GOVERNANCE AND ETHICS

CS SECTION 5

STUDY NOTES

KASNEB SYLLABUS

CONTENT

CHAPTER ONE

INTRODUCTION TO GOVERNANCE

Introduction

Corporate Governance refers to the way a corporation is governed. It is the technique by which companies are directed and managed. It means carrying the business as per the stakeholders' desires. It is actually conducted by the board of Directors and the concerned committees for the company's stakeholder's benefit. It is all about balancing individual and societal goals, as well as, economic and social goals.

Corporate Governance is the interaction between various participants (shareholders, board of directors, and company's management) in shaping corporation's performance and the way it is proceeding towards. The relationship between the owners and the managers in an organization must be healthy and there should be no conflict between the two. The owners must see that individual's actual performance is according to the standard performance. These dimensions of corporate governance should not be overlooked.

Corporate Governance deals with the manner the providers of finance guarantee themselves of getting a fair return on their investment. Corporate Governance clearly distinguishes between the owners and the managers. The managers are the deciding authority. In modern corporations, the functions/ tasks of owners and managers should be clearly defined, rather, harmonizing.

Corporate Governance deals with determining ways to take effective strategic decisions. It gives ultimate authority and complete responsibility to the Board of Directors. In today's market- oriented economy, the need for corporate governance arises. Also, efficiency as well as globalization are significant factors urging corporate governance. Corporate Governance is essential to develop added value to the stakeholders.

Corporate Governance ensures transparency which ensures strong and balanced economic development. This also ensures that the interests of all shareholders (majority as well as minority shareholders) are safeguarded. It ensures that all shareholders fully exercise their rights and that the organization fully recognizes their rights.

Corporate Governance has a broad scope. It includes both social and institutional aspects. Corporate Governance encourages a trustworthy, moral, as well as ethical environment.

Importance of Corporate Governance

1. Good corporate governance ensures corporate success and economic growth.
2. Strong corporate governance maintains investors' confidence, as a result of which, company can raise capital efficiently and effectively.
3. It lowers the capital cost.
4. There is a positive impact on the share price.
5. It provides proper inducement to the owners as well as managers to achieve objectives that are in interests of the shareholders and the organization.
6. Good corporate governance also minimizes wastages, corruption, risks and mismanagement.
7. It helps in brand formation and development.
8. It ensures organization in managed in a manner that fits the best interests of all.

Principles of Corporate Governance

Corporate governance in the Company is based on the following principles:

Accountability
The Code of Corporate Governance envisages accountability of the Board of Directors of the Company before all shareholders in accordance with the legislation in force, and is the governing document for the Board of Directors in issues related to strategy planning, administration and control over the Company's executive bodies.

Fairness
The Company undertakes to protect the rights of its shareholders and treat all shareholders on an equal basis. The Board of Directors enables its shareholders to receive efficient protection if their rights are violated.

Transparency
The Company shall provide timely disclosure of credible information on all the important facts related to its activities, including information on its financial condition, social and environmental measures, results of activities, ownership and management structures; the Company shall provide free access to such information for all interested parties.

Responsibility
The Company acknowledges the rights of all interested parties envisaged by the legislation in force, and aims at cooperation with such parties in order to provide steady development and ensure financial stability of the Company.

PRINCIPLES OF GOOD CORPORATE GOVERNANCE

i. introduction

Corporate Governance is concerned with the establishment of an appropriate legal, economic and institutional environment that would facilitate and allow business enterprises to grow, thrive and survive as institutions for maximizing shareholder value while being conscious of and providing for the well-being of all other stakeholders and society.

Good Corporate Governance requires that the State puts in place and maintains an enabling environment in which efficient and well-managed companies can thrive. It is therefore expected that companies will continue to play their part in encouraging dialogue between the public and private sectors in promoting good public governance and an enabling business environment.

It is the responsibility of the owners of the corporation to elect competent directors and to ensure that they govern the corporation in a manner consistent with their stewardship.

Good corporate governance dictates that the Board of Directors governs the corporation in a way that maximizes shareholder value and in the best interest of society. It is neither in the long-term interest of the enterprise or society to short-change customers, exploit labour, pollute the environment or engage in corrupt practices.

The guidelines which follow set 21 principles of good corporate governance, aimed primarily at the Board of Directors in corporations with a unitary Board structure. These are followed by a sample code which expounds on these principles.
The following is a summary of the principles of good corporate governance:

Authority and Duties of Members [or Shareholders]

Members or shareholders [as owners] of the corporation shall jointly and severally protect, preserve and actively exercise the supreme authority of the corporation in general meetings. They have a duty, jointly and severally, to exercise that supreme authority of the corporation to:

- ♦ Ensure that only competent and reliable persons, who can add value, are elected or appointed to the Board of Directors;
- ♦ Ensure that the Board is constantly held accountable and responsible for the efficient and effective governance of the corporation so as to achieve corporate objectives, prosperity and sustainability.
- ♦ Change the composition of a Board that does not perform to expectation or in accordance with the mandate of the corporation.

Leadership

Every corporation should be headed by an effective Board that should exercise leadership, enterprise, integrity and judgment in directing the corporation so as to achieve continuing prosperity and to act in the best interest of the enterprise in a manner based on transparency, accountability and responsibility.

Appointments to the Board

Appointments to the Board of Directors should, through a managed and effective process, ensure that a balanced mix of proficient individuals is made and that each of those appointed is able to add value and bring independent judgment to bear on the decision-making process.

Strategy and Values

The Board of Directors should determine the purpose and values of the corporation, determine the strategy to achieve that purpose and implement its values in order to ensure that the corporation survives and thrives and that procedures and values that protect the assets and reputation of the corporation are put in place.

Structure and Organization

The Board should ensure that a proper management structure [organization, systems and people] is in place and make sure that the structure functions to maintain corporate integrity, reputation and responsibility.

Corporate Performance, Viability and Financial Sustainability

The Board should monitor and evaluate the implementation of strategies, policies and management performance criteria and the plans of the corporation. In addition, the Board should constantly review the viability and financial sustainability of the enterprise and must do so at least once every year.

Corporate Compliance

The Board should ensure that the corporation complies with all relevant laws, regulations, governance practices, accounting and auditing standards.

Corporate Communication

The Board should ensure that the corporation communicates with all its stakeholders effectively.

Accountability to Members

The Board should serve the legitimate interests of all members and account to them fully.

