Part I

Corporate governance: frameworks and mechanisms

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Chapter 1

Defining Corporate Governance

Aims and Objectives

This chapter provides an introduction to the corporate governance discipline, predominantly from a UK perspective. The specific objectives of this chapter are to:

- discuss a range of definitions of corporate governance in order to arrive at a definition that is appropriate for this text, appreciating the dynamic nature of the subject;
- appreciate the development of corporate governance from a historical perspective;
- compare and contrast several theoretical frameworks that are applied to the corporate governance discipline;
- demonstrate the growing importance of a stakeholder-oriented approach to corporate governance;
- consider the frontiers of academic research in corporate governance.

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Introduction

'Corporate governance' has become one of the most commonly used phrases in the current global business vocabulary. The global financial crisis and credit crunch which have engulfed financial markets and economies around the world, causing bank failures and resulting in a recession in the UK and elsewhere, have further catapulted corporate governance onto centre stage. Increasingly, weaknesses in corporate governance are being held up as reasons for and causes of the current crisis. Excessive executive remuneration, failures in risk management and internal control systems, weak monitoring, lack of independence in the boardroom and a distinct dearth of boardroom ethics are being blamed for the liquidity crisis and its repercussions. There is a public outcry at the way in which bankers have taken risks which have led to the crisis, at the same time receiving massive salaries and bonuses, with calls for

greater accountability from the banking sector. The notorious collapse of Enron in 2001, one of America's largest companies, focused international attention on company failures and the role that strong corporate governance needs to play to prevent them. Similarly, corporate crises such as Parmalat have shown that corporate governance weaknesses in different economies around the world can lead to similar problems. The UK responded to Enron by producing the Higgs Report (2003) and the Smith Report (2003), whereas the US produced the Sarbanes–Oxley Act (2002). However, the effectiveness of these principles and codes of corporate governance best practice may be called into question in the light of recent events.

Although the UK and the USA responded sharply and effectively to the failure of Enron, by strengthening the corporate governance framework, something seems to be missing from their efforts. Although policy-makers focused on strengthening systems of internal control (internal audit, audit committees and the role of non-executive directors, for example), the current crisis is riddled with corporate governance failures emanating from poor risk management, inadequate internal controls and weak monitoring of boards. What has gone wrong? Frameworks for 'good' corporate governance are embedded in the UK, the USA and elsewhere around the world, but for some reason these frameworks have not delivered protection to major banks and other significant organizations. The links between weak corporate governance and corporate collapse are now being made for the first time in relation to the current crisis. Corporate governance problems were identified as primary causes for previous corporate failures. So why were lessons not learned? Why did banks and other organizations repeat earlier mistakes, when they were so well-publicized? This is a mystery for academics and policy-makers alike, and remains a question requiring debate, even when this book has explored various possibilities.

Nations around the world have instigated far-reaching programmes for corporate governance reform for some years now, as evidenced by the proliferation of corporate governance codes and policy documents, voluntary or mandatory, both at the national and supra-national level. See Figure 7.1 in Chapter 7 for an illustration of how corporate governance best practice is being diffused around the world through the gradual development of codes of practice in a profusion of countries. In my view the present focus on corporate governance will be maintained into the future and over time, especially given recent events. The phenomenal growth of interest in corporate governance has been accompanied by a growing body of academic research. As the discipline matures, far greater definition and clarity are being achieved concerning the nature of corporate governance. Furthermore, as the discipline matures both in terms of academic research and in terms of policy-making and codes of practice, the definition of corporate governance is evolving rapidly. As we shall see throughout this chapter, corporate governance is a dynamic concept which has grown and transformed in many varied ways over the last 15 years. It is likely that corporate governance will continue to evolve in the future both passively, in response to events, but also actively, as academics and practitioners seek to improve continuously the accountability of organizations to stakeholders and to society as a whole.

One of the most significant developments in corporate governance has been its increasingly inclusive nature, with stakeholder concerns being of growing importance to companies worldwide. For instance, the ever-worsening climate change crisis is becoming a crucial aspect of companies' strategic decision-making and risk management systems. Some may suggest that financial aspects of corporate governance

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need to be addressed before issues such as climate change. However, it is not possible for the corporate community and policy-makers to focus exclusively on the financial crisis: the climate crisis is happening at the same time and cannot be pushed to one side while financial issues are addressed. Indeed, climate change may offer solutions as well as problems in the current climate of financial depression, as 'green' technologies offer opportunities for economic development, as they attempt to solve the problems associated with climate change. This chapter considers the broad-ranging nature of corporate governance and the many ways of defining the subject. Corporate governance is now discussed from a theoretical perspective, setting the scene for the following chapters.

What is corporate governance?

There is no single, accepted definition of corporate governance. There are substantial differences in definition according to which country is considered. The main focus of this chapter and the following five is the agenda for corporate governance reform, mainly from a UK perspective. However, corporate governance failures in the USA and Italy are used in Chapter 2 to demonstrate the need to improve corporate governance mechanisms. Even within the confines of one country's system, such as the UK, arriving at 'a' definition of corporate governance is no easy task, especially given the evolving and dynamic nature of corporate governance. Corporate governance as a discipline in its own right is relatively new. The subject may be treated in a narrow or a broad manner, depending on the viewpoint of the policy-maker, practitioner, researcher or theorist. It seems that existing definitions of corporate governance fall along a spectrum, with 'narrow' views at one end and more inclusive, 'broad' views placed at the other. One approach towards corporate governance adopts a narrow view, where corporate governance is restricted to the relationship between a company and its shareholders. This is the traditional finance paradigm, expressed in 'agency theory' and epitomized in the definition encapsulated in the Cadbury Report (1992), which defined corporate governance as, '. . . the system by which companies are directed and controlled'. At the other end of the spectrum, corporate governance may be seen as a web of relationships, not only between a company and its owners (shareholders) but also between a company and a broad range of other 'stakeholders': employees, customers, suppliers, bondholders, to name but a few. Such a view tends to be expressed in 'stakeholder theory'. This is a more inclusive and broad way of treating the subject of corporate governance and one which has gradually attracted greater attention in recent years, as issues of accountability and corporate social responsibility are brought to the forefront of policy and practice in the UK and elsewhere. A relatively early definition of corporate governance sought to establish a broader remit for corporate governance than that enshrined in agency theory:

> . . . the governance role is not concerned with the running of the business of the company *per se*, but with giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations of accountability and regulation by interests beyond the corporate boundaries
>
> (Tricker, 1984)

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However, it is interesting that the recent Walker Review (2009) defined corporate governance as follows:

> The role of corporate governance is to protect and advance the interests of shareholders through setting the strategic direction of a company and appointing and monitoring capable management to achieve this
>
> (Walker Review, 2009, p. 19)

Despite the far-reaching impact of the current global financial crisis and the now generally acknowledged need for corporate governance to be treated in a more stakeholder-inclusive manner, the Walker Review tends to assume a rather shareholder-centric approach to corporate governance.

In general, the definitions of corporate governance found in the literature tend to share certain characteristics, one of which is the notion of accountability. Narrow definitions are oriented around corporate accountability to shareholders. Some narrower, shareholder-oriented definitions of corporate governance focus specifically on the ability of a country's legal system to protect minority shareholder rights (e.g., La Porta *et al*., 1998). However, such definitions are mainly applicable to cross-country comparisons of corporate governance, and at present we are focusing on corporate governance within the UK. We return to the legal influence on different systems of corporate governance around the world in Chapters 7 and 8. Broader definitions of corporate governance stress a broader level of accountability to shareholders and other stakeholders.

