

CORPORATE GOVERNANCE – ANOTHER TYPE OF MANAGEMENT

STOICA PETRICĂ*

“Vasile Alecsandri” University of Bacau, 157 Calea Marasesti, RO-600115, Bacau, Romania

Abstract: The concept of corporate governance appeared on the background of financial combinations atypical for market economy, in which well-known companies have been involved, some of them resulting in financial scandals which have been spread around the world. It is the case of companies with notoriety as ENRON, PARMALAT, BARING, ANDERSEN and others, which the public has known initially in terms of economic development and subsequently as examples of disastrous failures due to the ignorance of management risks, managers' greed, the lack of professionalism of external auditors etc. I have made a brief presentation of the concept of corporate governance seen from several points of view, the need for governance, its evolution in international organizations and the types of models encountered in practice.

Key words: corporate governance, codes of conduct, internal audit, external audit, audit committees

1. INTRODUCTION

From a linguistic point of view, the term *corporate governance* should be studied first individually, taking each of its two words separately and then together to understand the interrelation between them. In Romanian, the word *governance* has the same meaning with the notion of management. The vocabulary of the Romanian language gives the notion of governance the meaning of management, which involves all the activities of an entity falling within the scope of management [1]. Corporation derives from body, which implies an idea of wholeness, of organization, i.e. it means a legal form of existence other than that of individuals. Although dictionaries are quite accurate in relation to the individual analysis of the meaning of the two words, their simple combination offers a variety of interpretations by defining the concept of corporate governance. In the Anglo-Saxon system, the concept is used in the practice of Internal Auditors, being also mentioned in the context of international internal audit standards.

In 1961, at the request of the Organization for Economic Cooperation and Development (O.E.C.D.), a research has been carried out on the emerging literature in the United States of America with regard to corporate governance, concluding with existence of four theoretical sources:

- the theory of action (of those who invest);
- the theory of administration;
- the theory of the social partners;
- company's policy.

* Corresponding author, email: stc_petrica@yahoo.com
© 2012 Alma Mater Publishing House

Following this study, OECD defined the concept of corporate governance, as set of relationships among the company's management, its Board, its shareholders and other holders of titles; at the same time, it provides the structure through which resources are established in order to achieve those objectives and monitor the set performances.

The concept can be expressed both in a broad and in a narrow sense. A strict definition concerns the relationships between chiefs executive of corporations, managers and their shareholders, while a broad presentation may include a combination of laws, regulations, rules and practices in the private sector to generate profit for the realization of capital, as well as the fulfilment of the company's both legal and general obligations and expectations [2].

The definitions presented above reflect more general goals of corporate governance, such as: attracting capital, achieving activity efficiency, the generation of profit, the fulfilment of legal obligations and meeting the society's expectations [3]. Moreover, corporate governance refers to the relationship among the managers, executives and shareholders, the relationship between the organizations of interested parties and the company, as well as to the strict observance of the legal framework. As a result, the concept represents the overall leadership of the entire organization by accepting all internal components that work together, which in the end will be integrated in management, as well as the implementation of risk management within the organization, of the financial management system, including also the internal audit.

Corporate leadership is an approach on multiple levels within the system of relationships between groups of interests represented by employees, managers, shareholders, regulating bodies, the public and the media, and relations established between the Board of Directors and the internal or external interested parties.

The concept of corporate governance is perceived as having two components:

- a behavioural one, referring to the relationships between the company's managers, shareholders, employees, creditors, customers, suppliers, the State and various interest groups;
- a normative one, which involves the framework of regulations based on which these relationships and behaviours are carried out (company law, securities and capital markets law, bankruptcy law, etc.).

The management of risks, by creating an efficient control system, based on the observance of corporate governance policies and codes, is used to ensure the integrity, sincerity, transparency in terms of performance, the internal audit representing the key element of their monitoring.

The notion of corporate governance is relatively recent, appearing 30-35 years ago. Watergate scandal in the United States is usually considered to be the origin of the development of corporate governance in the last four decades. The investigations that have resulted from the Watergate scandal highlighted the involvement of companies in American politics, determining the review of internal control systems.

2. CORPORATE GOVERNANCE WITHIN ORGANISATIONS. CREATION AND EVOLUTION

As a historical evolution, the concept has been used by national institutions, commercial organisations and later became common in the private sector, being taken and applied in many fields of activity. The great need for capital to support the industrial investment was met by broadening some institutional instruments which were tested as early as the time of commercial capitalism. Institutional instruments such as banks, companies with capital shares and stock exchanges, bear the elements of separation between the holders of patrimonial rights and management respondents.