Responsibility to Stakeholders
The Board should identify the corporation's internal and external stakeholders; agree on a policy or policies determining how the corporation should relate to, and with them, in creating wealth, jobs and the sustainability of a financially sound corporation while ensuring that the rights of stakeholders [whether established by law or custom] are respected, recognized and protected.

Balance of Powers

The Board should ensure that no one person or group of persons has unfettered power and that there is an appropriate balance of power on the Board so that it can exercise objective and independent judgment.

Internal Control Procedures
The Board should regularly review systems, processes and procedures to ensure the effectiveness of its internal systems of control so that its decision-making capability and the accuracy of its reporting and financial results are maintained at the highest level at all times.

Assessment of Performance of the Board of Directors

The Board should regularly assess its performance and effectiveness as a whole and that of individual members, including the Chief Executive Officer. A summary of the major findings together with a statement confirming that the Board has carried out a self-assessment exercise should be made to the annual general meeting.

Induction, Development and Strengthening of Skills of Board Members

The Board should recognize the need for new members to be inducted into their roles and for all Board members to develop and strengthen their governance skills in light of technological developments, changing corporate environment and other variables. The Board should accordingly organize for the systematic induction and continuous development of its members.

Appointment and Development of Executive Management

The Board should appoint the Chief Executive Officer and participate in the appointment of all senior management, ensure motivation and protection of intellectual capital crucial to the corporation, ensure that there is appropriate and adequate training for management and other employees and put in place a succession plan for senior management.

Adoption of Technology and Skills

The Board must recognize that to survive and thrive it has to ensure that the technology, skills and systems used in the corporation are adequate to run the corporation and that the corporation constantly reviews and adopts the same in order to remain competitive.

Management of Corporate Risk

The Board must identify key risk areas and key performance indicators of the corporation's business and constantly monitor these factors.

Corporate Culture
The Board should define, promote and protect the corporate ethos, ethics and beliefs on which the corporation premises its policies, actions and behaviour in its relationships with all who deal with it.

Social and Environmental Responsibility
The Board should recognize that it is in the enlightened self-interest of the corporation to operate within the mandate entrusted to it by society and shoulder its social responsibility. For this reason, a corporation does not fulfill its social responsibility by short-changing beneficiaries or customers, exploiting its labour, polluting the environment, failing to conserve resources, neglecting the needs of the local community, evading taxation or engaging in other anti-social practices.

Recognition and Utilization of Professional Skills and Competencies
The Board should recognize and encourage professional development and, both collectively and individually, have the right to consult the corporation's professional advisers and, where necessary, seek independent professional advice at the corporation's expense in the furtherance of their duties as directors. [This is in addition to and not a substitute to their personal duty to acquire competence, training and information that would help them make informed, independent and astute decisions on issues relevant to the corporation.

Recognition and Protection of Members' Rights and Obligations
Members of the corporation have a right to receive any information that would materially affect their membership, to participate in any meeting of members and to participate in the election of directors and be facilitated to fully participate in all other resolutions of interest to them as members.

The attention of the Boards of Directors is increasingly being drawn to the need to ensure that:

- ♦ The governance framework takes account of gender and children's rights and the special needs of disabled and/or handicapped citizens.
- ♦ The Corporation promotes the interests, rights and welfare of host communities.

- ♦ The Corporation protects and preserves the environment

CHAPTER TWO

THEORIES OF GOOD GOVERNANCE

Introduction

Corporations have become a powerful and dominant institution. They have reached to every corner of the globe in various sizes, capabilities and influences. Their governance has influenced economies and various aspects of social landscape. Shareholders are seen to be losing trust and market value has been tremendously affected. Moreover with the emergence of globalization, there is greater deterritorialization and less of governmental control, which results is a greater need for accountability. Hence, corporate governance has become an important factor in managing organizations in the current global and complex environment. In order to understand corporate governance, it is important to highlight its definition.

Corporate governance can be defined as a set of processes and structures for controlling and directing an organization. It constitutes a set of rules, which governs the relationships between management, shareholders and stakeholders. The term "corporate governance" has a clear origin from a Greek word, "kyberman" meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as "gubernare" and the French version of "governor" . It could also mean the process of decision-making and the process by which decisions may be implemented. Henceforth, corporate governance has much a different meaning to different organizations. In recent years, with much corporate failures, the countenance of corporate has been scared.

Corporate governance includes all types of firms and its definitions could extend to cover all of the economic and non-economic activities. Literatures in corporate governance provide some form of meaning on governance, but fall short in its precise meaning of governance. Such ambiguity emerges in words like control, regulate, manage, govern and governance. Owing to such ambiguity, there are many interpretations. It may be important to consider the influences a firm has or affected by in order to grasp a better understanding of governance. Owing to vast influential factors, proposed models of corporate governance can be flawed as each social scientist is forming their own scope and concerns. Hence, this article reviews various fundamental theories underlining corporate governance.
These theories range from the agency theory and expanded into stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, political theory and ethics related theories such as business ethics theory, virtue ethics theory, feminists ethics theory, discourse theory and postmodernism ethics theory.

Agency theory

It involves the problem of directors controlling a company whilst shareholders own the company. In the past, a problem was identified whereby the directors might not act in the shareholders (or other stakeholders) best interests. Agency theory considers this problem and what could be done to prevent it.

Key concepts of agency theory

A number of key terms and concepts are essential to understanding agency theory.

- An **agent** is employed by a **principal** to carry out a task on their behalf.
- **Agency** refers to the relationship between a principal and their agent.
- **Agency costs** are incurred by principals in monitoring agency behaviour because of a lack of trust in the good faith of agents.
- By accepting to undertake a task on their behalf, an agent becomes accountable to the principal by whom they are employed. The agent is **accountable** to that principal.

The separation of ownership and control

Agency theory can be applied to the agency relationship deriving from the separation between ownership and control.

- Companies that are quoted on a stock market such as the London Stock Exchange are often extremely complex and require a substantial investment in equity to fund them, i.e. they often have large numbers of shareholders.
- Shareholders delegate control to professional managers (the board of directors) to run the company on their behalf.
- The Directors (agents) have a **fiduciary responsibility** to the shareholders (principal) of their organisation (usually described through company law as 'operating in the best interests of the shareholders').
- Shareholders normally play a passive role in the day-to-day management of the company.
- Directors own less than 1% of the shares of most of the UK's 100 largest quoted companies and only four out of ten directors of listed companies own any shares in their business.
- Separation of ownership and control leads to a potential conflict of interests between directors and shareholders.
- The agents' **objectives** (such as a desire for high salary, large bonus and status for a director) will differ from the principal's objectives (wealth maximisation for shareholders).