The broadest definitions consider that companies are accountable to the whole of society, future generations and the natural world. This text presents a relatively broad definition of corporate governance for the purposes of this book, based on my own view of corporate governance issues. For the purposes of this book, corporate governance is defined as *the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity*. A broader, more stakeholder-oriented approach to corporate governance is essential in today's society.

This text attempts to show throughout that theoretical frameworks based exclusively on shareholder accountability are not necessarily inconsistent with theoretical frameworks which champion stakeholder accountability. The reason underlying this argument is that shareholders' interests can only be satisfied by taking account of stakeholder interests, as companies that are accountable to all of their stakeholders are, over the long term, more successful and more prosperous. This approach also encapsulates the concept of the 'business case' which we will mention later, as well as the current approach of the European Union and the UK to adopt the 'enlightened shareholder' approach. The above definition of corporate governance therefore rests on the perception that companies can maximize value creation over the long term, by discharging their accountability to all of their stakeholders and by optimizing their system of corporate governance. This view is supported by the emerging literature. Some of this literature is discussed in Chapters 9 and 10, specifically. Indeed, my own empirical research has provided substantial support for the view that corporate financial performance is positively related to corporate governance. The research findings provide substantial evidence to suggest a growing perception among institutional investors in the City of London and within the corporate community, that there is a corporate governance

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dividend as well as a dividend attached to stakeholder accountability. Indeed, I have found from my research that one reason 'good' corporate governance, as well as corporate social responsibility, is linked significantly to good corporate financial performance is its link with management quality. Better managers instigate better corporate governance and pay attention to their stakeholders. Better managers also manage companies more effectively and produce higher financial returns. This view was expressed by an investment analyst in a large UK investment institution, who commented that:

> I feel that organisations that demonstrate a commitment to a broad range of stakeholders are likely to show better management skills than those that do not . . .[1]

The Higgs Report (2003) reflected a similar sentiment, emphasizing a strong link between good corporate governance, accountability and value creation, in the following:

> . . . the UK framework of corporate governance . . . can clearly be improved . . . progressive strengthening of the existing architecture is strongly desirable, both to increase corporate accountability and to maximise sustainable wealth creation.
>
> (Higgs Report, 2003, p. 12, para. 1.13)

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The agenda for corporate governance and risk management launched recently by the ACCA confirms the important role which stakeholders are now afforded in corporate governance:

> In acting as good stewards, boards should work for the organisation's success. Boards should also appropriately prioritise and balance the interests of the organisation's different stakeholders. In a shareholder owned company, shareholder interests are paramount but their long term interests will be best served by considering the wider interests of society, the environment, employees and other stakeholders as well.
>
> (ACCA, 2008)

Overall, this perception is growing among the professional community, and academic research is beginning to provide empirical evidence in support of this view of corporate governance, accountability and corporate profitability. However, this is the 'business case' for corporate governance and, more generally, for corporate social responsibility. Should companies improve corporate governance and discharge accountability to all of their stakeholders purely because it is ethical? These ethical issues are discussed in the subsection on stakeholder theory on p. 14. In the real world, it is unlikely that businessmen and investors will be interested in acting ethically unless there are positive financial returns to be made from

[1] This view was expressed in a questionnaire arising from a collaborative research project I was involved in. The questionnaire survey was conducted in January 2003 and was distributed to all of the members of the Society of Investment Professionals, who amount to over 4000 investment analysts, fund managers, trustees, *inter alia*. The survey focused specifically on social, ethical and environmental disclosure and socially responsible investment, as an important aspect of corporate governance.

so doing. As there appears to be a strong business case underlying corporate governance reform and stakeholder accountability, then the corporate and financial communities are more likely to embrace these approaches. Having provided an introduction to corporate governance and a sample of the many approaches to defining the subject, it is time to discuss a number of theoretical frameworks that are used to analyse corporate governance issues.

Theoretical frameworks

A number of different theoretical frameworks have evolved to explain and analyse corporate governance. Each of these frameworks approaches corporate governance in a slightly different way, using different terminology, and views corporate governance from a different perspective, arising from a different discipline (e.g., the agency theory paradigm arises from the fields of finance and economics, whereas transaction cost theory arises from economics and organizational theory). Other frameworks, such as stakeholder theory, arise from a more social-orientated perspective on corporate governance. Although there are marked differences between the various theoretical frameworks, as they each attempt to analyse the same problems but from different perspectives, they do share significant commonalities. Further, the frameworks overlap theoretically. This section aims to outline some of the most commonly used theoretical frameworks in accounting and finance-related disciplines and to specify some of the commonalities and differences between these competing paradigms. Agency theory, transaction cost theory and stakeholder theory are examined. Other approaches include organization theory and stewardship theory (see Tricker, 1978). It is also important to recognize that there are cultural and legal influences on corporate governance, which are considered in Part II, where relevant.

To appreciate fully the various theories of corporate governance, it is useful to review briefly the development of stock markets, as their structure and operations have led to the development of agency theory. For the purposes of this chapter, the development of limited liability is revisited, with the aim of laying the foundations of agency theory.[2] Before stock markets developed, companies relied on finance from wealthy individuals, usually relatives of the entrepreneur. Companies were owned and run by the same people. For economies to grow, it was necessary to find a large number of different investors to provide money for companies, so that they could expand. The principal element of today's stock markets, which has encouraged investors to buy shares, thereby ensuring a steady flow of external finance for companies, is known as limited liability. This was developed in 1855 and means that *shareholders are not responsible for the debts* of the companies in which they invest. The development of limited liability meant that investors were more prepared to buy shares, as all they would risk was their investment – not their entire wealth. A stock market is a means by which a company can raise capital by selling shares to investors, who become shareholders. Not only can investors buy shares, but also these financial

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[2] Arnold (1998) provided a detailed history of the development of stock markets as a way for companies to obtain finance and is a useful text for students to read in order to appreciate the links between the development of UK capitalism and corporate finance.

securities may be traded on the stock market. It is important to remember that the only time the company receives any funds is when the shares are sold for the first time. The important issue from a theoretical viewpoint is that in buying a share, even though an investor does not jeopardize his entire wealth, he is becoming an 'owner' of the company. However, although the majority of shareholders own, in part, the investee company, they have little to do with running the company, as this is the job of the company directors, to whom they entrust their funds.