The corporation was represented as a multitude of different contractual relations between parties (capital investors, employees, customers, suppliers, etc.) through the concept of company as a legal entity in commercial law. Within it, the two parties have occupied a distinct position:

- on the one hand, the shareholders, as their patrimonial rights are exercised only as a last resort, after all others have valorised their debts;
- on the other hand, managers, since they have a privileged information system through their position in the organisation.

Belonging to the organisation, they may be tempted to offer themselves special advantages or to lead the company in a direction favourable to them.

The emergence of international companies that were involved in fraudulent financial combinations has generated a series of financial scandals, due to non-compliance with legal procedures, the ignorance of risk management, neglecting the recommendations of the internal auditors, ending with the manipulation of the external auditors. The negative effects of this phenomenon have affected both companies' employees who have lost their jobs and shareholders having effect on companies' brand, due to the loss of public confidence in their management. Corporate governance was necessary, being determined by a series of failures in the field of private law, which took place in a relatively short time, producing, by their amplitude, true financial earthquakes, which has caused the loss of investors' confidence in the way both large companies and public institutions were managed.

2.1. Corporate governance and good practices

As a reaction to those events, concerns have arisen to research the common causes of failures of the private companies. A particular contribution was brought by the United Kingdom by means of Sir Adrian Cadbury, which in 1992, drew up the Cadbury report, after the analysis of the crisis in the 1980s. The purpose of the code was to ensure a non-discriminatory treatment towards shareholders, preventing financial scandals and regaining the confidence of the public and investors in the governance practices of companies.

In the European Union, the concept of corporate governance has been better developed after 1997, when there have been several cases of bankruptcy of publicly traded companies. This has led to the majority of countries to adopt corporate governance codes, but they are optional. At the international level, the implementation of solutions and corporate governance principles has been conducted by means of codes of good practice. Regardless of country, the codes of good practice are presented as regulations or guidelines, constituting a way to organize and manage entities and public services. The European Union stands out through the adoption of over 40 codes, almost every country having at least one code of corporate governance.

In time most transnational companies have defined their own codes of good practice, becoming more transparent compared to shareholders, in good part due to the increase of activism, but also because, being listed on the stock exchange, they were interested to have a good image towards investors.

Although the imposing of a single model on the long term is not desired, the trend is to advance towards global standards, as a universal point of reference, in accordance with the typical wishes of investors around the world.

In many developed countries, there are corporate governance institutes which operate under the patronage of stock exchange institutions, with the purpose of organising trainings for managers, carrying out tests and assessing the standard knowledge of corporate governance, supporting publicly traded companies in developing their own codes of ethics and good practice.

The United Kingdom has brought the greatest contribution to the development of the concept of corporate governance through the development of ethical codes and reports, owning about one third of the total codes issued in member countries of the European Union. Here are the advantages brought by the implementation of high standards of management companies:

- the efficient use of resources, both at the level of companies and at the level of national savings;
- the decrease of the capital cost for companies;
- the increase of investors' confidence, due to a sensitive reduction in the discretionary attitude of managers;
- the lowering of corruption level.

On the other hand, poor corporate governance stifles foreign investment and reduces investors' confidence. The importance of corporate governance for the development of capital markets is undeniable. Most studies show that the improvement of corporate governance is required especially for developing markets, where both foreign and domestic investment should be encouraged. Good corporate governance is a prerequisite for the integrity and stability of the financial system, of stock exchanges and companies, thereby reducing the cost of disasters [4].

In order to protect the interests of investors and shareholders, the countries of the European Union have developed a series of corporate governance codes, both nationally and internationally. The topics generally recommended by these codes assume the creation of audit committees at the level of companies, made up of

independent directors, who should be responsible for the reporting of financial statements and continuous monitoring of the internal and external audit of companies.

A component of the corporate governance code is the code of ethics, adopted on the basis of rules of conduct, whose implementation is the same as for the other corporate elements. The code of ethics should include deontological and ethical rules, applied both to the members of the Council and of the Executive and to the shareholders and employees of a company. The literature in the field of corporate governance mentions the attributes of corporate governance, such as: discipline, transparency, independence, responsibility, equity or the fair treatment and social responsibility [5].

Many codes of corporate governance have a mixture of principles, guidelines and recommendations while, in fact, these are often nothing more than a set of rules or measures to achieve the basic attributes.

2.2. Models of corporate governance

The principles of corporate governance of O.C.D.E., approved in 1999 and revised in 2004, constitute the terms of reference for the definition of corporate governance actions in the European Community. The governance structure contains internal components (administrator, manager, shareholder, employee, supplier, and creditor), and according to them the literature has promoted the following systems of corporate governance:

- the traditional model;
- the co-determination model;
- the risk model.

