

THE NEXUS OF CORPORATE GOVERNANCE DEVELOPMENTS AND CORPORATE FAILURES

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Abstract

Since 1992 there has been an increase in the development of corporate governance principles after the wide spread corporate failures in the UK and US in the late 1980s. In response to these failures, various good corporate governance principles and regulations have been developed by different institutions to address the factors that lead to the failures.

The basis of the study is to find out whether the developments in corporate governance have led to a decrease in the incidence of corporate failures.

In doing so, I used data from UK newspapers, journals, magazines and other publications relating to the period under review. The years were divided into groups made up of four years each and ranked according to corporate governance developments and failures. After which, the Spearman's Rank Correlation Coefficient formula was used to determine the level of correlation.

My findings indicated that, there is a fairly strong positive correlation between developments in corporate governance and corporate failures meaning that as the number of codes and principles increased the number of corporate failures also increased.

The study also identified some of the reasons for the continuous corporate governance failures as board incompetence, poor risk management by companies, ineffective internal controls, and the failure of external auditors to remain neutral.

The researcher is, however, convinced that if the principles and codes that have been developed are effectively assimilated by boards of directors, there could be a significant reduction in corporate failures in the near future.

1 Research

1.1 Research context

Large organisations have a considerable number of stakeholders; namely shareholders, debenture holders, trade creditors, bankers, employees and government agencies. The board of directors are usually tasked with the responsibility of ensuring that the interests of the various stakeholders are satisfied equitably. However, this is not often the case; there are numerous cases where “fat cat” directors who have paid themselves huge allowances and acquired expensive assets have driven their companies to a halt. The interests of the board of directors and the stakeholders ought to coincide but in practice this is not the case. The challenge of corporate governance therefore is how to synchronise the numerous and diverse interests of the various stakeholders and that of boards of directors.

As a result of this, laws and codes of best practices have been developed on company reporting and auditing to solve the problem through the delineation of the relationship between board of directors, auditors and shareholders.

2 Literature Review

I would like to begin my enquiry into corporate governance developments and failures by reviewing relevant principles, theories and practices in this area beginning with the definition of corporate governance by various bodies.

A very simple and straight forward definition of corporate governance is that, 'it is about the way corporate entities are governed' (Tricker, 1984). Its primary concern is about practices

and procedures aimed at ensuring that organisations are run in such a way that they are able to achieve their objectives. Good corporate governance ensures that the board of directors of a company perform their duties with integrity, independence and transparency.

Although corporate governance focused primarily on large public companies which have floated shares in the major stock markets of the world, most of the principles of good corporate governance are also applicable to smaller and unincorporated organisations such as state-owned enterprises, educational institutions, government agencies, local authorities, associations and charitable organisations. All these organisations have the same dilemma in terms of satisfying the interests of stakeholders. Whereas a company should be run in the interests of shareholders, a state-owned enterprise should be run in the interest of the general public and government. In the same vein, a charitable organisation should be run in the interest of the donors and beneficiaries.

Irrespective of the type of organisation, ownership and structure, the overarching principles are that all organisations should act ethically and in a socially responsible manner.

1.2 Research objective

To find out whether developments in corporate governance from 1992 to 2008 in the United Kingdom had a correlation with corporate failures.

Another definition of corporate governance is 'the system by which companies are directed and controlled,' (Cadbury Report 1992). By

this definition, the board is tasked with the duty of governance. The shareholders' role is to approve or disapprove the nomination of those nominated by the nomination committee to serve on the board. The board's responsibilities include: setting the long-term objectives of the company, providing guidance and leadership to bring them to fruition,

supervising the management of the business and reporting to the shareholders on their stewardship. This definition is similar to the one by the Paris-based forum of democratic markets; the Organisation for Economic Cooperation and Development (OECD) which defined corporate governance as:

a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The definitions by the Cadbury Report and the OECD appear to limit corporate governance to only business organisations due to the emphasis on shareholders thus relegating the interest of other stakeholders to the background. An all embracing definition of corporate governance is the one by the Chartered Institute of Public Finance and Accountancy (CIPFA, 1995) as:

the structures, systems, and policies in an organisation, designed and established to direct and control all operations and relationships on a continuing basis, in an honest and caring manner, taking into account the interests of all stakeholders and compliance with all applicable laws and regulatory requirements.