Agency theory

The introduction of limited liability and the opening up of corporate ownership to the general public through share ownership had a dramatic impact on the way in which companies were controlled. The market system in the UK and the USA, *inter alia*, is organized in such a way that the owners, who are principally the shareholders of listed companies, delegate the running of the company to the company management. There is a separation of ownership and control that has led to the notorious 'agency problem'. Berle and Means (1932) discussed the extent to which there was a dispersion of shareholding, which consequently led to a separation of ownership and control in the USA. Prais (1976) showed that a similar structure of ownership and control operated in the UK. The agency problem was first explored in Ross (1973), with the first detailed theoretical exposition of agency theory presented in Jensen and Meckling (1976). They defined the managers of the company as the 'agents' and the shareholder as the 'principal' (in their analysis there is one shareholder versus the 'managers'). In other words, the shareholder, who is the owner or 'principal' of the company, delegates day-to-day decision-making in the company to the directors, who are the shareholder's 'agents'. The problem that arises as a result of this system of corporate ownership is that the agents do not necessarily make decisions in the best interests of the principal. One of the principal assumptions of agency theory is that the goals of the principal and agent conflict. In finance theory, a basic assumption is that the primary objective for companies is shareholder wealth maximization. In practice this is not necessarily the case. It is likely that company managers prefer to pursue their own personal objectives, such as aiming to gain the highest bonuses possible. Managers are likely to display a tendency towards 'egoism' (i.e., behaviour that leads them to maximize their own perceived self-interest; Boatright, 1999). This can result in a tendency to focus on project and company investments that provide high short-run profits (where managers' pay is related to this variable), rather than the maximization of long-term shareholder wealth through investment in projects that are long-term in nature. Hence British industry has been notorious for 'short-termism'. Interestingly, short-termist attitudes due to flawed remuneration structures and excessive risk-taking have been blamed in part for the current crisis in the world banking sector.

Short-termism has been defined as a tendency to foreshorten the time horizon applied to investment decisions, or raise the discount rate above that appropriate to the firm's opportunity cost of capital (Demirag and Tylecote, 1992). It is considered to characterize countries that are classified generally as 'outsider-dominated' (see Franks and Mayer, 1994; Short *et al*., 1998), where this means that the economy is not only dominated by large firms controlled directly by their managers but also indirectly through the actions of outsiders, such as institutional investors. This categorization of corporate

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governance systems is discussed in more detail in Chapter 7. Further, short-term pressure on companies has arisen from the institutional investment community, who have been more interested in gaining quick profits from portfolio investment than in the long-term survival and growth of their investee companies. They have been accused of 'churning' shares in order to make high returns on investment, regardless of the effects of their actions on managers, who as a consequence have been under pressure to focus on short-term performance (Sykes, 1994). This aspect of institutional investment is covered in more depth in Chapter 5.

In this corporate governance environment, managers are tempted to supplement their salaries with as many perquisites (such as holidays through the company, office equipment and the like) as possible – again leading to a reduction in shareholder value. The reduction in shareholder's welfare is known as the 'residual loss' in agency theory terminology. Overall, we can see that the ownership structure in the UK (and in other countries with similar market systems) leads to a significant problem of divergent objectives. This 'agency problem' presents shareholders with a need to control company management.

An important question is therefore, 'how can shareholders exercise control over company management?' Another important and basic assumption of agency theory is that it is expensive and difficult for the principal to verify what the agent is doing (see Eisenhardt, 1989). There are a number of ways in which shareholders' and managers' interests may be aligned, but these are costly. Agency costs arise from attempts by the shareholder to 'monitor' company management. Monitoring by the shareholder is expensive, as it involves initiating activities such as shareholder engagement (expensive on resources and time-consuming). Incentive schemes and contracts are examples of monitoring techniques. The literature shows that solutions to agency problems involve establishing a 'nexus' of optimal contracts (both explicit and implicit) between management and the company's shareholders. These include remuneration contracts for management and debt contracts. These contracts seek to align the interests of the management with those of the shareholder. Although agency costs arise from establishing these contracts, costs are also incurred from the agents' side. Managers are keen to demonstrate to the shareholder that they are accountable and that they are following the shareholder wealth maximization objective. They may provide extra information about risk management in their annual reports, for example, which will add costs to the accounting process. They may expend additional resources in arranging meetings with primary shareholders. The costs associated with such initiatives are referred to as *ex-ante* bonding costs. The total agency cost arising from the agency problem has been summarized as comprising of: the sum of the principal's monitoring expenditures; the agent's bonding expenditures; and any remaining residual loss (see Hill and Jones, 1992). One of the main reasons that the desired actions of principal and agent diverge is their different attitudes towards risk. This is referred to as the problem of 'risk sharing', as managers and shareholders prefer different courses of action because of their different attitudes towards risk (see Shankman, 1999).

We now consider the direct ways in which shareholders can 'monitor' company management and help to resolve agency conflicts. These methods of shareholder activism and their impact are discussed in more detail in Chapter 5. First, as owners of the company, shareholders have a right to influence the way in which the company is run, through voting at AGMs. The shareholder's voting right is an important part of his or her financial asset. An area of the finance literature is devoted to investigating the use of voting rights by shareholders, particularly institutional investors, and some of this literature is discussed in Chapter 5. Shareholders can influence the composition of the board of directors in their investee companies (the

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companies in which they invest) through voting at AGMs. There is also a range of other issues on which shareholders may vote. Voting by shareholders constitutes 'shareholder activism'. Although the voting right is seen to constitute part of a shareholder's financial asset, institutional investors do not necessarily consider it to be a benefit, but rather an albatross around their necks. One pension fund director interviewed by the author commented that:

> There is a weakness in the present system of corporate governance in that responsibility for ownership rests with people who don't want it and are not seeking it. We are investing in shares because they give us a good return and it is coincidental really that they bring with them this responsibility. I am not saying we don't want this responsibility. I am just saying it is difficult to handle that sort of thing.

However, the same interviewee also suggested that one important result from the introduction of the Combined Code was that fund managers are taking more interest in corporate governance and in particular are voting at AGMs. As we see in Chapter 5, there have been a series of initiatives in the UK aimed at improving the voting mechanism for institutional investors by, for example, facilitating electronic voting systems.

Connected to shareholder voting rights is the takeover mechanism, which represents another means of controlling company management. Jensen and Ruback (1983) emphasize the importance of the stock market as a means of disciplining company management through the takeover mechanism. If shareholders are dissatisfied with a company's management structure they can vote in favour of a takeover. Clearly, the threat of takeover is *per se* a disciplining force on managers, as they are unlikely to want to lose their jobs. Directors' contracts represent one means by which they can gain some security, although lengthy contracts are becoming less popular as corporate governance reform continues.

Another way in which shareholders may attempt to align managers' interests with their own is through the passing of shareholder resolutions, where a group of shareholders collectively lobby the company on issues with which they are dissatisfied. This is an extreme form of shareholder activism which has been employed infrequently in the UK. An illustration of shareholder activism can be seen in the BP-Amoco case in Chapter 10 (see Illustration 10.3). Of course, shareholders also have the option of divesting (selling their shares). This is the ultimate action and represents a failure on the part of the company to retain investors, where the divestment is due to dissatisfaction with management activities. An example of this was the case of Huntingdon Life Sciences, a company that conducts scientific research through animal experimentation. Not only did this company lose its principal UK institutional investors, as they were forced to divest following lobbying by animal rights groups, but it also lost investment from institutions in the USA. There has, however, been a recent backlash, with industry lobbies in the UK retaliating against animal rights extremists by demanding greater police protection from the Government for their employees and shareholders. This case is discussed in more detail in Chapter 10 in the context of socially responsible investment (see Illustration 10.1). Clearly, if companies lose major shareholders, the market loses confidence in the company, more shareholders sell their shares and the share price plummets. Without financial support the company will fail. It is in the interests of listed companies not only to attract potential investors but also to retain them. Divestment is the ultimate threat.