Agency theory and corporate governance

Agency theory can help to explain the actions of the various interest groups in the corporate governance debate.

Examination of theories behind corporate governance provides a foundation for understanding the issue in greater depth and a link between an historical perspective and its application in modern governance standards.

- Historically, companies were owned and managed by the same people. For economies to grow it was necessary to find a larger number of investors to provide finance to assist in corporate expansion.

This led to the concept of limited liability and the development of stock markets to buy and sell shares.

- Limited liability: limited risk and so less interest in the firm.
- Stock market: wide and limited individual ownership and the ability to simply sell without the need to take any interest in the firm.
- Delegation of running the firm to the agent or managers.
- Separation of goals between wealth maximisation of shareholders and the personal objectives of managers. This separation is a key assumption of agency theory.
- Possible short-term perspective of managers rather than protecting long-term shareholder wealth.
- Divorce between ownership and control linked with differing objectives creates agency problems.

Examples of principal-agent relationships

Shareholders and directors

The separation of ownership and control in a business leads to a potential conflict of interests between directors and shareholders.

- The conflict of interests between principal (shareholder) and agent (director) gives rise to the 'principal-agent problem' which is the key area of corporate governance focus.
- The principals need to find ways of ensuring that their agents act in their (the principals') interests.

- As a result of several high profile corporate collapses, caused by over-dominant or 'fat cat' directors, there has been a very active debate about the power of boards of directors, and how stakeholders (not just shareholders) can seek to ensure that directors do not abuse their powers.
- Various reports have been published, and legislation has been enacted, in the UK and the US, which seek to improve the control that stakeholders can exercise over the board of directors of the company.

Shareholders and auditors

The other principal-agent relationship dealt with by corporate governance guidelines is that of the company with its auditors.

- The audit is seen as a key component of corporate governance, providing an independent review of the financial position of the organisation.
- Auditors act as agents to principals (shareholders) when performing an audit and this relationship brings similar concerns with regard to trust and confidence as the director-shareholder relationship.
- Like directors, auditors will have their own interests and motives to consider.
- Auditor independence from the board of directors is of great importance to shareholders and is seen as a key factor in helping to deliver audit quality. However, an audit necessitates a close working relationship with the board of directors of a company.
- This close relationship has led (and continues to lead) shareholders to question the perceived and actual independence of auditors so tougher controls and standards have been introduced to protect them.
- Who audits the auditors?

The cost of agency relationships

Agency costs arise largely from principals monitoring activities of agents, and may be viewed in monetary terms, resources consumed or time taken in monitoring. Costs are borne by the principal, but may be indirectly incurred as the agent spends time and resources on certain activities. Examples of costs include:

- incentive schemes and remuneration packages for directors
- costs of management providing annual report data such as committee activity and risk management analysis, and cost of principal reviewing this data
- cost of meetings with financial analysts and principal shareholders
- the cost of accepting higher risks than shareholders would like in the way in which the company operates
- cost of monitoring behaviour, such as by establishing management audit procedures.

Residual loss

This is an additional type of agency cost and relates to directors furnishing themselves with expensive cars and planes etc. These costs are above and beyond the remuneration package for the director, and are a direct loss to shareholders.

Agency problem resolution measures

- Meetings between the directors and key institutional investors.
- Voting rights at the AGM in support of, or against, resolutions.
- Proposing resolutions for vote by shareholders at AGMs.
- Accepting takeovers.
- Divestment of shares is the ultimate threat.

Need for corporate governance

- If the market mechanism and shareholder activities are not enough to monitor the company then some form of regulation is needed.
- There are a number of codes of conduct and recommendations issued by governments and stock exchanges. Although compliance is voluntary (in the sense it is not governed by law), the fear of damage to reputation arising from governance weaknesses and the threat of delisting from stock exchanges renders it difficult not to comply.

Examples of codes of conduct include:

- The UK Corporate Governance Code (2010) for Corporate Governance adopted by the Financial Services Authority (FSA) in the UK.
- OECD code on ethics.
- ACCA codes.
- Specific regulation regarding director remuneration and city code on takeovers.

Stewardship theory

Unlike agency theory, stewardship theory assumes that managers are stewards whose behaviors are aligned with the objectives of their principals. The theory argues and looks at a different form of motivation for managers drawn from organizational theory. Managers are viewed as loyal to the company and interested in achieving high performance. The dominant motive, which directs managers to accomplish their job, is their desire to perform excellently. Specifically, managers are conceived as being motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses. Therefore, there are non-financial motivators for managers.

The theory also argues that an organization requires a structure that allows harmonization to be achieved most efficiently between managers and owners. In the context of firm's leadership, this situation is attained more readily if the CEO is also the chairman of the board. This leadership structure will assist them to attain superior performance to the extent that the CEO exercises complete authority over the corporation and that their role is unambiguous and unchallenged. In this situation, power and authority are concentrated in a single person. Hence, the expectations about corporate leadership will be clearer and more consistent both for subordinate managers and for other members of the corporate board. Thus, there is no room for uncertainty as to who has authority or responsibility over a particular matter. The organization will enjoy the benefits of unity of direction and of strong command and control.

Examples

Stewardship models may include environmental concerns, where a company believes it should operate with as little impact as possible on the earth. Other companies may champion human or animal rights, refraining from using products that are made in sweatshops or tested on live subjects. Still others may honor the owner's religious beliefs that show themselves in the form of servant leadership. These models tend to be subjective, with management determining the boundary between socially responsible or irresponsible behavior.

Effects On Business

A company committed to a higher purpose will draw clients who share that same purpose. However, if the owners talk about stewardship or social responsibility in its corporate governance, the customers carefully weigh this against how the company truly operates. Discrepancies between talk and action alienate the client

Effects On Employees

Employees can tell fairly quickly if a company's stewardship stance translates into how they're treated. Workers may have higher expectations than they would if an employer operates under a pure profit motive. However, employees who hold to the same vision tend to stick around and work hard to achieve the company's goals even if compensation is not as much as they can get elsewhere. A solid sense of stewardship improves company morale when the workers feel they're part of something bigger.

