CORPORATE GOVERNANCE – STATE OF THE ART AND NEW RESEARCH TRENDS

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Abstract

Corporate governance is a relatively recent field of economic research. Interest in this field has been spurred by the high number of corporate scandals at the turn of the 21st century (Enron, Tyco, Adelphia, WorldCom, etc.). They opened the eyes of the public all over the world to the abuses that companies can do when they are not under strict surveillance. Traditional studies have focused on formal and structural aspects of governance, seen from the perspective of accounting, finance, corporate law. This article attempts to provide an overview of the topics of interest in corporate governance research of future research directions.

Keywords: corporate governance, corporate scandals, new research directions.
JEL classifications: G30, G34, G39.

1. INTRODUCTION

Corporate governance is a relatively recent area of research in the broader field of economics. Interest in it was spurred by the increasing number of governance breakdowns, such as corporate scandals. Among them, the ones occurring in 2002 (the Enron case, the corporate meltdowns and frauds of Tyco, Adelphia, WorldCom, Global Crossing), were, probably, the most prominent and the most influential in raising public awareness of what corporations can do when they are not under tighter surveillance. They had such a strong impact on public consciousness[i] because of the high sums that were involved, and also because of the opportunity that they provided to assess the failure of check and balance mechanisms (Monks, Minow, 2004: 1). On the other hand, breakdowns in corporate governance have been identified in the high amounts of money paid as CEO compensation, which have always been an outrage for shareholders.

Such breakdowns or other signs of corporate crisis have brought corporate governance to the attention not only of the media, but also of the academia. Scholars of corporate governance usually start from distinguishing between management and governance. Management involves the activities of running the business, and its actors are managers, at various levels, who create strategies and plans to fulfill the corporate mission and reach the business's profit targets, by the efficient use of material and human resources. Governance, on the other hand, sets the conditions within which management can perform its tasks effectively. It also refers to the oversight of the entire corporation, on behalf of its owners (i.e. shareholders).

This is a very broad and unrefined definition. A more precise one would be that corporate governance deals with "the ways in which suppliers finance to corporations assure themselves of getting a return on their investment" (Shleifer and Wishny, 2007: 52). Despite national variations, the architecture of corporate governance rests on similar pillars: "internal managerial control and monitoring mechanisms" and "external monitoring and control mechanisms" (van Frederikslust, *et a*l, 2007: 1). The main problem that governance sets to solve, in the particular context of a certain corporate and national culture, is how to construct the right types of safeguards, of checks and balances that would ensure that the board of directors acts as a team, in the interest of the shareholders, while preserving their independence of opinions and positions.

2. APPROACHES TO CORPORATE GOVERNANCE

As a field of academic inquiry, corporate governance has traditionally been the turf of economists only, who have been debating over how good or bad existing governance mechanisms are (Easterbrook and Fischel, 1991, Jensen, 1989) (apud Shleifer, Vishny, 2007), have drawn comparisons between various systems of corporate governance across the globe, and have developed theories that can be applied to corporations. Also, scholars have been reworking definitions of governance and analysed it from the perspective of accounting, finance, management, organizational behavior and strategy.

An article from 1997, by Andrei Shleifer and Robert W. Vishny, provides a survey of corporate governance up to that point in time. They investigated the topic with the hope that understanding corporate governance can stimulate institutional changes in places where they needed to be made. Their approach is based on the agency problem, as developed, theoretically, within the contractual view of the firm. Seen in this perspective, the firm is the creation of an entrepreneur who raises funds from investors to develop a business. The business is owed by financers, and run by managers. The agency problem refers to the difficulties investors have in assuring that "their funds are not expropriated or wasted on unattractive projects" (Shleifer, Vishny, 2007, 54) but they earn them dividends. The authors argue that the weight of financer control over management depends on whether they are big financers or small financers. Also, the role of courts in settling issues between business owners and business managers varies from country to country, and in most cases they are only called upon in major violations by managers of investors' rights. They conclude that "both the legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system" (Shleifer, Vishny, 2007: 77).