Having explained what corporate governance is, it is equally important to explain what it is not. Corporate governance is not concerned with day-to-day management of operations by business executives. Although the powers of executive managers to direct business operations is one aspect of governance, managerial skills are not. Similarly, corporate governance is not concerned with formulating business strategy even though it is the responsibility of board of directors to take strategic decisions.

Although corporate governance codes and principles are mainly focused on large public limited companies which have shares displayed in the major stock markets of the

world, many of the principles of corporate governance are also applicable to small/medium-sized companies, charitable organisations and public corporations.

The distinction between management and corporate governance was summed up by Tricker (1984) as 'whilst management processes have been widely explored, relatively little attention has been paid to the means by which companies are governed. If management is about running businesses, governance is about seeing that it run properly. All companies need governing as well as managing.'

2.2 Brief history of corporate governance

Following the occurrence of well-publicised events of corporate failures in the UK and in the US during the last decade of the twentieth century, the recognition of the need for changes in the way public companies were governed grew over time. This occurrence raised concerns as to the nature of financial reporting, the control mechanisms and the management of risk by public companies.

Inquiries into some of these failures revealed that, there were some published financial reports that were inaccurate; and investors such as institutional shareholders, were not adequately informed about what was going on in their organisations. The external auditors were also found culpable in some of these failings as a result of their inability to sight these failures before they occurred. These notwithstanding, most of the blame was placed on the heads of the self-seeking activities of some very influential chief executive officers whose lack of personal restraint, coupled with the docile attitude of the non-executive directors who were unable to hold the executive directors to properly account for their stewardship.

The enthusiasm for best practices and good corporate governance began in the UK when the report of the Committee chaired by Sir Adrian Cadbury on the Financial Aspects of Corporate Governance (The Cadbury Report) was published in 1992. The report later became 'a land mark in thinking on corporate governance.' The report included a code of best practice for UK listed companies to comply with.

In 1995, a working group chaired by Mr. Paul Myners who was then chairman of Gertmore Plc was set up to look into the relationship between companies and institutional investors. The committee made far reaching recommendations in terms of how the

relationship between corporate investors and directors could be facilitated. The report included suggestions for improving communication between investors and companies as well as the conduct of Annual General Meetings (AGMs). The report urged corporate (institutional) investors to re-examine their responsibility as shareholders to ensure good corporate governance and success of the companies in which they have shares. According to the report, when a company is not performing well; instead of rushing to sell their shares, they should rather try to put things right. The report further admonished that, if the corporate investors did not actively involve themselves in the governance of companies in which they have investments and exercised their rights, they could be forced to do so through legislation.

After the Cadbury report, another committee was set up to reassess how its recommendations on corporate governance were being implemented by UK listed companies. The committee came out with the Greenbury Report in 1995, which largely dealt with board emoluments. The report came out with a set of guidelines on how to establish remuneration committees, increase disclosures about remuneration of the board as well as having a remuneration policy. The report also pressed for specific notice periods in directors' service contract and determination of compensation payment in the event of early termination of contracts.

Subsequently, another committee on corporate governance was set up and chaired by Sir Ronald Hampel to review the recommendations of the Cadbury and Greenbury Committees. The Hampel Committee as it was known published its report in 1998 which covered a number of issues such as; the constitution of the board of directors, the responsibility of the board, the board's remuneration, the duties of shareholders, communication between the board and owners, annual reports, auditing and internal control.

The Hampel Report concluded that its recommendations be joined together with those of the Cadbury and Greenbury Committees to form a single code of corporate governance and this resulted in the production of the first Combined Code in 2003.

Following these developments, the UK Government, also considered changes to the companies act in order to improve corporate governance. A company law review was initiated in 1998 and a government white paper on the proposed changes of the law was published in 2002 to introduce new regulations for the disclosure of more information on directors' remuneration by listed companies.

The Combined Code which is now the overall master piece for the governance of listed companies is being reviewed from time to time. The Combined Code for 2003 was reviewed in 2006 and the report for the review of the 2006 code was released in 2008. The review report for the Combined Code of 2008 was also released in 2010.

