



RESEARCH ARTICLE

A SURVEY OF CORPORATE GOVERNANCE: ISSUES, RECOMMENDATIONS AND QUESTIONS

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ABSTRACT

This is a review paper which is highlighting the theoretical and pragmatic literature on understanding various issues of the corporate governance. This paper is an effort to provide direction on the main controversies among researchers on various corporate governance systems being implemented in several countries (developed and underdeveloped). This article tries to measure the importance of legal protection of investors and concentration of ownership among specific groups in order to achieve personal agendas in corporate governance systems around the world. In the end main drivers of the future direction of corporate governance principles, policies and practices have also been discussed.

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INTRODUCTION

Corporate governance can be simply defined as such sets of rules which govern the entire systems of the institutions. These rules have such nature that it directly impacts the performance, capability of being accountable to various stakeholders and stewardship of the corporation. The main aim of corporate governance systems is to fill the gaps between various stakeholders of the company including the board, investors of various categories, administration and creditors through following its laws. A good system of corporate governance handles the issues of power sharing among the shareholders in an appropriate manner and avoids any type of friction among the controlling and minority shareholders, board of directors and management. The firm is the nucleus of contracts of varied importance and nature. It includes contracts which influence the performance of top management and decision makers for example contract among debt holders and the firm & firm and top management (Jensen and Meckling, 1976).

However, the transition economies face a major hindrance in the way of their development which is weak corporate governance mechanisms. The study of Barca, Iwai, Pagano, & Trento (1999) show that the major cause of seize of external investments is weak system of corporate governance. According to La Porta, Lopez-de-Silanes, Shleifer, & Vishny (2000), argument presented above is further strengthened. Through strong corporate governance, appropriate institutional changes are amicably established. There arises an interesting question about the agency problem which is discussed in paragraphs to.

Several scandals like Enron, WorldCom, and Adelphia emerge due to weak systems of governance in result of which the managers commit financial embezzlements through

accounting records. From examples like these there arises a question about the protection of the rights of shareholders, creditors and other parties dealing with company. In the coming discussion all questions which are raised by the researcher are critically reviewed through literature studies. Now to start with a question arises on the powers of top management. These powers, if not checked under a certain system, can become catalyst for various types of frauds as seen from above examples. Therefore, this creates an anxiety among the investors that what happens with their investments in absence of systems of accountability of top management and control of activities related with ownership dissemination. Here a question arises that whether the corporate governance issue has not been entirely solved and there is still a need of more to study on controlling major problems of corporate governance? The studies of advanced economies show that they have managed to keep inflows of capital consistent and appropriate division of profits among the stakeholders but even then it cannot be concluded that they have covered all aspects of corporate governance. The study of Jensen (1993) shows that corporate governance still needs improvements. In fact, even in developed Countries like US and Russia, there is a debate going on the credibility of the existing governance mechanisms.

In nutshell corporate governance tries to resolve the issues between various stakeholders of the corporation through answering the following questions: How the managers are engaged in such system that they should share a justifiable share of profit with the shareholders? How the investors get surety that their money is not invested in unviable investment schemes? How the corporate governance system ensures to control the management? Enhancing the performance of the company needs sustained growth and development which cannot be achieved without good corporate. Moreover, it is a system which on the one side ensures attraction for future

capital investments through building a trustworthy image of the corporation and on the other side assures various stakeholders of the corporation, whether investors or creditors, to get the expected return on their investment. To conclude, it can be said that this issue of declaring the best corporate governance system is the most tricky one and it requires development of more improved corporate governance mechanisms.

The Agency Issue

Jensen and Mecking (1976) firstly generated the concept of agency problem and Fama and Jensen (1983 a,b) developed it in the coming years. This problem is about the terms and conditions of capital investment and payment of dividend between the financiers and the managers in shape of a contract. The ideal situation is that the financiers and managers signs a contract that contain about the amount to be invested and the division of dividend. Technically speaking this situation is not practicable because future is uncertain and therefore we cannot predict it. The agency problem arises when the managers try to form a complete contract in order to attract more investments. According to Bertrand (2009) and Hermalin (2005) weakness of agency problem in corporate governance has encouraged for development of new models based on changes in the various trends.

