Monks & Minow (2011) Extract from Chapter 5 'International Governance', in *Corporate Governance.*

The Asian Financial Crisis provided a costly lesson on the dangers of weak governance for both the economies of Asia and the investors who invested in them during the late 1990s. It also resulted in a coordinated domestic and international effort to improve governance in the region. These included changes at both the firm level and the macro level environment. You should now read Monks and Minow's brief account of the changes that occurred after the crisis, 'World Bank and G7 Response', on pages 458–59 of *Corporate Governance*. You might like to compare these efforts with the response to the Global Financial Crisis, over a decade later.

1.5 Conclusion

Interest in corporate governance has continued to gather momentum around the globe due to a host of factors, but mainly driven by the demand of investors. You should now understand the key concepts relating to the subject of corporate governance, and the developments that have occurred. It is important for you to understand that the study of corporate governance is the study of connections among relationships across a wide variety of corporate 'constituents'. It is bound to be interdisciplinary. You will benefit by adopting a broad analytical perspective and by taking a practical approach to the issues you encounter.

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