Effects On Clients

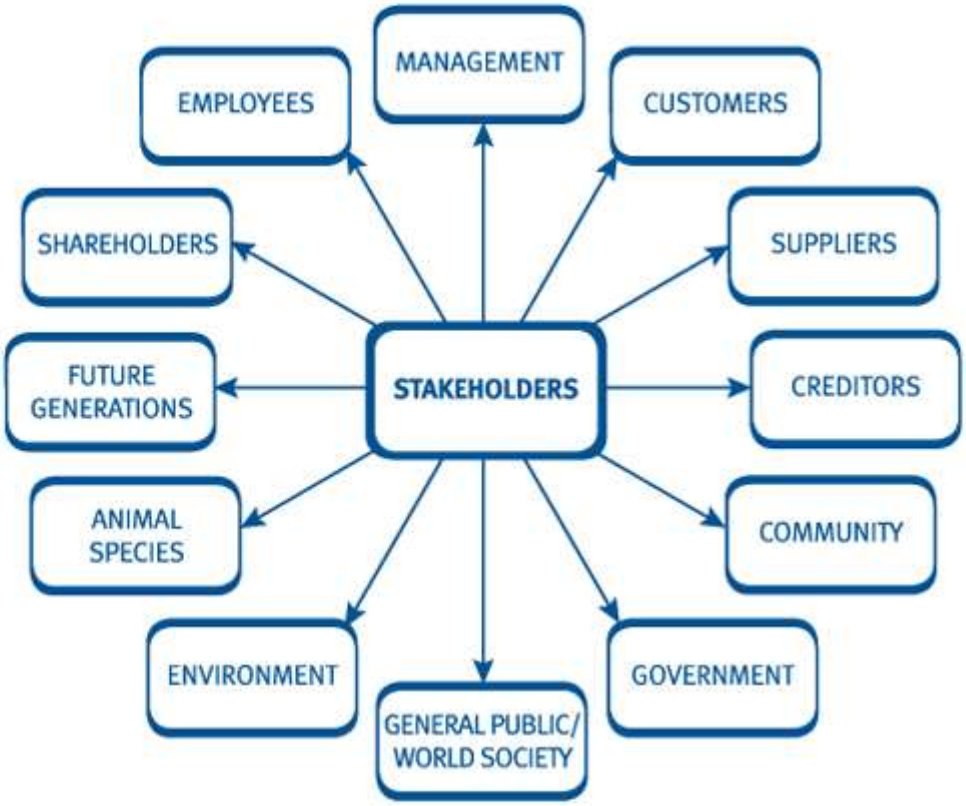
Customers also like to feel like they're part of something, and may stay with a stewardship-driven business even if its price for goods or services is higher. However, a company's stance on stewardship may rub some potential customers the wrong way, particularly if their cause is unpopular or management becomes strident about their beliefs.

Common Pitfalls

Stewardship-based companies find themselves under a microscope. If clients or workers sense the higher mission is just talk, the company will lose trust or credibility. A company may cite social responsibility as justification for higher prices or inferior products. But even if a company stays true to its mission, it may miss out on some profits for the sake of its higher purpose. As a company matures, stewardship may fall by the wayside if the founders are no longer around to set the tone. On the other hand, employees and workers may take advantage of this stewardship mindset for their own purposes.

Stakeholder theory

The basis for stakeholder theory is that companies are so large and their impact on society so pervasive that they should discharge accountability to many more sectors of society than solely their shareholders.



Stakeholder theory may be the necessary outcome of agency theory given that there is a business case in considering the needs of stakeholders through improved customer perception, employee motivation, supplier stability, shareholder conscience investment.

These ideas were originally developed by Ed Freeman in the 1980s, but have achieved a wider currency in the UK, in part through initiatives such as the RSA's 'Tomorrow's Company' project. Stakeholder theory challenges agency assumptions about the primacy of shareholder interests. Instead it argues that a company should be managed in the interests of all its stakeholders. These interests include not only those of the shareholder but also a range of other direct and indirect interests. The employee is obviously a key stakeholder and there have been long-running arguments amongst governance academics such as Margaret Blair that employees just as much as shareholders are 'residual risk-takers' in a firm. An employee's investment in firm-specific skills means that they too should have a voice in the governance of the firm. But stakeholder theory would also insist that other groups - suppliers and customers - have strong direct interests in company performance while local communities, the environment as well as society at large have legitimate indirect interests.

The argument that is repeatedly raised against a stakeholder view of the firm is that it is hard to operationalise because of the difficulties of deciding what weight should be given to different stakeholder interests. In terms of corporate governance it is argued that, were executives to be made accountable to all of a company's stakeholders they would, in effect, be answerable to none. Enlightened stakeholder theory therefore suggests the practical value of accountability to shareholders even if a board takes other interests into account in its conduct of a firm.

In relation to company performance, however, stakeholder theory has made a number of key contributions. The recent profusion of interest in business ethics can be traced to stakeholder ideas. Excessive levels of executive pay and the way that these have often gone hand in hand with company downsizing and all its negative impacts on employees and local communities undermine the legitimacy of the demand for 'shareholder value'. Corporate failures and associated pension fund collapses threaten both the basis of the traditional psychological contract as well as the 'licence to operate' that underpins the privileges afforded by society to corporate entities. Globalisation has also brought with it the rise of the single-issue pressure group and a heightened visibility to corporate practices - the use of child labour, environmental damage, corruption - that might formerly have remained hidden from sight. The importance that is now given to corporate value statements, as well as the board's role in creating corporate ethics codes, and social and environmental reporting all reflect an acknowledgement of a wider set of corporate obligations beyond the delivery of shareholder value, or at least insist that such performance must be realised within certain ethical constraints.

While ethical codes have the potential to constrain *how* performance is pursued, arguably the most direct contribution of stakeholder ideas to company performance is to be found in Kaplan and Norton's (1992) ideas about the Balanced Scorecard and the revolution in performance measurement that this has encouraged. Kaplan and Norton acknowledge the power of measurement on performance, as well as the potential distortions on operational effectiveness that can arise from purely financial accounting measures like earnings per share or return on investment.