One question arises here that lets accept that a manager of a corporation cannot impound the investment absolutely but he can have the interest to freely use it. The study of Jensen and Murphy (1990) is a good example of this. It means that at the time of acquisitions the declaration of the dividend by the bidder can be negative highlighting contradictory relationship between investors and firm performance. The researchers are divided on this matter when the literature is studied. This is another issue where the differences between the managers and shareholders get potentially vital. The literature suggests that there are pros and cons of diversification for the shareholders but the costs seem to outnumber the benefits (Shleifer & Summers, 1990; Lang, Poulsen, & Stulz, 1995).

According to Jensen (1986) agency issue arises not only in those firms who have excessive cash and but also have poor options to invest. There are apparent proofs of agency problems when managers feel danger of losing the control through takeovers. The findings of Long & Walkling, (1984) are that when the managers have personal benefits attached with the corporation or in order to safe their jobs then the chance of profitable takeovers is very unlikely and this leads to loss of shareholders. This is evident from study of Jarrell and Poulsen (1987) that in order to initiate the takeover's failure, changes are made to particular clauses of charter and publically announced which result in loss of wealth of shareholders.

Financing without Governance

Now the argument is that in order to induce the investors in future to invest in their companies the managers repay their old investors. This argument has been made originally in the framework of autonomous borrowing, where there is no continuation of legal enforcement of contracts (Bulow and Rogoff, 1989). This argument has been supported by various

studies including the study of Diamond (1991) which suggests that the reputation of company is established by paying off the debts. The study of Gomes (1996) shows that company increases its goodwill among the shareholders by paying the dividends in time. This helps the corporations to get funds. However, there are instances available in literature about repo developing as a tool to get financing from the private sector. There are examples from United States as well as from other countries which specify that the shares being issued by corporations, whether first issue or subsequent, are systematically overvalued (Ritter and Rydqvist, 1994; Xu & Wang, 1999).

Legal Protection

The study of Laporta, Lopez-de-Silanes, Shleifer and Vishny (2000) indicate that one of the main factors of expansion of local capital markets is the continuation and effectiveness of legal rules protecting investors. Furthermore in order to put an appropriate corporate governance system the legal protection of investors is the imperative. The factors which devise a mechanism of distribution of decision rights among the various stakeholders of a corporate sector include corporate law, government regulation, the corporate charter and by-laws and corporate policy. Therefore, the legal system plays a catalyst role in analyzing the governance system of any corporation.

Research shows that there are certain governance tools available which can reduce the agency problem if not completely abolish it. According to Hart (1995) the investors, who invest, want control in exchange of the amount being invested. As a matter of fact outside financing is a contract between the investors and the company. The investors, because of the amount invested in the firm, have rights on the assets of the firm. Therefore, the investors can sue the firm if the later infringes the conditions of the contract. There are certain governance systems which are considered trust worthy like one being used in US firms but questions have been raised on its reliability after the ENRON incident.

Here a question arises that are the boards effective in any of the countries? To find out the answer of this question one has to look into the literature. The boards remove the top line managers, showing poor performance, in the United States but condition is that the board should consist of external and unbiased directors. Otherwise boards show passive behavior on any of the issues except to those where a true performance disaster occurs. Jensen (1993) has found evidence in the case of US that management controls the boards in the corporate sector of United States. The courts in OECD¹ countries, in general, accept the inspiration of managers' role of loyalty to various stakeholders.

There is another question which needs answer that whether the controlling shareholders benefit from a situation where courts hesitate to provide protection of rights to minority shareholders? The literature shows us quite a story as it explains that in less developed countries like India, where there are firms owned by large family members, the impounding of the controlling shareholder on the minority shareholders is a serious problem. Furthermore in countries where there is weaker investor protection and pathetic rule of

law, the controlling shareholders tend to benefit (Doidge, Karolyi, & Stulz, 2004; Nenova, 2003). The task of making amendments in the law for investors' protection is a complex process which needs lots of time and other formalities like involvement of political figures. In spite of going into all the fuss, prevalence of sound corporate governance mechanisms at firms' level is a practicable solution. The amendments in the legal reforms relating to counter the control issue should be on the agenda of policy makers as a top priority.