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Another way in which core institutional investors can influence investee company management is through engagement and dialogue, namely one-on-one meetings between a representative from the investment institution and a manager from the company. Such meetings are taking place more and more frequently and seem to be influencing corporate behaviour in a significant way. Holland (1998) considered the function of such meetings from a financial reporting perspective, showing that private disclosure through engagement and dialogue was developing to supplement public corporate disclosure. More recently, the role adopted by one-on-one meetings as a means of disciplining company management has been explored (Roberts *et al.*, 2006). There is a distinct link between these one-on-one meetings and managerial decision-making, although the Hampel Report (1998)[3] suggested that institutional investors do not want to be involved in companies' business decisions. However, there are important legal issues involved in the content and results of these meetings. If any price-sensitive information is revealed by company management (i.e., information which, if traded on, could affect share prices) to the institutional investors, then it is against the law for the investor to trade on this information until it becomes publicly available. This has led to many controversies in the past and occasionally results in 'insider dealing', where an investor (or a member of the family of an investment manager, for example) sells or buys shares in a company on receipt of private information, in order to make personal profit. Such events are high profile and result in court cases, if information becomes public. For example, the recent Enron trials found one of the former directors guilty of insider dealing, as will be discussed in Chapter 2. The legal framework relating to insider dealing is dealt with in more detail in Chapter 5.

If the market mechanism and shareholders' ability to express themselves are not enough to monitor and control managerial behaviour, some sort of regulation or formal guidance is needed. Indeed, if markets were perfectly efficient and companies could compete in an efficient market for funds, artificial initiatives aimed at reforming corporate governance would be redundant, as:

> . . . we should not worry about governance reform, since, in the long run, product market competition would force firms to minimize costs, and as part of this cost minimization to adopt rules, including corporate governance mechanisms, enabling them to raise external capital at the lowest cost . . . competition would take care of corporate governance.
>
> (Shleifer and Vishny, 1997, p. 738)

However, markets are not perfectly competitive and therefore intervention is necessary in order to improve corporate governance, help companies to raise finance and make companies more accountable to their shareholders and other stakeholders. Agency problems do exist between companies and their shareholders throughout the world, and Governments are intervening by producing policy documents and codes of corporate governance best practice at an amazing rate, as can be seen from Figure 7.1.

Since the early 1990s several 'voluntary' codes of practice and policy documents have been developed in the UK to help companies improve their standards of corporate governance – to make companies more

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[3] This is the third significant report on corporate governance in the UK. It is discussed in detail in Chapter 3.

accountable to shareholders and other stakeholders. The Cadbury Report, Greenbury Report, Hampel Report, Turnbull Report, Higgs Report, Smith Report, Tyson Report, Turner Review and Walker Review, and their accompanying codes of practice, are introduced in Chapter 3. Although the codes of conduct and recommendations contained in the related policy documents are voluntary, companies that are listed on the stock exchange have to disclose the extent to which they comply with the codes. Fears of damage to companies' reputations arising from the potential exposure of corporate governance weaknesses renders it difficult for listed companies not to comply. A good example of this relates to the separation of chairman and chief executive. UK companies not complying with the Combined Code (updated regularly) in this area will be branded as having weak corporate governance checks and balances. Similarly, peer pressure has an effect with companies competing to be seen as compliant. The 'comply or explain' approach to corporate governance is explored in Chapter 3. We now turn to discuss a different theoretical framework for corporate governance, namely transaction cost theory.

Transaction cost theory

An exposition of transaction cost theory, describing its historical development, may be found in Williamson (1996). He stated that transaction cost theory was, '. . . an interdisciplinary alliance of law, economics, and organization . . .' (Williamson, 1996, p. 25). This discipline was initiated by Cyert and March's (1963) *A Behavioural Theory of the Firm*, a work that has become one of the cornerstones of industrial economics and finance theory. Theirs was an attempt to view the firm not as an impersonal economic unit in a world of perfect markets and equilibria, but rather as an organization comprising people with differing views and objectives. Transaction cost theory is based on the fact that firms have become so large that they, in effect, substitute for the market in determining the allocation of resources. Indeed, companies are so large and so complex that price movements outside companies direct production and the markets co-ordinate transactions. Within companies, such market transactions are removed and management co-ordinates and controls production (Coase, 1937). The organization of a company (e.g., the extent of vertical integration) seems to determine the boundaries beyond which the company can determine price and production. In other words, it is the way in which the company is organized that determines its control over transactions.

Clearly, it is in the interests of company management to internalize transactions as much as possible. The main reason for this is that such internalization removes risks and uncertainties about future product prices and quality. It allows companies to remove risks of dealing with suppliers to some extent (e.g., by owning both breweries and public houses, a beer company removes the problems of negotiating prices between supplier and retailer). Any way of removing such information asymmetries is advantageous to company management and leads to reduction in business risk for a company. There are nontrivial and prohibitive costs in carrying out transactions in the marketplace, and it is therefore cheaper for companies to do it for themselves through vertical integration. The same analysis applies equally well to the case of oil companies in their various stages of production, from oil exploration, to refining and eventual retail distribution.

Traditional economics considers all economic agents to be rational and profit maximization to be the primary objective of business. Conversely, transaction cost economics attempts to incorporate human

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behaviour in a more realistic way. In this paradigm, managers and other economic agents practise 'bounded rationality'. Simon (1957) defined bounded rationality as behaviour that was intentionally rational but only limitedly so. Transaction cost economics also makes the assumption of 'opportunism'. This means that managers are opportunistic by nature. The theory assumes that some individuals are opportunistic, some of the time. The result of assuming bounded rationality and opportunism is that companies must:

> . . . organize transactions so as to economize on bounded rationality while simultaneously safeguarding the transactions in question against the hazards of opportunism.
>
> (Williamson, 1996, p. 48)

Opportunism has been defined as 'self-interest seeking with guile' and as 'the active tendency of the human agent to take advantage, in any circumstances, of all available means to further his own privileges' (Crozier, 1964, p. 265). Given the problems of bounded rationality and opportunism, managers organize transactions in their best interests, and this activity needs to be controlled. Such opportunistic behaviour could have dire consequences on corporate finance as it would discourage potential investors from investing in companies. Immediately, we can see similarities here between agency theory and transaction cost economics, as both theories present a rationale for management to be controlled by shareholders. We now examine the ways in which transaction cost theory and agency theory are similar.

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Transaction cost theory versus agency theory

Difficulties in disentangling agency theory and transaction cost economics have been acknowledged in the literature (see, e.g., Gilson and Mnookin, 1985). Williamson (1996) addressed the extent to which agency theory and transaction cost theory provided different views of the theory of the firm and of managerial behaviour. He concluded that one of the main differences between agency theory and transaction cost theory was simply the use of a different taxonomy (i.e., using different terminology to describe essentially the same issues and problems). For example, transaction cost theory assumes people are often opportunistic, whereas agency theory discusses moral hazard and agency costs. Agency theory considers managers pursue perquisites whereas in transaction cost theory managers opportunistically arrange their transactions. Another difference is that the unit of analysis in agency theory is the individual agent, whereas in transaction cost theory the unit of analysis is the transaction. However, both theories attempt to tackle the same problem: 'how do we persuade company management to pursue shareholders' interests and company/shareholder profit maximization, rather than their self-interest?' They are simply different lenses through which the same problems may be observed and analysed. We now consider a third 'lens', that of stakeholder theory.