Equally useful, from a theoretical perspective, is Herman Siebens' article "Concepts and Working Instruments for Corporate Governance", from 2002, in which he tackles especially the role of directors in governance. What this article and others that deal with directors emphasise, is that every member of the board must be independent and well informed, in order to make decisions that will consider the welfare of shareholders and stakeholders. He gives an ample description of the conditions of possibility of governance and highlights the relevance of all stakeholders in voting on the direction a company will go, and not just the relevance of shareholders.

As we explained in the introduction to this paper, interest in corporate governance issues spawned in the aftermath of huge corporate scandals in 2002, which broadened the theoretical and ethical issues involved in the academic studies of governance. Thus, Sandra C. Vera Munoz looked at legislative reforms in the US that have been enforced with a view to preventing the reoccurrence of corporate breakdowns after the scandal of Enron, Tyco, WorldCom, etc., and she emphasized the challenges that auditing committees face in protecting investors' interest[ii]. A similar interest in reforms in corporate governance practices is shared by Darryl Reed who, in an article from 2002[iii], chose developing countries as his site of investigation. He noticed a spread of American and British-based mechanisms to the developing countries, and drew attention to the connection between ethics and development, and between corporate reforms and the spread of market liberalization. The article is heavily theoretical, in its dialogue between ethics, corporate governance and development studies.

Apart from almost purely theoretical articles, such as the one just mentioned above, there have been numerous articles that looked at governance in particular non-Anglo-American contexts. Thus, Flavio M Rabelo and Flavio C. Vasconcelos focused on corporate governance in Brasil[iv], Boniface Ahunwan tackled corporate governance practices in Nigeria[v], Rossouw, G. J., van der Watt, A., Malan, D. P elaborate on financial and ethical issues of corporate governance in South Africa[vi], Bettina Palazzo addressed governance in the United States and in Germany[vii], in a comparative perspective. Solomon and Solomon[viii] give a brief outline of corporate governance in twenty six countries from Europe, Asia, Africa, Australia and the Americas, with a focus on the role of boards, institutional investors, transparency and socially responsible investment.

A very useful combination of theoretical and practical information is provided by Van Frederikslust, Ang and Sudarsanam's *Corporate Governance and Corporate Finance. A European Perspective.* Their book offers a historical perspective on corporate governance, that goes back as far as the industrial revolution, and looks at agency costs and ownership costs, ownerships structures, different patterns of control, executive compensation – a new and controversial topic, financial strategies and takeovers. One of the strengths of the book is the rich number of case studies, which makes it an asset for teaching purposes.

3. NEW RESEARCH TRENDS

As the previous brief overview of current work on corporate governance shows, the predominant approach has been informed by principles of hard-core economics disciplines, sometimes tackled from a comparative perspective that pits the Anglo-American governance practices against non-American, and/or non-European countries.

In the very recent present, and in the future, governance has been and will be analysed from an interdisciplinary perspective, or from the perspective of sciences such as sociology, psychology and law. A 2008 issue of *Organization Science* was precisely an example of the new directions that can to be successfully treaded in order to increase our understanding of corporate governance with the purpose of improving it.

Hambrick, Werder and Zajac, the editors of No 3 issue of *Organization Science,* define corporate governance as “the formal structures, informal structures, and processes that exist in oversight roles and responsibilities in the corporate context,” and they identify two directions of research: a micro direction (from the organization inward) and a macro direction (from the organization outward) (Hambrick, *et a*l. 2008: 381).