From above it can be concluded that there is variation in the degree of protection of rights of investors all across the globe. It has been seen that in developed countries like US, Japan and Germany, where rule of law is better, courts tend to interfere only in simple matters of corporations and avoid unnecessary involvement in complicated issues. The condition of less developed countries is even worse as there is weak rule of law and issue of reliability for example India (La Porta *et al.*, 1997). However, less developed countries such as India, where there is weaker enforcement of law protection to investors' rights, there is a need of revolution in the laws by the policy makers and also improvements are required in the corporate governance mechanisms and their implementation.

Issue of Large Investors

Corporate governance has to deal with another issue is that to what extent the benefit of control is enjoyed by large investors over the minority investors or management over the other stakeholders.

Organization for Economic Cooperation and Development

Bebchuk, Cohen, & Ferrell (2009) have figured out that there are many grievances regarding the power exercised by the management over the shareholders. It has also been seen that the shareholder who holds lion's share try to control the board and other stakeholders (Berle & Gardiner, 1932). Deng & Wang (2006) indicates in his study related to the analysis of corporate governance mechanisms in China that being a socialist economy like China state is the owner of public properties so there is no owner of state shares. This is said to be one of the major factor which has showed the way to issues like corruption and poor corporate governance mechanisms in the listed firms (Xu & Wang, 1999; Peek & Rosengren, 2003).

There are some other attractive questions regarding takeovers. First of all the cost of takeovers become very heavy as the new owner will have to pay anticipated increase in profits in order to make shareholders relax and keep their shares intact which is key to a successful turnover (Grossman and Hart, 1980). Such acquisitions can in fact boost agency costs when bidding managements overpay to get them personal benefits of control (Shleifer and Vishny, 1994). Moreover, takeovers entail a liquid capital market which can satisfy huge capital needs of the bidders immediately. Last but not least, various lobbies like board lobbies can resist the takeovers which can make takeovers politically an enormously weak option. The best example in this regard can be of the United States where state antitakeover legislation plays its role in ending the 1980s takeovers (Jensen, 1993).

Another stakeholder who can influence on the decision making of a corporation is creditors. For example banks, just like large shareholders, invest in the corporations and want higher returns. These banks have more opportunities to dictate terms on corporations to which then lend in the form that the later may come back to them in case of default or if they want rescheduling of their loans. Therefore, the banks are in a position to influence the decisions of corporation management but still the evidence on this point is limited. Furthermore, the banks are able to hold up both the equity and debt of the corporations or they enjoy the option of voting the equity of other financiers (OECD, 1995).

The Costs of Large Investors

The argument which I may put here is diversification policies in examining the relationship between managers and shareholders have noticeable concerns. Some studies suggest that diversification has benefits for shareholders but others say it has more costs. According to the study of Lang, Poulsen, & Stulz (1995), corporate diversification results in significant losses for shareholders. The benefits of large owners are known well and one of the features of these large owners is that the later are not diversified (Demsetz and Lehn, 1985). The counter argument is that this is true that large ownership increases benefits to the shareholders but it is also true that it features weak control of management. It has also been analyzed that this cost is not as much alarming as the diversification cost.

The large investors, being realized of their power, tend to take corporate decisions for achieving their personal gains so they ignore the minority rights. This characteristic is even more fatal for the management if their control rights are greater than their cash flow rights (Grossman and Hart, 1980). In this situation the large investors exercise their superiority in distribution of dividends as per their liking if they control the firm in the course of a pyramid formation which means one share one vote system. Furthermore, they exploit various business dealings with the company like greenmail and share repurchases (Dann and DeAngelo 1983). The study of Barclay and Holderness (1992) shows that in case of US the large investors try to enjoy the benefits of control over the minority investors when their ownership in terms of votes reach a certain point. However there are no substantial evidences of large investors exploiting the minority investors in US case. Therefore, it can be inferred that there are costs of higher level of ownership and dispersed ownership.