Stakeholder theory

Stakeholder theory has developed gradually since the 1970s. One of the first expositions of stakeholder theory, couched in the management discipline, was presented by Freeman (1984), who proposed a general theory of the firm, incorporating corporate accountability to a broad range of stakeholders. Since

then, there has been an abundance of writing based on stakeholder theory, across a wide array of disciplines (see, e.g., Donaldson and Preston, 1995). The role of companies in society has received increasing attention over time, with their impacts on employees, the environment, local communities, as well as their shareholders, becoming the focus of debate. Social and environmental lobby groups have gathered information on business activities and have targeted companies that have treated their stakeholders in an unethical manner.

Stakeholder theory may be viewed as a conceptual cocktail, concocted from a variety of disciplines and producing a blend of appealing sociological and organizational flavours. Indeed, stakeholder 'theory' is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational social science (Wheeler *et al*., 2002). A basis for stakeholder theory is that companies are so large, and their impact on society so pervasive, that they should discharge an accountability to many more sectors of society than solely their shareholders. There are many ways of defining stakeholder theory and 'stakeholders', depending on the user's disciplinary perspective. One commonality characterizing all definitions of stakeholders is to acknowledge their involvement in an 'exchange' relationship (Pearce, 1982; Freeman, 1984; Hill and Jones, 1992). Not only are stakeholders affected by companies, but they in turn affect companies in some way. They hold a 'stake' rather than simply a 'share' in companies. Stakeholders include shareholders, employees, suppliers, customers, creditors, communities in the vicinity of the company's operations and the general public. The most extreme proponents of stakeholder theory suggest that the environment, animal species and future generations should be included as stakeholders. Indeed, the stakeholder relationship has been described as one of exchange, where the stakeholder groups supply companies with 'contributions' and expect their own interests to be satisfied via 'inducements' (March and Simon, 1958). Using this analytical framework, the general public may be viewed as corporate stakeholders because they are taxpayers, thereby providing companies with a national infrastructure in which to operate. In exchange they expect companies as 'corporate citizens' to enhance, not degrade, their quality of life (Hill and Jones, 1992). Indeed, every stakeholder represents part of the nexus of implicit and explicit contracts that constitutes a company. However, many writers refer to 'stakeholders' simply as those who have a legitimate stake in the company, in the broadest sense (Farrar and Hannigan, 1998).

In the UK, the Corporate Report (ASSC, 1975) was a radical accounting proposal for its time, which suggested that companies should be made accountable for their impact on a wide group of stakeholders. The way that the Corporate Report hoped to achieve this was by encouraging companies to disclose voluntarily a range of statements aimed for stakeholder use, in addition to the traditional profit and loss account, and balance sheet. The additional statements included a statement of value added, an employment report, a statement of money exchanges with Government, a statement of transactions and foreign currency, a statement of future prospects and a statement of corporate objectives. This was the first time that such an all-encompassing approach to financial reporting was considered seriously by a professional UK accounting body. The report excited substantial controversy, although its impact was negligible at the time. One reason for the apparent dismissal of the Corporate Report was the change of Government, with the Conservative Party coming to power in 1979 and advocating a more free-market approach than the Labour Party. In more recent years, however, a stakeholder approach to accounting and finance has become more acceptable, particularly in light of the change of Government from Conservative to Labour

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in 1997 and the growing emphasis on an 'inclusive' society. Indeed, Wheeler and Sillanpää (1997) explained the importance of developing a stakeholder society and highlighted the need for companies to be accountable to a wide range of stakeholders. Their book was endorsed by Tony Blair, the UK Prime Minister, as the 'right' approach to industrial activity.

Linked to stakeholder theory is the idea of corporate social responsibility, which is explored more fully in Chapter 9. This is becoming a major issue for companies in the current political and social climate. Companies are being actively encouraged by social and environmental lobby groups to improve their attitudes towards stakeholders and to act in a socially responsible manner. One motivation for encouraging corporate social responsibility derives from a belief that companies have a purely moral responsibility to act in an ethical manner. This 'pure ethics' view assumes that companies should behave in a socially responsible way, satisfying the interests of all of their stakeholders, because this is 'good'. This is intuitively appealing. Quinn and Jones (1995) defined this approach as 'noninstrumental ethics', arguing that company managers have no special rules that allow them to ignore their moral obligations as human beings and that, whether ethical behaviour is profitable or not, it must be adhered to. They provided strong analytical arguments that agency theory could only be applied effectively if four moral principles were adhered to: avoiding harm to others; respecting the autonomy of others; avoiding lying; and honouring agreements. Indeed, they claimed that the principal–agent model could only hold if it was embedded in the setting of these four moral principles. Why should the 'moral obligation' to 'keep a promise' to maximize shareholder wealth be any more important, or supersede, basic human principles, such as avoiding harm to others? In other words:

> How can one be morally bound to an agreement to ignore one's other moral obligations?
>
> (Quinn and Jones, 1995, p. 36)

This argument formed the basis of their exposition of 'agent morality', where agents must first attend to their basic moral duties as human beings, as they have no special dispensation from moral obligations. Only after meeting these moral obligations could they attend to their obligation to maximize shareholder wealth.

Company law, however, makes a purely ethics-motivated approach to business impractical, as companies have a legal and fiduciary obligation to shareholder wealth maximization.[4] Similarly, institutional investors have a legal, fiduciary obligation to maximize the returns of their clients. The issue of fiduciary duty and the growing relevance of environmental, social and governance considerations for institutional investors are discussed in Chapter 10. These legal obligations mean that the 'business case' for corporate social responsibility is the only realistic approach for company management. The legal system has been shown to be a significant barrier to the non-instrumental ethics case for business in the USA (Quinn and Jones, 1995). The basic philosophy of separate legal personality of companies, as famously encapsulated

[4] A 'pure ethics' motive attracts derision from many members of both the professional and academic community, who view it as completely impractical and unrealistic. For example, one of our academic colleagues, who will remain nameless, dismisses a pure ethics approach as the 'pink fluffy bunny' view of corporate governance.

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in the *Salomon versus A. Salomon & Co. Ltd* decision (see Farrar and Hannigan, 1998), is incompatible with a framework that makes directors personally accountable for their behaviour. Even the latest review of company law in the UK, which has attempted in its various drafts to stress the needs for business to be accountable to stakeholders, has ultimately resigned corporate social responsibility to a back seat, based on the 'materiality' of social, environmental and ethical risks to the business. In other words, companies should only take account of these factors in so far as they affect the bottom line. The implications of the Modernising Company Law (2002) review for corporate social responsibility and socially responsible investment are discussed, within the context of corporate governance, in Chapter 9. It is almost impossible to pursue ethical business unless it is demonstrated to be profitable, not only because of the attitudes of managers and shareholders but also because of our legal system and corporate governance structures. There has to be a strong business case for corporate social responsibility if companies are going to pursue it enthusiastically. It would take more than a change in attitude to reconstitute company law in the UK and elsewhere. A typical illustration of the 'business case' or 'instrumental ethics' approach to social responsibility may be found in a report produced by Rio Tinto:

> The business case underpinning our commitment to sustainable development has become more compelling. Companies that maintain high standards across the full spectrum of their social, environmental and economic performance have shown that they attract the best people, enhance the motivation and commitment of their employees and sustain the loyalty of their customers. They typically enjoy strong relationships with other stakeholders and benefit from a stronger corporate reputation. All these add to shareholder value.
>
> (Report to Society, Rio Tinto, 2004, p. 2)

This illustration is used by Jones (2006), who contrasts the pure ethics case, encapsulated in a subjective framework for environmental responsibility, with the 'real-life business case' demonstrated through corporate social reporting. He shows that companies are reporting on the environment unequivocally for 'business case' motives. The extent to which stakeholder theory and agency theory may be considered together, rather than be viewed as mutually exclusive, is now assessed.

