Concept and Significance Of Corporate Governance

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Abstract

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

However corporate governance has wider implications and is critical to economic and social well being, firstly in providing the incentives and performance measures to achieve business success, and secondly in providing the accountability and transparency to ensure the equitable distribution of the resulting wealth. The significance of corporate governance for the stability and equity of society is captured in the broader definition of the concept offered by Sir Adrian Cadbury (2002): "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals.

Key word: Corporate governance, Concept of corporate governance

INTRODUCTION

Corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. However, the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomenon. As a result different people have come up with different definitions that basically reflect their special interest in the field. It is hard to see that this ‘disorder’ will be any different in the future so the best way to define the concept is perhaps to list a Few of the different definitions rather than just mentioning one definition.

DEFINITIONS

1. "Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of return", www.encycogov.com, Mathiesen [2002]. “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”, The Journal of Finance, Shleifer and Vishny [1997].

2. "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance", OECD April 1999. OECD's definition is consistent with the one presented by Cadbury [1992].
3. "Corporate governance - which can be defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society -....", from an article in Financial Times [1997].

4. "Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, president of the Word bank, as quoted by an article in Financial Times, June 21, 1999.

5. "Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges...corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy” Maw et al. [1994].

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However corporate governance has wider implications and is critical to economic and social well being, firstly in providing the incentives and performance measures to achieve business success, and secondly in providing the accountability and transparency to ensure the equitable distribution of the resulting wealth. The significance of corporate governance for the stability and equity of society is captured in the broader definition of the concept offered by Sir Adrian Cadbury (2002): "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

The current wave of reform of corporate governance commenced with the Cadbury Code of Practice published by the London Stock Exchange in 1992; proceeded with an OECD inquiry in 1997-99, and the publication of OECD guidelines on corporate governance which have been adopted in national codes by all of the industrial countries, and with the assistance of the World Bank and Asian development bank, by many developing countries. The urgency of this endeavor was increased by the Asian financial crisis of 1997-98 that revealed the danger of systemic corporate governance failure. These codes have been reinforced by the influence of the market through investment institutions, and national regulators. Even with the efforts towards comprehensive reform serious weaknesses in corporate governance still occur as with the HIH Insurance and One-Tel collapse in Australia, and the failure of a series of major corporations in the United States in 2001/2002 commencing with Enron and WorldCom. It is likely interest in creating more robust institutions of corporate governance will remain an important social and economic priority for some time to come.

SIGNIFICANCE OF CORPORATE GOVERNANCE

A. Agency Theory and corporate management

In modern economies, the management and control of companies is increasingly separated from the ownership. It is in line with the Agency Theory that pointing out the importance on separating day to day corporate management from the owners to the managers. The purpose of the separation system is to create efficiency and effectiveness by hiring professional agents in managing the company. It is happened where the CEOs of public companies have responsibility to act as agents for the owners. While the owners seek to gain information (by evaluation), develop incentive systems to ensure agent actions in the owner's interests. Agency theorists attempt to design the most cost effective information
However there is a problem in this separation of corporate management and ownership as well. Managers may seek to maximize their own-self interest at the expense of shareholders. Furthermore this separation may lead to a lack of transparency in the use of funds in the company and in the proper balancing of the interests of, for instance, shareholders and managers and of controlling and minority shareholders.

B. Corporate Governance background

Companies increasingly depend on external capital (equity, loans) for the financing of their activities, investment and growth. It is therefore increasingly in their interest to assure external financiers of the proper and most efficient use of funds, and of the fact that the management acts in the best interest of the company. Such assurance is given by a system of corporate governance. A sound corporate governance system should provide effective protection for shareholders and creditors, so that they can assure themselves of getting a proper return on investment. It should therefore also help to create an environment conducive to the efficient and sustainable growth of the corporate sector. Corporate governance can therefore be defined as: a set of rules that define the relationship between shareholders, managers, creditors, the government, employees and other internal and external stakeholders in respect to their rights and responsibilities, or the system by which companies are directed and controlled. (taken from Cadbury Committee of United Kingdom) The objective of corporate governance is to create added value to the stakeholders.

International principles for corporate governance are emerging. These principles cover:
- the rights of shareholders, who should be timely and properly informed about the company, who should be able to participate in decisions concerning fundamental corporate changes, and who should share in the profits of the company;
- equitable treatment of shareholders, especially minority and foreign shareholders, with full disclosure of material information and prohibit abusive self dealing and insider trading;
- the role of stakeholders should be recognized as established by law and active co-operation between corporations and stakeholders in creating wealth, jobs and financially sound enterprises;
- timely and accurate disclosure and transparency on all matters material to company performance, ownership and its stakeholders;
- the responsibilities of the board in the management, the supervision of the management and the accountability to the company and shareholders.

The government plays an important supporting role by issuing and enforcing adequate regulation on for instance company registration, disclosure of financial company data and rules on the responsibilities of commissioners and directors. The company however has the prime responsibility for implementing a system of good corporate governance within the company. The company should recognize the importance that a system of good corporate governance has for the interests of its shareholders, its financiers and its employees, and therefore, for the company itself. Companies should anticipate stronger enforcement of existing laws and regulations, the introduction of new regulations and increasingly strong public scrutiny over their actions.

C. The Benefits of Corporate Governance

By applying Corporate Governance to the companies, there are some benefits that could be gained. The benefits are as follows:

1. Easier to raise capital;
2. Lower cost of capital;
3. Improved business performance and improved economic performance;
4. Good impact on share price. (Due to the current Indonesian situation, privatization of State-Owned Enterprises can contribute significantly to the state budget).
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Good corporate governance ensures that the business environment is fair and transparent and that companies can be held accountable for their actions. Conversely, weak corporate governance leads to waste, mismanagement, and corruption. It is also important to remember that although corporate governance has emerged as a way to manage modern joint stock corporations it is equally significant in state-owned enterprises, cooperatives, and family businesses. Regardless of the type of venture, only good governance can deliver sustainable good business performance.

SUMMARY

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