2.3 The international dimension of corporate governance

In spite of the fact that the UK is the torch-bearer of corporate governance; there have been some efforts by other countries in different parts of the world in establishing similar codes and principles. Most countries especially African countries perceive corporate governance within the context of wooing investors.

In South Africa for instance, a code for good corporate governance had been developed by the King's Committee in 2000. The USA who initially appeared to show little interest in corporate governance, however, changed dramatically following the collapse of the energy company Enron and a number of other corporate governance scandals and failures that led to the dissolution of the famous

auditing firm; Arthur Andersen. Since then a number of recommendations for change in corporate governance have been proposed by the New York Stock Exchange and this culminated in the enactment of the Sarbanes-Oxley Act, 2002.

Much has not been heard about Ghana in terms of good corporate governance. It appears corporate governance in Ghana is still business as usual except the Ghana Investment Promotion Centre (GIPC) which used good corporate governance as one of the criterion for the membership of Ghana Club 100.

The corporate failures in many State Owned Enterprises (SOEs) and the regular news paper publications of scandals involving some companies and public institutions all bear testimony to the need for good corporate governance principles and practices in Ghana. This will serve as a check on the behaviour of directors who often mismanage the affairs of institutions and/or organisations with impunity.

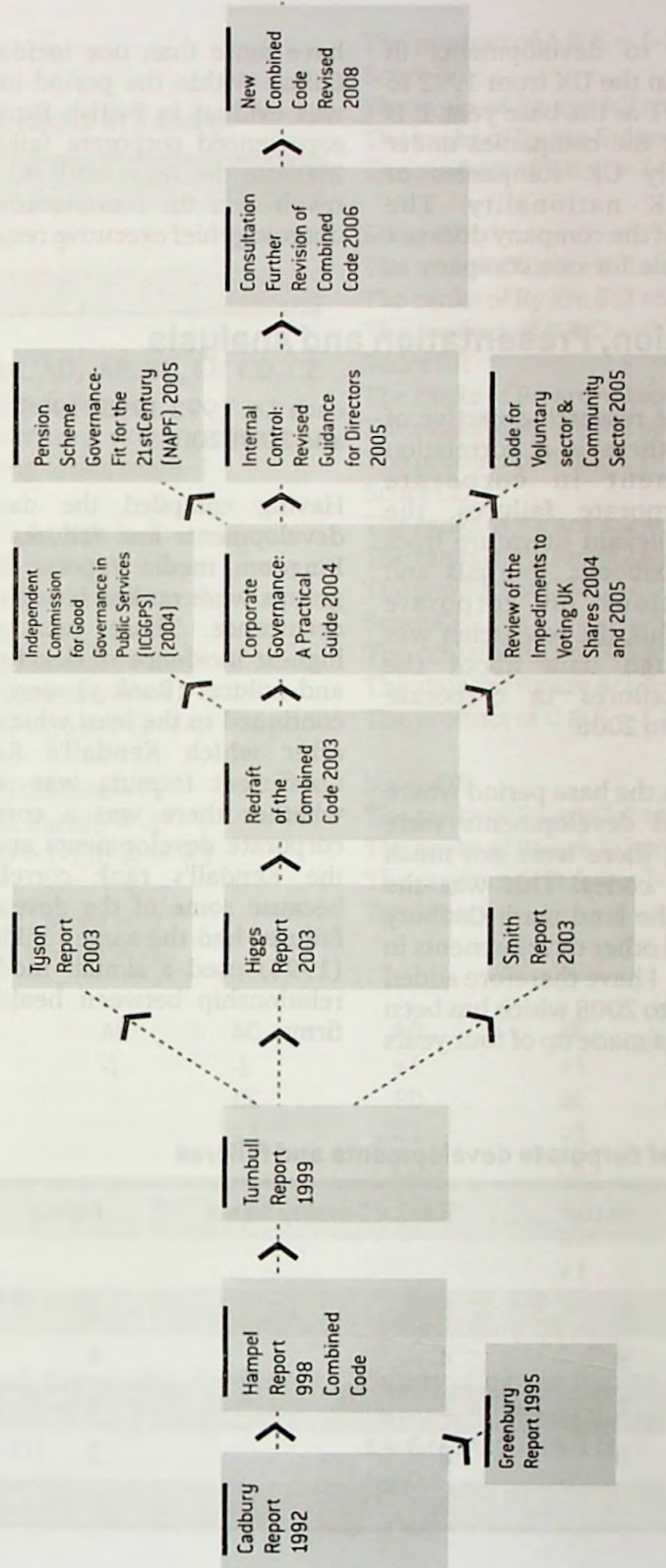
2.4 Development in corporate governance

A development in corporate governance for the purpose of my research is a new provision or regulatory requirement that all corporate entities or a particular category of corporate entities are expected to comply with or explain why they cannot comply. Corporate governance codes in the UK are not laws.

2.5 Corporate failure

A corporate failure for the purpose of my research is a major setback or occurrence in the life of an organisation that if proper care or analysis had been done could have been averted. An example is the BP gas explosion in Texas in the US in 2005. A corporate failure does not necessarily mean liquidation.

Chart 2.2.1 The Development of Corporate Governance in the UK from the Cadbury Report in 1992 to the Combined Code in 2008



Source: Adapted from Solomon, (2008) The UK experience P.53 Figure 3.1.

