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Corporate governance – a global challenge

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Summary

The significance of corporate governance is now widely recognized, both for national development and as part of international architecture, addressing the converging interests of competitiveness, corporate citizenship, social and environmental responsibility. The study addresses the general international principles of corporate governance, it analyzes the circumstances for complying with the principles and gives an insight into investors' perception regarding this important aspect in the management of a corporation. The case study provides details on the South African code of corporate governance.

KEYWORDS: corporate governance, code of corporate governance, investor, principles, transparency, accountability, leadership, King Report, South Africa

1. INTERNATIONAL PRINCIPLES OF CORPORATE GOVERNANCE

"Corporate governance is concerned with holding the balance between economic and social goals and between individual and common goals. The aim is to align as nearly as possible the interests of individuals, corporations and society." (Sir Adrian Cadbury, Corporate Governance Overview, 1999, World Bank Report)

The significance of corporate governance is now widely recognized, both for national development and as part of international architecture, addressing the converging interests of competitiveness, corporate citizenship, social and environmental responsibility. It is also an effective mechanism for encouraging efficiency and combating corruption. Companies are governed within the framework of law and regulations of the country in which they operate. Communities and countries differ in their culture, regulation, law and generally the way business is done. In consequence, there can be no single generally applicable corporate governance model. Yet there are international standards that no country can escape in the era of the global investor. Thus, international guidelines have been developed by the Organization for Economic Cooperation and Development (OECD), the International Corporate Governance Network and the Commonwealth Association for Corporate Governance. The four primary pillars of fairness,

ISSN 1582-3024

accountability, responsibility and transparency are fundamental to international guidelines of corporate governance.

Fairness. The systems that exist within the company must be balanced in taking into account all those that have an interest in the company and its future. The rights of various groups have to be acknowledged and respected. For example, minority shareholder interests must receive equal consideration to those of the dominant shareholders.

Accountability. Individuals or groups in the company who make decisions and take actions on specific issues, need to be accountable for their decisions and actions. Mechanisms must exist and be effective to allow for accountability. These provide investors with the means to query and assess the actions of the board.

Responsibility. With regard to management, responsibility pertains to behavior that allows for corrective action and for penalizing mismanagement. Responsible management would, when necessary, put in place what it would take to set the company on the right path. While the board is accountable to the company, it must act responsively to and with responsibility towards all stakeholders of the company.

Transparency. Transparency is the ease with which an outsider is able to make meaningful analysis of a company's actions, its economic fundamentals and the non-financial aspects pertinent to that business. This is a measure of how good management is at making necessary information available in a candid, accurate and timely manner – not only audit data but also general reports and press releases. It reflects whether or not investors obtain a true picture of what is happening inside the company.

Corporate governance principles were developed, inter alia, because investors, with the era of professional manager, were worried about the excessive concentration of power in the hands of management. This protection against greed could on the other hand, erode the enterprise and encourage subservience. A balance is needed.

The 19^{th} century saw the foundations being laid for modern corporations: this was the century of the entrepreneur. The 20^{th} century became the century of management: the phenomenal growth of management theories, management consultants and management teaching, all reflected this pre-occupation. The 21^{st} century promises to be the century of governance.

2. INVESTOR PERCEPTION

One of the difficulties, but also challenges, has been to provide sufficient empirical evidence that good corporate governance pays. In recent years, research has been

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developed that increasingly supports this position. In its Investor Opinion Survey published in June 2000, McKinsey & Co found that good governance could be quantified and was significant. For the survey, well-governed companies were defined as:

- Having a clear majority of outsiders on the board, with no management ties;
- Holding formal evaluations of directors;
- Having directors with significant stakes in the company and receiving a large proportion of their pay in the form of stock options;
- Being responsive to investors requires information on governance issues.
- The survey found that:
- More than 84% of the more than 200 global institutional investors indicated a willingness to pay a premium for the shares of a well-governed company over one considered poorly governed but with a comparable financial record;
- ¾ of these investors indicated that board practices were at least as important as financial performance, when evaluating companies for potential investment;
- The actual premium these investors would be willing to pay varied from country to country. In the United Kingdom, they would pay 18% more for the shares of a well-governed company than for the shares of a company with similar financial performance but with poorer governance practices. In emerging markets and markets perceived to have poor governance practices, this premium escalated to 22% for a well-governed Italian company and to as much as 27% for one in Venezuela or Indonesia.

3. LEADERSHIP IN CORPORATE GOVERNANCE

Corporate governance is essentially about leadership:

- Leadership for efficiency, enabling companies to compete effectively in the global economy, and thereby create jobs;
- Leadership of probity because investors require confidence and assurance that management will behave honestly and with integrity in regard to their stakeholders;
- Leadership with responsibility as companies are increasingly called upon to address legitimate social concerns relating to their activities;
- Leadership that is both transparent and accountable, otherwise business leaders cannot be trusted and this will lead to the decline of companies.