Stakeholder versus agency theory

Is it possible that companies can maximize shareholder wealth, in an agency theory framework, at the same time as satisfying a broad range of stakeholder needs? In other words, 'is there any consistency between stakeholder theory and agency theory?' The importance of this question, and related questions, cannot be overstated, given the pervasive impact that businesses have on society in our consumer-led, multinational-driven world. Yet the answer remains elusive. Modern frameworks for business which depict a 'sustainable organization' culture within a corporate community and which also recognize the interdependencies and synergies between the company, its stakeholders, value-based networks[5] and

[5] Wheeler *et al.* (2002) used the term Value Based Networks (VBNs) to refer to new communities that are being created from a desire (or need) to create and increase value.

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society are emerging from the academic literature. Such an approach to business seeks to maximize value creation, through simultaneous maximization of economic, social and ecological welfare. Some academic work has provided empirical evidence that stakeholder management leads to improved shareholder value (Hillman and Keim, 2001).[6] However, stakeholder theory has long been vilified as the anathema of shareholder-based agency theory (e.g., Sternberg, 1998). We revisit this perspective, embodied in the work of Milton Friedman, in Chapter 9. From this viewpoint, the only moral obligation facing managers is to maximize shareholder return, as this results (in an efficient market) in the 'best' allocation of social resources (see, e.g., Drucker, 1982; Jensen, 1991). The continual friction between these two theoretical frameworks was discussed by Shankman (1999), who pointed out that agency theory has for a long time represented the dominant paradigm for business and that the conflict between agency and stakeholder theories of the firm can be characterized as:

> . . . an ongoing struggle between economic views of the firm which are decidedly silent on the moral implications of the modern corporation, and ethicists who place the need for understanding ethical implications in a central role in the field of business ethics.
>
> (Shankman, 1999, p. 319)

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Indeed, on a theoretical basis, there are significant differences between the two theoretical paradigms, which at first sight render the two theories irreconcilable. For example, Shankman (1999) described stakeholder theory, but not agency theory, as normative in orientation, showing that the whole theoretical and philosophical underpinnings of the two theories were at variance. Nevertheless, there is a growing perception among theorists and practitioners that these two paradigms may be compatible (Wheeler *et al*., 2002) and that an altered approach to their theoretical derivation may allow them to be treated within one framework. For example, Shankman (1999) argued that agency theory may be subsumed within a general stakeholder model of companies, as:

(i) stakeholder theory is the necessary outcome of agency theory and is thus a more appropriate way to conceptualize theories of the firm;

(ii) agency theory, when properly modified, is at best a narrow form of stakeholder theory;

(iii) the assumptions about human behaviour and motivation implicit in agency theory are contradictory; and

(iv) all theories of the firm must uphold an implicit moral minimum that includes certain fundamental rights and principles and assumptions of human behaviour that may very well require other traditional theories of the firm to be modified or even reconceived.

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[6] Hillman and Keim (2001) used an index to measure stakeholder performance for companies, known as the Kinder, Lydenburg, Domini Index. This index was compiled by an independent rating service that focuses exclusively on ranking approximately 800 companies according to nine areas of social performance.

Similarities between the theoretical standpoints are evident on close examination. For example, it is the manager group of stakeholders who are in a position of ultimate control, as they have decision-making powers allowing them to allocate the company's resources in a manner most consistent with the claims of other stakeholder groups (Hill and Jones, 1992). This means that it is company management who are ultimately responsible for satisfying stakeholders' needs and expectations. Using agency theory terminology, given their unique position of responsibility and accountability, managers' interests need to be aligned not only with shareholders' interests but also with the interests of all other stakeholder groups. As stated in Hill and Jones (1992):

> . . . there is a parallel between the general class of stakeholder–agent relationships and the principal–agent relationships articulated by agency theory. Both stakeholder–agent and principal–agent relationships involve an implicit or explicit contract, the purpose of which is to try and reconcile divergent interests. In addition, both relationships are policed by governance structure.
>
> (Hill and Jones, 1992, p. 134)

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Balancing the needs and interests of different stakeholder groups is notoriously difficult. This should not however be used as an excuse for making no effort to achieve such a balance. Hill and Jones (1992) also pointed out that many of the concepts and language of agency theory could be applied equally well to stakeholder–agency relationships. Overall, they argued that principal–agent relationships, as defined by agency theory, could be viewed as a subset of the more general class of stakeholder–agent relationships. Indeed, in developing 'stakeholder–agency theory' they sought to develop a modification of agency theory aimed at accommodating theories of power arising from a stakeholder perspective. They argued that stakeholder-derived and agency theory perspectives on organizational phenomena, which have been viewed as mutually exclusive interpretations, may indeed be interpreted in one model, by making a series of assumptions about market efficiency.

The moral discourse for company management implied by agency theory and stakeholder theory is vastly different. As Quinn and Jones (1995) explained, adopting one perspective (that of agency) leads to a discourse based on self-interest, whereas adoption of the other leads to a discourse of 'duty' and social responsibility. Unless these two perspectives can be merged in some way, the managerial discourse cannot be expected to combine fully the extremes of profit-seeking self-interest and moral responsibility to society.

As discussed above, the only realistic compromise solution to this problem is to adopt the business case, rather than the pure ethics case. The business case for managers to adopt a stakeholder-oriented approach is based on the notion that 'good ethics' is 'good business', and that employing ethics as a strategic management tool increases the present value of the firm (Blanchard and Peale, 1988; Kotter and Heskett, 1992; Quinn and Jones, 1995). This is, according to Quinn and Jones (1995), an example of 'instrumental ethics' whereby managers choose an approach of corporate social responsibility in order to maximize shareholder wealth. As argued earlier, this is really the only approach to ethics that makes sense in the modern world, given the extant legal and regulatory environment confronting businesses. Unless corporate social responsibility and accountability enhance shareholder wealth, neither company management nor large institutional investors, nor small-scale shareholders would ever endorse it as a realistic approach to corporate activity. It is more realistic to accept that ethics have to be profitable in order to be

acceptable to businesses. But why should this not be the case? People are generally ethical, therefore ethical behaviour should be rewarded in a free market and unethical behaviour punished in an Adam Smith environment (see, e.g., Boatright, 1999).[7] This was certainly the case with Enron when managerial, unethical behaviour became public knowledge, as we can see from the case study in Chapter 2.[8]

It seems increasingly likely that creating value for stakeholders by businesses focusing attention on maximizing value for local communities, employees and environmental impacts (to name but a few) may be synonymous with creating financial value for shareholders. Ignoring the needs of stakeholders can lead to lower financial performance and even corporate failure. Corporate social, ethical and environmental performance is being viewed increasingly by investors as an indicator of management quality and a proxy for performance in other areas of the business. A company that is well managed is likely to have a good environmental management system and high levels of stakeholder dialogue and engagement. Indeed, the efforts made by many companies to increase the quality and quantity of cross-stakeholder dialogue are impressive. Camelot plc is a salient example of a company attempting to demonstrate an eagerness to embrace stakeholder dialogue and active engagement with diverse stakeholder groups (see Illustration 9.4 for a full discussion of this company's approach to stakeholders). However, this may be due to the company's heightened vulnerability in the area of ethics, given its core business of gambling. Nevertheless, any company with bad stakeholder relations could be characterized by poor management and consequently poor financial performance. This is one scenario – and one that is being accepted more widely in practice. There is, however, a large element of scepticism concerning the genuine improvements in stakeholder accountability arising from the increase in dialogue, as we see from the discussion in Chapter 9 (e.g., Owen *et al.*, 2001).