My study is limited to developments in corporate governance in the UK from 1992 to 2008 with 1987 to 1991 as the base year. It is important to note that the companies under consideration are only UK companies or companies with UK nationality. The geographical location of the company does not matter. It is also possible for one company to

have more than one incidence of corporate failure within the period under review. This was evident in British Petroleum (BP) as it experienced corporate failure in 2005, and 2007 for the Texas explosion and shareholder revolt over the remuneration package of an outgoing chief executive respectively.

3 Data Collection, Presentation and Analysis

In order to achieve the research objective of finding out whether there is a correlation between development in corporate governance and corporate failures, the researcher reviewed relevant literature from committee reports, textbooks, journals and newspaper publications on corporate governance. Through this, the researcher was able to gather enough data about the developments and failures in corporate governance from 1992 to 2008.

1987-1991 was used as the base period where corporate failures and developments were minimal. At that time, there were not much corporate governance codes. This was the period that preceded the land mark Cadbury Report which triggered other developments in corporate governance. I have therefore added this to the period 1992 to 2008 which has been split into four groupings made up of four years

each i.e. 1992-1995, 1996- 1999, 2000-2003 and 2004-2008.

Having compiled the data on corporate developments and failures from the United Kingdom media reports, the various year groups were ranked based on the number of occurrence. Those year groups with the highest incidence of developments (Rank x) and failures (Rank y) were ranked as 5 and continued to the least which was ranked as 1 after which Kendall's Rank Correlation Coefficient formula was used to find out whether there was a correlation between corporate developments and failures. I used the Kendall's rank correlation coefficient because some of the developments and the failures had the same rankings. Altman et al (1994) used a similar model to establish a relationship between healthy and unsound firms.

Table 3.1.1: Rankings of corporate developments and failures

Period	Letter	Rank x Developments	Ranky
Failures			
1987-1991	A	5	3
1992-1995	B	4	5
1996-1999	C	3	4
2000-2003	D	2	2
2004-2008	E	1	1

Source: UK Media (2008)

Workings

Table 3.1.2: **Ranked values of x and y**

Rank	A	B	C	D	E
Rx	5	4	3	2	1
Ry	3	5	4	2	1

The scores are AB, AC, AD, AE, BC, BE, CD, CE and DE are obtained as follows:

If the score is in increasing order, score +1; but if it is in decreasing order, score -1