The Balanced Scorecard embodies key stakeholder interests in a firm-specific set of measures that link important operational drivers to financial performance. It therefore provides managers with a way to explore the inter-dependencies between customers' needs, and what the company must do operationally to meet these needs and sustain competitive success. It has both an immediate performance focus as well as pointing to key areas for continuous improvement and innovation. Kaplan and Norton suggest that the orientation of traditional performance systems is the 'control' of individual behaviour through measurement. By contrast the focus of the Balanced Scorecard, they suggest, is 'strategy and vision', that establishes goals but then promotes initiative and learning - both individual, team, and across-functions - in pursuit of such goals. From this perspective the key role of senior executives and the board lies in the setting of company strategy and vision. High performance depends on the board's understanding of the key business and competitive drivers, its capacities for strategic thought, as well as its communication and leadership skills in relation to staff, customers and financial markets.

Governance and transaction cost theory

Transaction cost theory can be viewed as part of corporate governance and agency theory. It is based on the principle that costs will arise when you get someone else to do something for you .e.g. directors to run the business you own.

Transaction cost theory

Context - the "make or buy" decision

Transaction cost theory (Wiliamson) was first discussed in the context of the decision by a firm whether to do something in-house or to outsource.

Organisations choose between two methods of obtaining control over resources:

- the ownership of assets (**hierarchy solutions** – decisions over production, supply, and the purchases of inputs are made by
managers and imposed through hierarchies) and
- buying in the use of assets (**the market solution** – individuals and firms make independent decisions that are guided and coordinated by market prices).

The decision is based on a comparison of the "transaction costs" of the two approaches. Transaction costs are the indirect costs (i.e. non production costs) incurred in performing a particular activity, for example the expenses incurred through outsourcing.

When outsourcing, transaction costs arise from the effort that must be put into specifying what is required and subsequently coordinating delivery and monitoring quality.

High transaction costs for outsourcing may suggest an in-house solution whereas low transaction costs for outsourcing would support the argument to outsource.

Governance

Transaction cost theory can be applied to a discussion of governance by viewing it as as an alternative variant of the agency understanding of governance assumptions. It describes governance frameworks as being based on the net effects of internal and external transactions, rather than as contractual relationships outside the firm (i.e. with shareholders).

Transaction costs

Transaction costs will occur when dealing with another external party:

- Search and information costs: to find the supplier.
- Bargaining and decision costs: to purchase the component.
- Policing and enforcement costs: to monitor quality.

The way in which a company is organised can determine its control over transactions, and hence costs. It is in the interests of management to internalise transactions as much as possible, to remove these costs and the resulting risks and uncertainties about prices and quality.
For example a beer company owning breweries, public houses and suppliers removes the problems of negotiating prices between supplier and retailer.

Transaction costs can be further impacted by the following:

- **Bounded rationality**: our limited capacity to understand business situations, which limits the factors we consider in the decision.
- **Opportunism**: actions taken in an individual's best interests, which can create uncertainty in dealings and mistrust between parties.

The significance and impact of these criteria will allow the company to decide whether to expand internally (possibly through vertical integration) or deal with external parties.

The variables that dictate the impact on the transaction costs are:

- Frequency: how often such a transaction is made.
- Uncertainty: long term relationships are more uncertain, close relationships are more uncertain, lack of trust leads to uncertainty.
- Asset specificity: how unique the component is for your needs.

Internal transactions

Transaction costs still occur within a company, transacting between departments or business units. The same concepts of bounded rationality and opportunism on the part of directors or managers can be used to view the motivation behind **any** decision.

The three variables given above can be applied to all behaviour by managers:

- Asset specificity: amount the manager will personally gain.
- Certainty: or otherwise of being caught.
- Frequency: endemic nature of such action within corporate culture

The degree of impact of the three variables leads to a precise determination of the degree of monitoring and control needed by senior management.

Possible conclusions from transaction cost theory

- Opportunistic behaviour could have dire consequences on financing and strategy of businesses, hence discouraging potential investors. Businesses therefore organise themselves to minimise the impact of bounded rationality and opportunism as much as possible.
- Governance costs build up including internal controls to monitor management.
- Managers become more risk averse seeking the safe ground of easily governed markets.

Transaction cost theory versus agency theory

Transaction cost theory and agency theory essentially deal with the same issues and problems. Where agency theory focuses on the individual agent, transaction cost theory focuses on the individual transaction.

- Agency theory looks at the tendency of directors to act in their own best interests, pursuing salary and status. Transaction cost theory considers that managers (or directors) may arrange transactions in an opportunistic way.
- The corporate governance problem of transaction cost theory is, however, not the protection of ownership rights of shareholders (as is the agency theory focus), rather the effective and efficient accomplishment of transactions by firms.

Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm.

Resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment.

Resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure.

It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival. According to Hillman, Canella and Paetzold (2000) that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influentials. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influentials are the political leaders, university faculty, members of clergy, leaders of social or community organizations.

The basic proposition of resource dependence theory is the need for environmental linkages between the firm and outside resources. In this perspective, directors serve to connect the firm with external factors by co-opting the resources needed to survive. This means that boards of directors are an important mechanism for absorbing critical elements of environmental uncertainty into the firm. Environmental linkages could reduce transaction costs associated with environmental interdependency. The organization's need to require resources leads to the development of exchange relationships between organizations. Further, the uneven distribution of needed resources results in inter-dependent organizational relationships. Several factors would appear to intensify the character of this dependence, e.g. the importance of the resource(s), the relative shortage of the resource(s) and the extent to which the resource(s) is concentrated in the environment .

In this context, many of the resources are directly and indirectly controlled by the government. Hence, appointing directors that have influence and access to key policy-makers and government is seen as an important strategy for survival because of their knowledge and prestige in their professions and communities, firms are able to extract useful resources. This could enhance the firm's legitimacy in society and to help it achieve their goals and improve performance. Through the resource dependence role, directors may also bring resources such as specialized skills and expertise. This concept has important implications for the role of the board and its structure, which in turn affects performance. In summary, resource dependence theory provides a convincing justification for the creation of linkages between the firm and its external environment through boards as firms that create linkages could improve their survival and performance.

LEGITIMACY THEORY

Legitimacy theory posits that businesses are bound by the social contract in which the firms agree to perform various socially desired actions in return for approval of its objectives and other rewards, and this ultimately guarantees its continued existence.

Political Theory

Political theory brings the approach of developing voting support from shareholders, rather bypurchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1993). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996).

Ethics Theories and Corporate Governace

Other than the fundamental corporate governance theories of agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory and political theory, there are other ethical theories that can be closely associated to corporate governance. These include business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, postmodern ethics theory.