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An essential aspect of this debate is the extent to which satisfying the needs of a divergent group of stakeholders can also lead to satisfaction of the ultimate objective of shareholder wealth maximization. Part III of this book attempts to demonstrate that in the long term there is little inconsistency between the ultimate objective of agency theory and the practice of a stakeholder approach. It is only by taking account of stakeholder as well as shareholder interests that companies can achieve long-term profit maximization and, ultimately, shareholder wealth maximization. This belief is principally based on a growing body of literature and empirical evidence that suggests that corporate accountability which takes into account a broad range of social, ethical and environmental factors is conducive to financial performance. This text attempts to show that businesses can be ethical and profitable, by considering the growing wealth of literature endorsing a positive relationship between corporate social responsibility and corporate financial performance.

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[7] Boatright (1999) explains that Adam Smith's invisible hand may, in an ethical environment, distribute wealth to socially responsible, ethical companies and distribute wealth away from unethical companies, through the free-market mechanism.

[8] There are, however, problems with the instrumental ethics case, or business case, for corporate social responsibility, as it is difficult to see how a company is being truly 'moral' if it is only pursuing ethicality for reasons of self-interest. See Quinn and Jones (1995) for an in-depth discussion of this dilemma. For example, they comment that, 'Discussions about stock price movements, instrumental ethics, and shareholder wealth maximization obscure the true moral argument' (p. 28). They also make the point that ethics is 'hard to fake'.

The evolving framework of corporate governance

As we can see from the above discussion, the history of corporate governance has to a large extent involved an ongoing power struggle between the proponents of a narrow, shareholder-oriented approach to corporate governance and a broader, stakeholder-oriented approach. It is my view that the stakeholder-oriented, or at least the 'enlightened shareholder' view seems to be winning this battle. Certainly, in the UK this would seem to be the case, although what people aspire to and how they actually behave in practice are not always consistent, as is apparent from the current financial crisis. The UK Companies Act 2006, and its revisions, which came into effect in October 2007 have placed an emphasis on greater stakeholder accountability by companies. There have been disappointments along the way, with efforts made during the lengthy company law review process of consultation perhaps falling short of their initial intentions (as we see in later chapters), but the overall result has been a shift of emphasis away from a purely shareholder view of accountability to a far broader concept of corporate governance. Company directors are now required by law to consider long-term consequences of their decisions, their employees' interests, their relationships with suppliers and customers, the impact of their activities on the environment and local communities. This means that for the first time in history, company directors are being forced, by law, to consider non-shareholding groups. Despite all the rhetoric on stakeholder accountability which has begun to emanate from corporate disclosures, in the form of sustainability reporting and other communications (which will be dealt with in detail in Part III of this book), the current collapse of banks worldwide seems to be connected in some way to a lack of corporate 'responsibility' to non-shareholding stakeholders. The current public sentiment in the UK and elsewhere around the world is one of amazement and disillusionment at the behaviour of senior bank board members. Bank after bank revealed immense debts and losses arising from bad risk management practices, excessive risk-taking, apparent greed in terms of excessive remuneration and bonuses, and a lack of consideration for the banks' stakeholders.

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The gravity of the credit crunch, the banking crisis and its repercussions, which are taking hold of the world's economy, is causing academics and practitioners to re-evaluate their perceptions and definitions of corporate governance. The recent framework for corporate governance and risk management developed by the ACCA in the UK does, in my view, represent a stakeholder-oriented approach to corporate governance which paints a definition of corporate governance 'fit for purpose' in the current global environment of uncertainty and financial strain. Although the framework does not represent a formal code of practice, and is therefore not equivalent in potency to the Combined Code, the ACCA represents an important and influential organization, directing accounting and finance in the City of London and, through its global reach, around the world. The main tenets of this framework orbit around a stakeholder-led perspective. The ACCA (2008) state that there are three complementary purposes of corporate governance, namely:

- **(i)** to ensure the board, as representatives of the organization's owners, protects resources and allocates them to make planned progress towards the organization's defined purpose;
- **(ii)** to ensure those governing and managing an organization account appropriately to its stakeholders; and
- **(iii)** to ensure shareholders and, where appropriate, other stakeholders can and do hold boards to account.

As a working definition of corporate governance for the current environment, the ACCA's framework has, in my view, captured the current climate, spirit and meaning of corporate governance aptly. Not only does their definition focus on companies' stakeholder accountability, but it also spells out the need for shareholders and stakeholders not to remain passive recipients of accountability but to demand it actively from companies. This approach places responsibility for good governance in the hands of all parties, not just the companies and their boards of directors. The framework produced by the ACCA is summarized in Illustration 1.1 below. As we can see from this framework, the ACCA emphasize the centrality of risk and risk management to corporate governance. As we shall see in later chapters, although previous policy documents and codes of practice have introduced risk management into the corporate governance agenda (via the Turnbull Report, 1998, 2005 and the Smith Report, 2003, 2008), mechanisms relating to risk management have taken a relatively backseat role, with the primary emphasis placed on board composition and conduct. The current global credit and financial crisis have forced risk and risk management issues to the forefront of corporate governance, and the ACCA framework responds to this change in timbre. Further, the recent Turner Review (2009) (and accompanying Code of Practice) and the Walker Review (2009) have insisted on improvements in remuneration structures such that excessive risk-taking is not encouraged.

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Illustration 1.1

ACCA Corporate Governance and Risk Management Principles (2008)

The principles set out below are matters that ACCA believes are fundamental to all systems of corporate governance that aspire to being the benchmark of good practice. They are intended to be relevant to all sectors globally and to any organization having a significant degree of separation between ownership and control. Many of these principles are also relevant to organizations where ownership and control lie with the same people.

1. Boards, shareholders and stakeholders share a common understanding of the purpose and scope of corporate governance
2. Boards lead by example
3. Boards appropriately empower executive management and committees
4. Boards ensure their strategy actively considers both risk and reward over time
5. Boards are balanced
6. Executive remuneration promotes organizational performance and is transparent
7. The organization's risk management and control is objectively challenged, independently of line management

8. Boards account to shareholders and, where appropriate, other stakeholders for their stewardship
9. Shareholders and other significant stakeholders hold boards to account
10. Corporate governance evolves and improves over time

The ACCA (2008) framework elaborates on each of these principles and in this elaboration there are some new angles on the traditional view of corporate governance. One of the most significant changes in approach is a focus on ethics and the need for boards to attend to the 'ethical health' of their organizations. We return to discussing this new emphasis in Chapter 4.