Score AB

The ranks of Rx are 5:4 score = -1

The ranks of Ry are 3:5 score = +1

The product of A & B = (-1)(+1) = -1

Score AC

The ranks of Rx are 5:3 score = -1

The ranks of Ry are 3:4 score = +1

The product of A & C = (-1)(+1) = -1

Score AD

The ranks of Rx are 5:2 score = -1

The ranks of Ry are 3:2 score = -1

The product of A & D = (-1)(-1) = +1

Score AE

The ranks of Rx are 5:1 score = -1

The ranks of Ry are 3:1 score = -1

The product of A & E = (-1)(-1) = +1

Score BC

The ranks of Rx are 4:3 score = -1

The ranks of Ry are 5:4 score = -1

The product of B & C = (-1)(-1) = +1

Score BD

The ranks of Rx are 4:2 score = -1

The ranks of Ry are 5:2 score = -1

The product of B & D = (-1)(-1) = +1

Score BE

The ranks of Rx are 4:1 score = -1

The ranks of Ry are 5:1 score = -1

The product of B & E = (-1)(-1) = +1

Score CD

The ranks of Rx are 3:2 score = -1

The ranks of Ry are 4:2 score = -1

The product of C & D = (-1)(-1) = +1

Score CE

The ranks of Rx are 3:1 score = -1

The ranks of Ry are 4:1 score = -1

The product of C & E = (-1)(-1) = +1

Score DE

The ranks of Rx are 2:1 score = -1

The ranks of Ry are 2:1 score = -1

The product of D & E = (-1)(-1) = +1

Total scores

Pair score	AB	AC	AD	AE	Total
	-1	-1	+1	+1	0
Pair score		BC	BD	BE	
		+1	+1	+1	+3
Pair score			CD	CE	
			+1	+1	+2
Pair score				DE	
				+1	+1
Total score (S) = 0 + 3 + 2 + 1 = 6					

Using Kendall's Rank Correlation Coefficient formula:

$$t = S / \{1/2n(n-1)\}$$

S is the total scores.

n is the number of pairs or rankings in the data i.e. 5.

Substituting the figures into the formula, we have;

$$t = 6 / \{1/2(5)(5-1)\}$$

$$t = 0.6$$

The Kendall's rank correlation coefficient ranges from -1 to +1. A score of -1 means there is perfectly strong negative correlation between the two variables and a score of +1 means there is a perfectly strong positive correlation. The degree of strength becomes lesser as you move from +1 to -1 ($-1 \leq t \leq +1$). The researcher found the Kendall's rank correlation coefficient to be +0.6 which implies there is a fairly strong correlation between corporate developments and

corporate failures in the UK over the period under review. In other words, as developments in corporate governance increased, so were the corporate failures. This result does not really reflect the spirit and true intentions of corporate governance codes and principles. The expectation is that as developments of corporate governance codes and principles increase, the number of corporate failures will decline tremendously.

4 Lessons, Conclusion and Recommendations

4.1 Lessons

There are several lessons to be learnt from the recent massive corporate failures around the world and the UK in particular. The lessons highlight the fact that corporate governance is global in the sense that bad corporate governance in one country could spill over to other countries or continents. It is therefore not surprising that international organisations have joined hands in the quest to generate codes for good corporate governance.

The following are some of the lessons from the corporate failures in the UK:

I. Poor risk management

Poor strategic decisions were taken due to lack of proper understanding and appreciation of risk management in business organisations. Until recently, many organisations had not thought it wise to have risk management committees; not even the banking sector which has a very high risk. Where there is an attempt to have such a function, it is sometimes assigned to the audit committee as an additional responsibility which has often resulted in poor risk management because the audit committee is already overburdened with its own duties and as such is not able to devote enough time for risk management.

ii. Unbridled growth

Frustrated by their inability to grow organically, some organisations have resorted to expansion by acquisitions and mergers which sometimes turned out to be a disaster. Boards must understand the fact that there is a limit to which every organisation can expand, beyond that diseconomies of scale will set in. Although there is synergy in mergers and acquisitions, if there is no proper risk analysis it could turn out to be a useless venture. The Royal Bank of Scotland (RBS) takeover of Abn Amro for example turned out to be a bad investment as the latter proved to be a liability rather than an asset.

iii. Board dominance

The desire by some chief executives to become powerful and dominate the decision making process has been one of the major contributors of the corporate failures in the UK. Although the Cadbury Report and the Combined Codes have all recommended that no single person or group of persons should have unfettered powers in the decision making processes of companies, it has been very difficult to stop individuals from doing that. Some chief executives have become so powerful that no one on the board can challenge them. The situation is compounded by the docile attitude of some non-executive directors and the absence of independent non-executive

directors to openly and strongly challenge some of these chief executives or chairmen. In 2008, Marks and Spencer had a chief executive officer who was also chairman of the same organisation and yet the board condoned it by being silent.