Business ethics is a study of business activities, decisions and situations where the right and wrongs are addressed. The main reasons for this are the power and influence of business in any given society is stronger than ever before. Businesses have become a major provider to the society, in terms of jobs, products and services. Business collapse has a greater impact on society than ever before and the demands placed by the firm's stakeholders are more complex and challenging. Only a handful of business giants have had any formal education on business ethics but there seems to be more compromises these days. Business ethics helps us to identify benefits and problems associated with ethical issues within the firm and business ethics is important as it gives us a new light into present and traditional view of ethics (Crane and Matten, 2007). In understanding the 'right and wrongs' in business ethics, Crane & Matten, (2007) injected morality that is concerned with the norms, values and beliefs fixed in the social process which helps right and wrong for an individual or social community. Ethics is defined as the study of morality and the application of reason which sheds light on rules and principle, which is called ethical theories that ascertains the right and wrong for a situation.

Whilst business ethics theory focuses on the "rights and wrongs' in business, f*eminist ethicstheory* emphasizes on empathy, healthy social relationship, loving care for each other and theavoidance of harm. In an organization, to care for one another is a social concern and not merely a profit centered motive. Ethics has also to be seen in the light of the environment in which it is exercised. This is important as an organization is a network of actions, hence influencing trans-communal levels and interactions (Casey, 2006). On the other end, *discourse ethics theory* is concerned with peaceful settlement of conflicts. Discourse ethics, also called argumentation ethics, refers to a type of argument that tries to establish ethical truths by investigating the presuppositions of discourse (Habermas, 1996). Meisenbach (2006) contends that such kind of settlement would be beneficial to promote cultural rationality and cultivate openness.

Virtue ethics theory focuses on moral excellence, goodness, chastity and good character. Virtueis a state to act in a given situation. It is not a habit as a habit can be mindless (Annas, 2003). Aristotle calls it as disposition with choice or decision. For example, if a board member decides to be honest, now that a decision which he makes and thus strengthens his virtue of honesty. Virtue involves two aspects, the affective and intellectual. The concept of affective in virtue theory suggests "doing the right thing and have positive feelings", whilst, the concept of intellectual suggests "to do virtuous act with the right reason". Virtues can be instilled with education. Aristotle mentions that knowledge on ethics is just like becoming a builder (Annas, 2003). Through the process of educating and exposure to good virtues, the development of ethical values in a child's life is evident. Hence, if a person i

CHAPTER THREE

PROMOTING GOOD COORPORATE GOVERNANCE

Rights of Shareholders

All shareholder rights shall be recognized, respected and protected.

Basic shareholder rights include:

♦ To secure methods of ownership registration;

♦ To convey or transfer shares;

♦ To obtain relevant information on the corporation on a timely and regular basis;

♦ To participate and vote in general shareholder meetings;

♦ To elect members of the Board; and

♦ To share in the residual profits of the company.

Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:

♦ Amendments to the statutes, or articles of incorporation or similar governing documents of the company;

♦ The authorization of additional shares; and

♦ Extra-ordinary transactions that in effect result in the sale of the company

Shareholders shall have the opportunity to participate effectively and vote in general shareholder meetings and shall be informed of the rules, including voting procedures that govern general shareholder meetings:

♦ Shareholders shall be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meetings.

♦ Opportunity shall be provided for shareholders to ask questions of the Board and to place items on the agenda at general meetings, subject to reasonable limitations.

♦ Shareholders shall be able to vote in person or in absentia, and equal effect shall be given to votes whether cast in person or in absentia.

♦ Shareholders shall be provided with adequate information on competencies required on the Board and given options to elect directors from amongst a range of qualified, competent, fit and proper persons.

Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership shall be disclosed.

The Board shall endeavour to ensure that markets for corporate control are allowed to function in an efficient and transparent manner. In this regard, the Board shall always seek to ensure that:

♦ The rules and procedures governing the acquisition of corporate control in the capital market, and extraordinary transactions such as mergers and sales of substantial portions of corporate assets shall be clearly articulated and disclosed so that investors understand their rights and recourse.

♦ Transactions shall occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

♦ Anti-take-over devices shall not be used to shield management from accountability.

♦ Shareholders, including corporate investors, consider the costs and benefits of using their voting rights.

The Board of Directors shall ensure that there is equitable treatment of all shareholders. In particular the Board shall ensure that:

♦ All shareholders of the same class are treated equally.

♦ Equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders shall have the opportunity to obtain effective redress for violation to their rights.

♦ Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about voting rights affiliated with all classes of shares before they purchase them. Any changes in voting rights within or between classes of shares should be subject to shareholder vote.

♦ Votes shall be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

♦ Processes and procedures for general shareholder meetings shall allow for equitable treatment of all shareholders.

♦ Company procedures do not make it unduly difficult or expensive to cast votes.

♦ Self-dealing and insider trading are prohibited.

♦ Members of the Board and managers disclose their material interests in transactions on matters affecting the corporation.

The Shareholders in turn have a duty and are well advised to exercise the supreme authority of the company in general meetings to hold the Board accountable for stewardship of the company.

Responsibilities to Other Stakeholders

The Board of Directors and the company recognize the rights of stakeholders as established by law and shall encourage active co-operation between the company and its stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. In this regard, the Board of Directors shall:

♦ Ensure that the rights of stakeholders that are protected by law are respected.

♦ Where stakeholder interests are protected by law, ensure that stakeholders have the opportunity to seek effective redress for any violation of their rights.

♦ Permit and facilitate performance-enhancing mechanisms for stakeholder participation.
♦ Ensure that where stakeholders participate in performance-enhancing mechanisms, they have access to all relevant information.

Authority and Duties of Shareholders

Shareholders of the company shall jointly and severally protect, preserve and actively exercise the supreme authority of the company in general meetings. They have a duty, jointly and severally, to exercise that supreme authority to:

♦ Ensure that only competent and reliable persons who can add value to the company are elected or appointed to the Board of Directors;
♦ Ensure that the Board of Directors is constantly held accountable and responsible for the efficient and effective governance of the company.
♦ Change the composition of a Board of Directors that does not perform to expectation or in accordance with the mandate of the corporation.

Leadership of the Company

The Board of Directors shall exercise leadership, enterprise, integrity and sagacious judgment in directing the company so as to achieve continuing prosperity for the company and shall always act in the best interests of the company.