Other professional bodies have also focused attention on developing guidelines and frameworks for good corporate governance practice. The Institute of Chartered Secretaries and Administrators (ICSA) have produced detailed guidelines for company secretaries, who regularly assume direct responsibility for corporate governance policy and for the corporate governance agenda within their organizations. ICSA therefore have a crucial role to play in ensuring that company secretaries are imbued with good corporate governance from the outset. The outcome of the Turner and Walker Reviews (2009) has consisted of in-depth recommendations which reflect to a large extent the content and orientation of the ACCA framework for corporate governance, discussed earlier.

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Academic research: the frontiers of corporate governance research

A review of academic research in corporate governance was published in a special issue of the *Accounting, Auditing and Accountability Journal*. Figure 1.1, taken from this issue (Brennan and Solomon, 2008), attempts to summarize the extant accounting and finance corporate governance literature by developing a framework to show the different aspects of research in this area. The framework is also intended to act as a road map for future researchers to navigate their way through the existing literature and develop new ways of addressing the subject, along the frontiers of research. The framework shows that corporate governance research in its infancy focused on a shareholder-centric approach, with narrow, econometric-based methodological approaches. As the discipline is maturing, research is broadening substantially, adopting different methodological approaches (such as qualitative research methods), addressing governance issues in different sectors, across different time horizons, and taking account of a larger number of stakeholder groups and their needs. It is the accountability aspects of corporate governance which have evolved dramatically in recent years, with the expectations for corporate accountability being transformed and extended. In this text, I intend to reflect the dimensions of this framework, by summarizing the academic research in corporate governance, at the same time showing how the agenda for corporate governance, both in the academic research community and in the practitioners' sphere, is evolving and broadening.

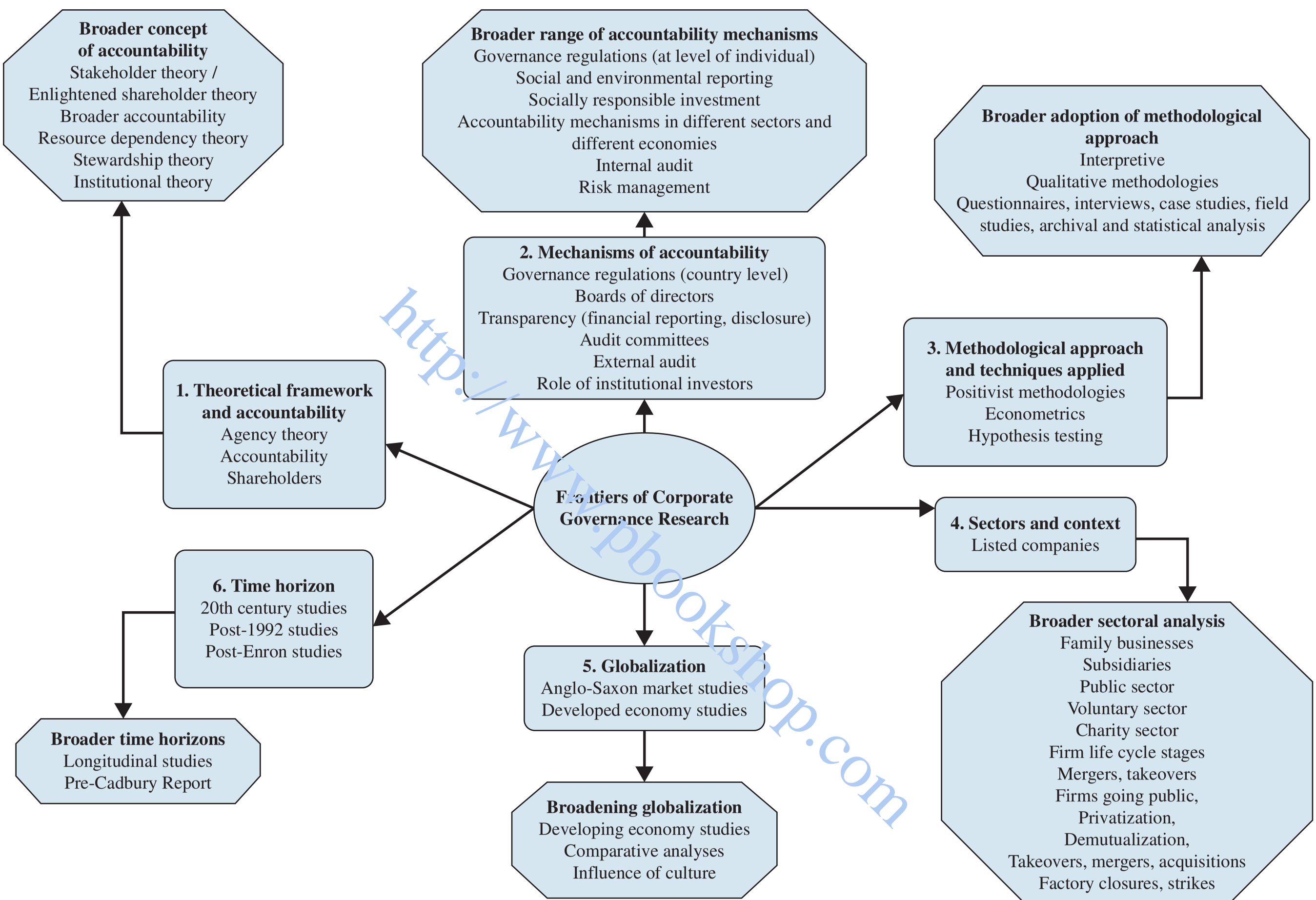

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Figure 1.1

Source: Brennan and Solomon (2008). Reproduced with permission

Chapter summary

In this chapter we have discussed a broad spectrum of definitions of corporate governance existing in the literature, ranging from a narrow, agency theory definition to broader, stakeholder-oriented definitions. The definition for the purposes of this book adopts a stakeholder-oriented approach to corporate governance, reflecting a general transformation towards a more stakeholder-oriented approach by business communities, financial institutions and society. We have also looked at new, forward-thinking frameworks such as that developed by the ACCA, and moves to incorporate a greater focus on risk and risk management, as well as the boundaries and frontiers of academic research. The chapter has also outlined three theoretical frameworks used for discussing and analysing corporate governance and has examined the extent to which they overlap. Having outlined some theoretical issues in corporate governance, we now turn to a discussion of the practical agenda for corporate governance reform. Our first task is to look at what happens when corporate governance fails, as in the cases of Enron and Parmalat. These cases clearly demonstrate a need for corporate governance reform. The recent cases of bank collapses are discussed in relation to corporate governance weaknesses. The next task is to examine the ways in which corporate governance may be improved by targeting a range of mechanisms, checks and balances.

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Questions for reflection and discussion

1 Read the definitions of corporate governance provided in this chapter. What would be your own, preferred definition of 'corporate governance'?

2 Which theoretical framework discussed in this chapter do you believe presents the most appropriate explicit framework for corporate governance, and why?

3 Do you think that agency theory and stakeholder theory are striving towards the same goal?

4 Read the discussion on the instrumental and non-instrumental ethics case for corporate social responsibility. Do you think either of these approaches is viable in today's business environment?

5 Look through a selection of corporate social responsibility/sustainability reports from UK listed companies. What reasons do the companies give for producing the report? Do their reasons coincide with a business case or a pure ethics motive for corporate social responsibility?

6 Do you agree that stakeholder accountability is taking precedence in businesses in recent years? Give your reasons. Do you think that the global financial crisis is focusing greater attention on corporate governance? Explain your answer.

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