The figure below gives a synthetic representation of the old and new approaches to corporations, seen from an inward perspective and from an outward one:

	Formal structure	**Behavioral structure**	**Behavioral process**
Organization ↓ **Inward**	**1. Economics** Designing optimal incentive and monitoring structure	**3. Power** Showing how positions affect power/politics within organisations	**5. Social psychology** Revealing how decision-making processes may be biased
Organization ↓ **Outward**	**2. Legal** Creating and enforcing governance rules and regulations for societal benefits	**4. Social network** Showing how power and information flow in interorganisational networks	**6. Symbolic management** Understanding how symbols and language can address normative compliance with societal norms and values

Source: [Apud Hambrick, Werder, Zajac, 2008, 382]

Figure no. 1 Old and new approaches to corporations

If we start reading the table from the left to the right, and from the upper column to the lower columns, we can expand on the information in the cells as follows:

1. Various branches of economics have dealt with governance in a descriptive and prescriptive perspective, assessing what it is and how it can be improved, in accounting and financial terms. This approach has been informed by the tenets of the agency theory, which emphasises optimal incentive contracting and structures of CEO and board of directors monitorisation. This approach looks inward, in the practical mechanisms of the organization.
2. In countries where corporate law has been significantly developed, and corporations, therefore, have a long history of existence as a form of business on the market, one could study corporate governance from a legal perspective, by analysing the governance rules and regulations that have been created and enforced. This is a perspective from the outside of the organization, that looks into the legal context that enables corporations to exist and regulates their social and economic action.
3. From a behavioral structure perspective, in an inward approach, one can investigate power relations and power differentials within the corporation, more precisely within the board of directors. Particular questions to be addressed are: What makes a director more influential than another? And how do power differentials impact board processes and outcomes? This is, according to Hambrick *et al.*, a new direction of research that can be very profitable in the future [p. 382].
4. In a perspective that looks from the organization to the outside and approaches the corporation and its environment in terms of behavioral structure, researchers of corporate governance can look at flows of power and information in

interorganisational networks. Governance practices nowadays operate at the nexus of heterogeneous institutional agents, among which Hambrick *et al* quote regulatory agencies and stock exchanges, media conglomerates, governance watchdog groups, institutional investors, executive search firms and executive compensation firms [383]. In our increasingly complex world, divergence and difference of interests can exist not only between the board and the owners, but also among the various shareholders and stake holders. Future research can look at how conflicts between long-term oriented and short term oriented shareholders are solved, what boundaries can be imposed on shareholder activism, how the tension between pressure to reveal information to the public and the need for "fair disclosure" [Hambrick *et al*., 2008: 383] can be reconciled, how efficiently governance mechanisms can regulate opportunism risks, and so on.

5. In terms of behavioral processes, social psychology can unpack biases in the decision making process at the level of the board of directors. Apparently, there are various barriers to an open-discussion culture on the board. Insights into boardroom processes can be gained by finding answers to questions such as "How can directors raise questions about possible drawbacks of managerial plans without seeming to criticize the managers, especially the CEO? How can a productive balance between controversial discussions and a constructive working climate be ensured? … Can board members who persistently disagree with the CEO, or with fellow board members, remain effective – and for how long?" [Hambrick *et al* , 2008: 384]. It is equally useful to investigate the relationship between the CEO and the board, the reasons that ground directors' decision-making, and their motivation to serve on the board.
6. Finally, future research on behavioral processes from the company to the outer world can focus on changes in societal values regarding corporate governance, on how companies convey the message that they are well governed, how they manage their public symbolic image ([apud Hambrick *et al* , 2008: 384].

4. CONCLUSIONS

Though the lines of future research traced by Hambrick, v. Werder and Zajac are inspiring, however, they are better suited for a context where corporations have a long tradition on the market. In recent market economies, where businesses are sometimes reluctant to openness and transparency, it is probably more feasible to research corporations in their relation with shareholder, stake-holders, the media and the broader public, than to research internal processes of decision making, CEO's or directors' status and motivation, and their role in the running of the corporation. Except for Russia, Poland and the former Yugoslavia, little research has been done in Eastern Europe on corporate governance issues. If it is rather hard to find answers to the new questions that research on corporate governance can raise, it may be a practical solution, for the moment, to find local – new - answers to "old" questions, and place them in a comparative perspective, not in the way of inventories but as in-depth analysis at micro levels.

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