iv. Inordinate desire for wealth

People are known to be naturally greedy and never satisfied with what they have and this is often reflected in the way boards have conducted the affairs of companies especially when it comes to payment of bonuses and other remunerations. This confirms the view of the agency theorists who believe that directors will always try to breach their fiduciary position by taking advantage of shareholders. It was therefore not surprising that the board of directors of RBS, a company that was bailed out by the UK government with tax-payer's money was demanding huge bonus payments in December 2009; but for the timely intervention of the general public, they would have gotten away with it. This incident brings to mind the crucial role that activists and civil society can play in corporate governance.

v. Ineffective internal controls

Weak internal control mechanisms are partly to blame for the corporate failures in some companies. Large complex organisations with branches spread over remote areas are often very difficult to coordinate. This situation is exacerbated by the inability of the internal auditors to spot and report fraudulent practices to top management for action. There is, however, some hope in the sense that internal auditors in the UK have now been empowered to report certain corrupt practices going on in organisations directly to the board.

vi. Incompetent boards

The inability of some boards of directors to provide independent and well informed judgement on senior management actions and strategic proposals also posed a great

challenge to good corporate governance. The Combined Code's recommendations for the evaluation of the performance of individual directors, chief executive officers, board chairmen as well as the board as whole is not being complied with. Other issues such as board training, induction and succession planning are not being adhered to. If these recommendations are continuously flouted, it would have far reaching consequences on the future of corporate governance in the UK.

vii. External auditors

This study also revealed how the independence of external auditors can be eroded by non-audit service fees. A practice which in the past led to the collapse of Enron resurfaced in 2008 with RBS. Deloitte the auditor of RBS received huge non-audit service fees from RBS, increasing every year in the last three years. As McConnell and Settle (2009) argued, Deloitte received £58.8m for 2008 service which hiked by £27.4m from £31.4m in 2007. This and other factors undermined the independence of Deloitte resulting in Deloitte seemingly approving the actions of RBS board. The Combined Code and the Walker Report warned companies about the dangers of boards having a close relationship with auditors. Although the Combined Code did not recommend the changing of audit firms, it did encourage the rotation of auditors which is laudable but it is doubtful if this is being done.

4.2 Conclusion

The results of the study shows that there is a fairly strong correlation between developments in corporate governance and corporate failures over the period under review. This implies that as the number of codes and principles increase, so are the number of failures. The ideal situation should have been that as the number of codes and principles increase, the number of failures should decline. It was clear from investigations that most of the boards were not complying with the various corporate governance codes and

principles leading to a repetition of past failures.

However, it is important to understand that corporate governance is not an event but a process. Although the current situation may be appalling, if the boards persist in their efforts to achieve good corporate governance there will be a turn around.

4.3 Recommendations

The researcher deemed it imperative to make the following recommendations based on the outcome of the study:

- i. Corporate governance practitioners should be more innovative in the governance of companies by aiming for continuous improvements. They should not become complacent if the existing structures and practices are working for them.
- ii. The existing codes need to be reviewed periodically to ensure that they are abreast with times and ahead of those who would like to take advantage of any loopholes in them.
- iii. The board of directors of companies must also take their risk management and internal control functions very seriously since most of the corporate failures occurred as a result of poor risk management and weak internal controls. Directors should undergo regular periodic training to enable them be able to understand and evaluate information from executive management as well as conduct effective risk analysis.
- iv. As recommended by the Combined Code (2010), directors should engage the services of external service providers to carry out some analysis in areas where they have limited expertise or do not have enough time to carry out all the necessary investigations.
- v. Shareholders of companies should be vigilant over the actions of board chairmen or chief executives so as to nip in the bud tendencies of being dominant.
- vi. There is the need for shareholders to have a second look at how appointments to boards are made. Appointments to boards should not be based on "contacts" or representation but solely on competence.
- vii. There is the need for governments' to regulate the unbridled growth strategies that are being developed by banks to ensure that they do not overgrow and make control and coordination very difficult for managers.
- viii. Although the company secretary's role as officer of the company is mainly advisory, he or she has a responsibility to ensure that the board complies with all legal and regulatory provisions. If he or she is not able to fulfil this function as a result of the intransigence of the board, he or she has an obligation to resign.

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