Searching for the right Corporate Governance System

From above it can be said that corporate governance structure varies a great deal all across the world. It has been observed that companies in US and UK depend on legal protection of investors whereas in case of takeovers the ownership is concentrated infrequently. However, in continental Europe and China there is more dependency on large investors and banks. In the rest of the world ownership is basically empowered by family system and a few of the owners belong to external sources like banks. These systems of corporate governance raise another question that which system is the best one which can be generalized to less developed countries as well. This objective of this section is to find out the answer

Of the question posed here.

Corporate Governance System comprising of Legal Protection and Large Investors

The findings of above are that both the large investors and legal protection are necessary for a sound corporate governance system. Large investors make management to keep good care of the rights of the investors specially while distributing dividends. The basic characteristic of these large investors is that they require votes to exercise control over management. On the other hand legal protection is imperative to induce small investors towards the corporation. Due to this the small investors feel confidence that they can raise their voice against any expropriation exercised by management or the large investors. Therefore, legal protection and large investors are the most important ingredients of an efficient corporate governance system.

I have seen in the above literature that most successful corporate governance systems have been dominated by these two features i.e. legal protection and large investors. I have found examples of US, Japan and Germany where corporate governance systems are one of the best. These corporate governance systems are highly dependent on legal protection and large investors. In US it has been observed through literature that the corporate governance systems are governed by such rules protects the minority investors through easy transfer of shares, ensuring zero tolerance for showing any type of influence by the management and even to sue the directors for their involvement in any violation. However as far as protection of rights of creditors are concerned, corporate governance systems in Germany and Japan are performing better than in US.

What Kind of Corporate Governance system can be adopted?

Now the question arises that do the US formula of large investor can benefit to the rest of the world. The answer to this query is complicated and still there is need of ample research on this. There are some weaknesses found in previous studies such as Easterbrook (1996) have not explained the role of large investors. According to Romano (1993) the expectation of alertness from the institutional investors in case of US is an inflated theory. There are many scholars who give preference to the governance system adopted in Germany and Japan and consider the corporate governance system of United States as a rough one (Charkham, 1994). But systems like vulture funds, LBOs, mergers and proxy fights have been produced repeatedly during the 20th century in the US economy. On the other side in Japan and Germany the large investors who are dictating corporate governance have some benefits like persuasion of corporate governance mechanisms through tolerant and knowledgeable investors. In addition these investors are also capable of helping out the troubled firms. Yet efficiency of these investors is still questionable because of some doubt on their robustness.

Conclusion and Future Research Dimensions

In this article I have tried to review the studies conducted on

The various structures being used all over the globe. The findings include that corporate governance faces the agency problem. The basic question arises about the problem of sharing the return on investment between the investors and the management. I find agency issue very severe as there are chances that the managers can impound their decisions on projects for their personal benefits without considering the interests of the investors. There are also occasions on which the managers can escape with the money of the investors. Moreover, these options are in abundant and also very well documented. There are various wide approaches to corporate governance. I have briefed about various options for a corporation to get investment.

A corporation may get the investment due to repute of management or from extremely positive hope of the investors to get their amount back. From this review I can clearly propose that without execution of sound corporate governance, financing activity cannot be operated at optimum level. In light of my discussion given above, I can classify two approaches of corporate governance which are ownership concentration and legal protection of investors. There is no doubt in saying that legal protection is one of the major building blocks of corporate governance. I have also discovered that in countries like US, Germany and Japan, where corporate governance systems are comparatively very sound, there has been considerable importance given to legal protection to investors and also large investors. These characteristics distinguish their governance system from the rest of the world where weak legal protection is provided to the investors and families have been denominating investors in the corporate structure, thus these are facing with limited external finance issue. In the course of developing this article, there are various questions come into my mind which can become the future result dimensions. As there is literature which explains that the managers can be controlled through large incentives so why not this concept is used to lessen down the agency problem in all across the world? What type of legal protection is required for the investors to promote sound corporate governance mechanisms in the corporations? Is the concentrated ownership among large investors beneficial for the corporation? Do large investors influence other stakeholders in the corporation and management? Do the influential groups like large investors or management adversely affect the corporate governance system in a corporation? I think we need to answer these questions if we want to reach at the best system of corporate governance.

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