Some companies have appointed corporate reputation officers (CRO) to monitor how third parties view the company and to report to the chief executive on their findings. The CRO reports on matters such as customer satisfaction and customer perception of key service areas. Of even greater importance in the information age,

ISSN 1582-3024

particularly in IT companies, is the report on human resources aspects such as morale, skills, training, incentives, attraction of talent and succession. Other examples of so-called non-financial aspects of company performance include innovation, training, reciprocal relationships with defined stakeholders, management credibility as seen by third parties, technology (as compared with technology of competitors), internal audit, management information systems, risk management, service standards, productivity levels, bench marketing etc.

What stakeholders are looking for are reports that evidence good leadership and results. While communicating in financial terms is retrospective, this is in a common language that is understandable to all stakeholders. The difficulty with communicating the less defined sustainability or non-financial aspects is that no universal reporting standard or language has yet been developed.

What investors want are understandable measurements, to enable them to judge performance, conformance and sustainability on a common basis.

4. CIRCUMSTANCES AND FACTORS FOR GOOD GOVERNANCE

Apart from the value added to a company by good corporate governance, the recent onslaught of corporate scandals has compelled the world to acknowledge the profound impact of corporate governance practices on the global economy.

Interest in such practices has been fuelled by the international financial crises of the 1990s. In East Asia, in 1997 and 1998, it was demonstrated that macro-economic difficulties could be worsened by systemic failure of corporate governance, stemming from:

- Weak legal and regulatory systems;
- Poor banking regulation and practices;
- Inconsistent accounting and auditing standards;
- Improperly regulated capital markets;
- Ineffective oversight by corporate boards and poor recognition of the rights of minority shareowners.

The implications for companies are profound. Simply by developing good governance practices, managers can potentially add significant shareowner value. The results of this survey should also be apparent to policy makers and regulators in recognizing that the creation of a good governance climate can make countries, especially in the emerging markets, a magnet for global capital. The survey emphasized that companies not only need to be well governed but also need to be perceived in the market as being well governed.

Historically, whilst focus on governing corporations has been financial, a balance sheet is only a record of one moment of the financial affairs of a company. Investors now want a forward-looking approach to reporting. What stakeholders want is a form of reporting from which they can see whether or not a company is likely to have sustained success.

5. CASE STUDY: REFORM OF THE SOUTH AFRICAN CODE OF CORPORATE GOVERNANCE

Code review and principles

The author of this study lived and worked in South Africa for a period of five years, acquiring significant experience of the country's financial market and corporate environment.

Corporate governance is of particular concern in developing economies, where the infusion of international investor capital and foreign aid is essential to economic stability and growth. Particular attention is given on corporate governance initiatives in South Africa, given its significance as an emerging market, its potential leadership role on the African continent and the country's notable corporate governance reform since the collapse of apartheid in 1994. The evolution of the country's corporate structure and the forces driving corporate governance reform over the past decade are notable. South Africa's initiatives can serve as models of enhanced corporate governance standards for the African continent.

Corporate Governance in South Africa was institutionalized by the publication of the King Report on Corporate Governance ("King Report 1994") in November 1994.

The King Committee on Corporate Governance was formed in 1992 under the auspices of the Institute of Directors to consider corporate governance, an aspect of increasing interest around the world, in the context of South Africa. This coincided with profound social and political transformation at the time with the dawning of democracy and the re-admission of South Africa into the community of nations and the world economy.

The purpose of the King Report was, and remains, to promote the highest standards of corporate governance in South Africa.

In 2002, the King Committee considered it appropriate to review corporate governance standards and practices for South Africa against developments that have taken place since the advent of the King Report 1994 in November 1994.

Four primary Guiding Principles were established for the purpose of this review:

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- To review the King Report 1994 and to assess its currency against developments, locally and internationally, since its publication on 29 November 1994;
- To review and clarify the earlier proposal in the King Report 1994 for an "inclusive approach" for the sustainable success of companies;
- To recognize the increasing importance placed on non-financial issues worldwide, and to consider and to recommend reporting on issues associated with social and ethical accounting, auditing and reporting, safety, health and environment;
- To recommend how compliance with a new Code of Corporate Governance for South Africa can be measured and based on outcomes.

A number of task teams were established to undertake a detailed review of specified areas of corporate governance, namely:

- The *Board and Directors* task team looked into issues regarding board practice, the status and responsibilities associated with executive, non-executive and independent directors, executive and non-executive director remuneration.
- The *Accounting and Auditing* task team considered developments surrounding auditing and non-audit services, accounting standards in relation to international developments, auditor skills required for reporting on non-financial aspects and the King Committee's previous recommendations regarding legal backing for accounting standards in South Africa.
- The *Internal Audit, Control and Risk Management* task team reviewed the role and function of internal audit and the scope and status of the internal auditor in relation to developments since 1994 against international best practice. It also investigated recommendations introducing risk management as a criterion for boards and companies in corporate governance.
- The *Integrated Sustainability Reporting* task team has the most compelling brief in that it had to analyse a wide range of complex, and in some cases, undefined area of reporting of a non-financial nature. Topics ranged from stakeholder engagement to ethics and ethical reporting, as well as social and transformation issues including black economic empowerment for example.
- The *Compliance and Enforcement* task team was required to consider the supervision and enforcement of existing statutory and regulatory provisions governing companies in South Africa and to make recommendations to improve compliance with governance guidelines.