Role and Functions of the Board

The Board of Directors shall exercise all the powers of the company subject only to the limitations contained in the law and the memorandum and articles of incorporation.

In this regard, it is expected that the Board of Directors shall fulfill the following functions:

♦ Exercise leadership, enterprise, integrity and sound judgments in directing the corporation so as to achieve continuing prosperity and to act in the best interest of the enterprise while respecting the principles of transparency and accountability;
♦ Ensure that through a managed and effective process, board appointments are made that provide a mix of proficient directors, each of whom is able to add value and bring independent judgment to bear on the decision-making process;
♦ Determine the corporation's purpose and values, determine the strategy to achieve its purpose and to implement its values in order to ensure it survives and thrives, and ensure that procedures and practices are in place that protect the corporation's assets and reputation;
♦ Monitor and evaluate the implementation of strategies, policies, management performance criteria and business plans;
♦ Ensure that the corporation complies with all relevant laws, regulations and codes of best business practice;
♦ Ensure that the corporation communicates with shareholders and other stakeholders effectively;

♦ Serve the legitimate interest of the shareholders and the corporation and account to them fully;
♦ Identify the corporation's internal and external stakeholders and agree on a policy, or policies determining how the corporation should relate to them;
♦ Ensure that no one person or a block of persons has unfettered power and that there is an appropriate balance of power and authority on the board which is, inter alia, usually reflected by separating the roles of the Chief Executive Officer and Chairman, and by having a balance between executive and non-executive directors;
♦ Regularly review processes and procedures to ensure the effectiveness of its internal systems of control, so that its decision-making capability and the accuracy of its reporting and financial results are maintained at a high level at all times;
♦ Regularly assess its performance and effectiveness as a whole, and that of the individual directors, including the Chief Executive Officer;
♦ Appoint the Chief Executive Officer and at least participate in the appointment of senior management, ensure the motivation and protection of intellectual capital intrinsic to the corporation, ensure that there is adequate training in the corporation for management and employees, and a succession plan for senior management;
♦ Ensure that all technology and systems used in the corporation are adequate to properly run the business and for it to remain effectively competitive;
♦ Identify key risk areas and key performance indicators of the business and monitor these factors;
♦Ensure annually that the corporation will survive, thrive and continue as a viable going concern.

In Order to fulfill these functions, the Board of Directors shall:

♦ Meet regularly and retain full and effective control over the company.
♦ Evolve procedures for the selection and removal of individual directors (including the chairman and chief executive) to facilitate regular alteration of the mix and composition of the Board ensuring relevant rejuvenation.
♦ Define the limits of authority of the Chief Executive and other top executives.
♦ Compile and communicate company policies, strategies etc. covering style of operation; external and internal relationships; markets and business; required rates of return and performance standards; growth and change policies; planning and budgetary procedures.
♦ Review and approve strategic plans and arrange that meaningful plans are produced at all levels on an on-going basis covering the longest realistic time-scale.
♦ Determine the (actual and potential) total resources of the company in terms of men, money, methods, equipment etc. and market position, and allocate these by unit and time-scale, defining closely what returns are expected and when.
♦ Devote sufficient time to their responsibilities.
♦ Structure and organize the company.
♦ Monitor management performance.
♦ Map out the mechanisms for internal and external liaison and communications.
♦ Define how the Board will operate including:

- What information or reports it requires on a monthly or quarterly basis.
- How, with what data, and by what means, it will constantly monitor management performance and the financial progress of the company.
- How it will evaluate its own performance at least once every year.

♦ Ensure that the company is properly managed and for the attainment of lawful objectives.
♦ Ensure that the company's affairs are not managed or conducted in a manner oppressive to any of its shareholders or for fraudulent purposes.
♦ Ensure that the company complies with all statutory requirements.

Composition of the Board

The Board shall include a balance of executive and non-executive directors (including independent non-executive directors) such that no individual or group of individuals or interests can dominate its decision taking.

The Board shall be chaired by an independent director who is not managing the company.

There are two key tasks at the top of the company, that of running the Board and that of the Chief Executive responsible for running the company. Therefore as a general rule, there is a clear division of these roles to ensure that a balance of power and authority is maintained, and that no one individual has unfettered powers of decision. Where these roles are combined, the reasons thereof shall be publicly explained.

The roles of the Chairman are:

♦ To lead the Board;
♦ To chair meetings of the Board and members, ensuring order, proper conduct of meetings, affording participants a reasonable opportunity to speak, ensuring decisions are fairly made, deciding on technicalities and to cast the deciding vote in case of ties;
♦ To organize and facilitate a balance of internal and external relationships, and ♦ To facilitate effective Board management.

Independent non- executive directors shall be independent of management, and free from any business or other relationship which would interfere with the exercise of their ability to bring an independent judgment to bear on issues of strategy, performance, resources, key appointments and standards of conduct. Independent non-executive directors shall be relied upon in matters where there is potential for conflict of interest e.g.:

♦ Financial reporting (Audit Committee)
♦ Nomination and remuneration of directors ♦ Evaluation of Board performance

It is suggested that:

♦ The company must contain at least one third of its members as non-executive directors.
♦ Persons with full time employment in any company or organization should not hold many non-executive directorships elsewhere [indicatively, not more that two].
♦ Persons without full-time employment in one organization (professional directors, consultants etc.) should not hold more than ten non-executive directorships.

♦ Executives from subsidiaries, the parent company or any other of its acquisitions cannot become non-executive directors on the parent company.
♦ Suppliers, direct customers or other trading associates of the company cannot become non-executive directors of the company.
♦ Persons with prior professional or social relationships with directors of the company cannot become non-executives directors in the company.

THE COMPANY SECRETARY

The company must always have a qualified, competent, fit and proper company secretary who must have the requisite knowledge and experience necessary to undertake the statutory duties and responsibilities of the post and advise the Board. The Company Secretary should have responsibility for ensuring that the company adheres to this code of best practice for corporate governance.

SUMMARY CORE DUTIES OF THE COMPANY SECRETARY

The following list includes both those duties which are legal obligations as well as those which result from Best Practice. This is not a comprehensive list and the Company Secretary may have to use their initiative to ensure that all core duties are fulfilled. The Company Secretary will also have to refer to all relevant legislation.

