**lecture8- introduction to corporate governance**

**Introduction**

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

**1-Ownership and control**

Although recent discussion and interest in corporate governance has tended to focus on issues relating to financial crises and such high profile corporate scandals as Enron and WorldCom, corporate governance has in fact been of concern ever since the foundation of the joint-stock company. Much of this concern centred on the separation of ownership from control. Adam Smith, in the eighteenth century, was one of the first economists to express unease over the governance of joint stock companies: The directors of such [joint-stock] companies, however, being the managers of other people’s money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of rich men, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

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

* The factory system: this formed the basis of the industrial revolution and was responsible for bringing large numbers of workers under a single management.
* The modern corporation: the advent of the modern corporation placed the wealth of many individuals under the same central control.

Authors, such as Eugene Fama (1980), later came to view the separation of ownership as a move from the classical model of an entrepreneur or ownermanager single-mindedly operating the firm to maximise profits, to the development of ‘behavioural’ and ‘managerial’ theories that focus on monitoring and control. In this manner, the separation of ownership and control was viewed as an efficient form of organisation. The separation of ownership and control was effectively a separation of decision-making and risk-bearing functions, allowing organisations to benefit from specialising in management and risk bearing. Separating ownership and control also meant new costs for the firm. These are the monitoring costs associated with aligning the interests of owners and managers. Much of the study of corporate governance is concerned with how to minimise these costs and better align the interests of owners and managers. These costs form the basis of agency theory, which sought to explain the transaction or agency costs associated with reconciling the interests of shareholders as principals and managers as agents.

**2-Systems of corporate governance**

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

• The dispersed or outsider system of governance, which is characterised by dispersed ownership and shareholder protection and is associated with the UK and US.

• The concentrated or insider system, on the other hand, which is characterised by concentrated ownership and weaker shareholder protection, and is associated with European systems of governance.

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

**3-What is corporate governance**?

At its most basic, corporate governance refers to ‘the ways suppliers of finance to corporations assure themselves of getting return on their investment’ (Shleifer and Vishny, 1997: p. 736).

However, just like the corporation, corporate governance can be defined or interpreted in numerous ways.

Traditionally, corporate governance has focused on the shareholder/management relationship. This concerns mainly the internal governance relationships. Corporate governance refers to the systems, processes, and responsibilities involved in running and building value in a firm or organisation, and the way in which these are organised and directed at board level.

More recently, corporate governance has been used to describe a much broader relationship between institutions and stakeholders. Corporate Governance is concerned with the systems of laws, regulations, and practices which will promote enterprise, ensure accountability and trigger performance.

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

• firstly, it covers the manner in which shareholders, managers, employees, creditors, customers and other stakeholders interact with one another in shaping corporate strategies

• secondly, it relates to public policy, and an adequate legal regulatory framework, which are essential for the development of good systems of governance.

**Taking these points into account, corporate governance is viewed as a key element in improving the microeconomic efficiency of a firm, affecting the functioning of capital markets and influencing resource allocation.**

Megginson and Netter (2001) thus defines corporate governance as a nation’s ‘set of laws, institutions, practices and regulations that determine how limited liability companies will be run and in whose interest’ (Megginson & Netter, 2001: p. 377).

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

• A ‘good’ governance system supports a continual process of mobilising scarce resources to their most promising uses.

• The major components of the governance system are the legal, political, economic and social institutions that either constrain or enable the corporation. According to Holmstrom (1999), under this setup the firm is viewed as a ‘sub-economy’, and is dependent on the macro environment.

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

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

• attract capital

• perform efficiently

• achieve the corporate objective

• meet both legal and obligations and general societal expectations.

**Conlusion**

Interest in corporate governance has continued to gather momentum around the globe due to a host of factors, but mainly driven by the demand of investors. You should now understand the key concepts relating to the subject ofcorporate governance, and the developments that have occurred.