While it has been noted that some of the recommendations contained in the King Report have subsequently been superseded by legislation, this should only be seen as addressing the minimum acceptable standards. As society in South Africa has evolved since 1994 through local developments and international circumstances, it is clear that business in this country continues to be faced with many challenges in

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a complex environment of political imperatives, globalisation and increasing relevance of stakeholder interests.

Main aspects of the Code

The Code of corporate practices applies to the following business enterprises:

- All companies with securities listed on the Johannesburg Stock Exchange (JSE) South Africa;
- Banks, financial and insurance entities as defined in the various legislation regulating the South African financial services sector;
- Public sector enterprises and agencies including any department of State or administration.

The King Report approaches the following main aspects:

- **Boards and Directors**. All companies should be headed by an effective Board, which can both lead and control the company. It should have executive and non-executive directors (including independent directors) to the extent appropriate. The concept of a unitary Board, consisting of executive directors, with their intimate knowledge of company's activities, remains the favourite Board structure for companies in South Africa. Management of business risk and the exercise of commercial judgment on behalf of the company can be positively enhanced by this mutual association and exchange of business experience and knowledge. The Board has a collective responsibility to provide effective corporate governance that involves a set of relationships between the management of the company, its Board, its shareowners and other relevant stakeholders.
- **Risk management.** The Board must decide the company's appetite or tolerance for risk – those risks it will take and those it will not take in the pursuit of its goals and objectives. The Board has the responsibility to ensure that the company has implemented an effective ongoing process to identify risk, to measure its potential impact against a broad set of assumptions and then to activate what is necessary to proactively manage these risks.
- **Internal audit.** The definition of internal audit as applied by the Institute of Internal Auditors is as follows: Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.
- **Integrated sustainability reporting.** In a corporate context, sustainability means that each enterprise must balance the need for long-term viability and prosperity – of the enterprise itself and the societies and environment upon which it relies for its ability to generate economic value – with the requirement for short-term competitiveness and financial gain. Compromising

ISSN 1582-3024

long-term prospects purely for short-term benefits is counter-productive. Failure to create this balance will prove potentially irreparable, and have far-reaching consequences, both for the enterprise and the societies and environment within which it operates. Social, ethical and environmental management practices provide a strong indicator of any company's intent in this respect.

- **Accounting and auditing.** The external audit provides an independent and objective check on the way in which the financial statements have been prepared and presented by the directors to all stakeholders. An annual audit is an essential part of the checks and balances required and it is one of the cornerstones of the corporate governance.
- **Compliance and enforcement.** All the principles embodied in a code on corporate governance are effective only if adequate remedies and sections exist to enforce compliance with those principles. Good principles of corporate governance often coincide with existing legal principles. The latter are those company law rules governing the duties of directors and senior managers in a legal entity. They also include various statutory duties imposed on directors and managers in terms of numerous legislative provisions.

The South-African context

Governance in any context reflects the value system of the society in which it operates. Accordingly, it would be pertinent to observe and to take account of the African worldview and culture in the context of governance of companies in South Africa, some aspects of which are set out as follows:

- Spirit collectiveness is prized over individualism.
- An inclination towards consensus rather than dissension helps to explain the loyalty of Africans towards their leadership.
- Humility and helpfulness to others is more important than criticism of them.
- African culture is non-discriminatory and does not promote prejudice. This explains the readiness with which Africans embrace reconciliation at political business levels.
- Co-existence with other people is highly valued. The essence of "ubuntu" (humanity) that cuts across Africa is based on the premise that you can be respected only because of your cordial co-existence with others.
- There is an inherent trust and belief in fairness of all human beings. This manifests itself in the predisposition towards brotherhood.
- Highly standards of morality are based on historical precedent.
- A hierarchical political ideology is based on an inclusive system of consultation at various levels.
- Perpetual optimism is due to strong belief in the existence of an omniscient, omnipresent superior being in the form of the creator of mankind.

Monitoring and supervision across the entire spectrum of economic and commercial enterprise is impossible by any measure, and thus the recommendations contained in the Report remain self-regulatory. However, it would be in the self-interest of each company to take careful acknowledgement of the recommendations outlined in the Report and to adhere to these to the extent practicable and applicable.

6. CONCLUSION

In summary, successful governance in the world of the 21st century requires companies to adopt an inclusive and not an exclusive approach. The company must be open to institutional activism and there must be greater emphasis on the sustainable of non-financial aspects of its performance. Boards must apply the tests of fairness, accountability, responsibility and transparency to all actions and be accountable to the company but responsible towards the company's identified stakeholders. The correct balance between conformance with governance principles and performance in an entrepreneurial market economy must be found, but this will be specific to each company.

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