The Company Secretary will need to fulfill the following duties:

Board Meetings

Facilitating the smooth operation of the company's formal decision making and reporting machinery; organizing board and board committee meetings [e.g. audit, remuneration, nomination committees etc]; formulating meeting agendas with the chairman and/or the chief executive and advising management on content and organization of memoranda or presentations for the meetings; collecting, organizing and distributing information, documents or other papers required for the meeting; ensuring that all meetings are minuted and that the minute books are properly maintained and that all Board committees are properly constituted and provided with clear terms of reference.

General Meetings

Ensuring that an Annual General Meeting is held in accordance with the requirements of the Companies Act and the company's Articles of Association; obtaining internal and external agreement to all documentation for circulation to shareholders; preparing and issuing notices of meetings, and distributing proxy forms; preparing directors for any shareholder questions and helping them create briefing materials; overseeing the preparations for security arrangements.

At meetings, ensuring that proxy forms are correctly processed and that the voting process is carried out correctly; co-ordinating the administration and minuting of meetings.

Memorandum & Articles of Association
Ensuring that the company complies with its Memorandum and Articles of Association; drafting and incorporating amendments in accordance with correct procedures.

Stock Exchange Requirements

Monitoring and ensuring compliance with the Stock Exchange requirements as well as supervising the implementation of the model code and/or the company code for dealing in the company's securities, as appropriate; managing relations with the Stock Exchange through the company's brokers; releasing information to the market; ensuring the security of unreleased price-sensitive information; making applications for listing of additional issues of securities.

Statutory Registers

Maintaining the following statutory registers:

♦ Members
♦ Mortgage and charges;
♦ Directors and secretary;
♦Directors' interests in shares and debentures;
♦ Interests in voting shares;
♦ Debenture holders [if applicable].

Statutory Returns

Filing information with the Registrar of Companies to report certain changes regarding the company or to comply with requirements for periodic filing. Of particular importance in this regard are:

♦ Annual returns
♦ Report & accounts;
♦Amended Memorandum and "Articles of Association;
♦ Returns of allotments;
♦ Notices of appointment, removal and resignation of directors and/or the Company Secretary;
♦ Notices of removal or resignation of the auditors;
♦ Change of registered office;
♦ Resolutions in accordance with the Companies Act.

Report & Accounts

Co-ordinating the publication and distribution of the company's annual report and accounts and interim statements, in consultation with the company's internal and external advisers, in particular, when preparing the directors' report.

Share Registration

Maintaining the Company's register of members; dealing with transfers and other matters affecting share-holding; dealing with queries and requests from shareholders.

Shareholder Communications

Communicating with the shareholders [e.g. through circulars]; arranging payment of dividends and interest; issuing documentation regarding rights issues, capitalization issues, and maintaining good shareholder relations; maintaining good relations with institutional shareholders and their investment committees.

Shareholder Monitoring

Monitoring movements on the register of members to identify any apparent 'stake-building' in the company's shares; making appropriate enquiries of members as to the beneficial ownership of holdings.

Share and Capital Issues and Restructuring

Implementing properly authorized changes in the structure of the company's share and loan capital; devising, implementing and administering directors' and employees' share participation schemes.

Acquisitions, Disposals & Mergers

Participating as a key member of the company team established to implement corporate acquisitions, disposals and mergers; protecting the company's interests by ensuring the effectiveness of all documentation; ensuring that due diligence disclosures enable proper commercial evaluation prior to completion of a transaction; ensuring that the correct authority is in place to allow timely execution of documentation.

Corporate Governance

Continually reviewing developments in corporate governance; facilitating the proper induction of directors into their role; advising and assisting the directors with respect to their duties and responsibilities, in particular compliance with company law and, if applicable, Stock Exchange requirements; counselling them when preparing presentations and memoranda.

Non-Executive Directors

Acting as a channel of communication and information for non-executive directors.

Company Seal

Ensuring the safe custody and proper use of any company seals.

Registered Office

Establishing and administering the registered office; attending to the receipt, co-ordination and distribution of official correspondence received by the company, sent to its registered office; ensuring the provision of facilities for the public inspection of company register and documents.

Company Identity

Ensuring that all business letters, notices and other official publications of the company show the name of the company and any other information as required by the statutes and that the company's name is displayed conspicuously outside all places of business.

Subsidiary Companies

Ensuring that procedures are in place for the correct administration of subsidiary companies and that correct information is given to the holding company; maintaining a record of the group's structure.

General Compliance

Monitoring and laying in place procedures which allow for compliance with relevant regulatory and legal requirements, in particular under the Companies Acts, including legal requirements on retention of documents; retaining the minimum set of records required for commercial reasons; ensuring that procedures are in place to allow adequate historical archives to be maintained.

Internal and external corporate governance controls

Mechanisms and controls

Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. There are both internal monitoring systems and external monitoring systems. Internal monitoring can be done, for example, by one (or a few) large shareholder(s) in the case of privately held companies or a firm belonging to a business group. Furthermore, the various board mechanisms provide for internal monitoring. External monitoring of managers' behavior, occurs when an independent third party (e.g. the external auditor) attests the accuracy of information provided by management to investors. Stock analysts and debt holders may also conduct such external monitoring. An ideal monitoring and control system should regulate both motivation and ability, while providing incentive alignment toward corporate goals and objectives. Care should be taken that incentives are not so strong that some individuals are tempted to cross lines of ethical behavior, for example by manipulating revenue and profit figures to drive the share price of the company up.

Internal corporate governance controls

Monitors activities and then take corrective action to accomplish organisational goals. Examples:

- **Monitoring by the board of directors**: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance.Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes, *ex ante*. It could be argued, therefore, that executive directors look beyond the financial criteria.
- **Internal control procedures and internal auditors**: Internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting
- **Balance of power**: The simplest balance of power is very common; require that the President be a different person from the Treasurer. This application of separation of power is further developed in companies where separate divisions check and balance each other's actions. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people (customers, shareholders, employees) outside the three groups are being met.
- **Remuneration**: Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behavior, and can elicit myopic behavior.
- **Monitoring by large shareholders** and/or **monitoring by banks and other large creditors**: Given their large investment in the firm, these stakeholders have the incentives, combined with the right degree of control and power, to monitor the management.

External corporate governance controls

External corporate governance controls encompass the controls external stakeholders exercise over the organization. Examples include:

- competition
- debt covenants
- demand for and assessment of performance information (especially financial statements)
- government regulations
- managerial labour market
- media pressure
- takeovers