2.2.1. *The traditional model of corporate governance (in North-American traditional system)*

It is based on the existence of two legal relationships, and three levels, namely the relationship between shareholders and managers, on the basis of a contract of mandate, and another relationship between administrators and managers. In the latter relationship, managers have an authority derived from that of administrators. Also called the model of the shareholders' income maximisation, it is characterised by the dominance of independent persons and individual shareholders who are not bound by corporate business relationships. Their interest in the invested capital is manifested through dividends, being willing to any kind of reorganization of the non-profitable activity segments and financing of the others. The Annual General Meeting selects the company's Board of Directors, the decision-making system being based on the principle of "an action means a vote", and the Board of Directors elects the management, which is expected to take decisions in order to maximise the value of the shares held by shareholders. In this case, the value of shares is based on the present value of the projection of future dividends derived from net profit [6-8].

The deficiency of this model lies in the interest of investors focused excessively on profitability at the expense of a long-term strategy development.

2.2.2. *The Co-determination model (specific to the legal system in West European countries)*

It is characterised by the existence of the three legal relationships and four levels. The first relationship is established between shareholders with administrators plus representatives of the employees, the second between administrators plus representatives of the employees with administrators, and the third between administrators with managers. In the case of the relationship between shareholders and the Board itself there is interposed a superior Council composed of representatives of shareholders and employees. Its role replaces in certain respects the role of shareholder, because it performs a control function, analyses the company's strategic objectives and formulate recommendations to the Board of Directors. The model differs from the American one by the fact that shareholders are related to corporation by means of common interests, participating in both its management and control. The advantage of this model is that it allows the implementation of a long-term business strategy, and we can mention as disadvantage the inflexibility in prompt decision-making relating to ineffective activity segments [6-8].

2.2.3. *The model of corporate governance risk ("stakeholder model")*

Is characterized by the existence of two legal relationships, and four levels, by extending the law subjects found in the co-determination model:

- a relationship between shareholders and employees' representatives, e.g. customers, and/or banks, and/or suppliers, and/or State or public administration and/or administrators [5];

- a relationship established by administrators with employees' representatives, with customers, banks, with suppliers and with managers separately [6-8].

The motivation of this model lies in the need for the activity of a company not to be affected by the relationships that are created among all these people with different interests and risks.

As a result of the analysis of these three models we can state that, more or less, all are present in the Romanian management system, as well. In 1992, the Institute of Internal Auditors (I.I.A.) of the United Kingdom and Ireland have proposed the mandatory reporting of companies on the internal audit system, demanding the Boards of Directors to make an assessment of the effectiveness of internal control mechanisms within organisations. I.I.A. conclusion was based on the organisation within entities of an independent compartment of internal audit, which could function with competent staff and resources in order to provide, for the management and the audit committee, periodic assessments on the evolution of the internal control system and the management of risk assessment.

2.2.4. The Impact of Corporate Governance in the Romanian Business Environment

The methods of privatization of commercial companies used after 1990 have created the possibility of wide access of employees and managers to their capital, in comparison with external shareholders, weakly represented in their membership, due to the shortage of means of control and lack of experience.

Privatization has led to the emergence of a great number of shareholders, not interested in increasing the efficiency of work, but lacking the effective means of control. Inevitably the inefficient governance of these companies had as a consequence the appearance of conflicts of interest between the majority and the minority shareholders.

Most of the times, the conflict was caused by the violation of the minority shareholders' rights and the diminution of their wealth by the majority shareholders. The conflict between the majority and the minority shareholders has usually resulted in other conflicts between management, the Board of Directors and minority shareholders, as well as between the majority shareholders and the company's business partners.

In such conditions, a solution for solving conflicts has been the application of corporate governance principles. The meant the setting of clear, imperative rules relating to the shareholders' rights, the fair treatment of shareholders, increasing the role applied to members who take part in corporate governance, ensuring the transparency and dissemination of information, making the Board of Directors more responsible.

Corporate governance principles have imposed the need to make the administrators more responsible towards the company by giving them tasks of loyalty, and when they acted in good faith, they were not blamed for the decisions taken, if, subsequently, they proved to be wrong. The distinction between the executive and non-executive functions of administrators, the delegation of the executive function to an Executive Committee or members of the Board of Directors are directives which are part of the corporate governance principles.

As concerns the shareholders' rights, it is necessary to protect and facilitate the exercise of the shareholders' rights and to ensure a fair treatment both in terms of participation at general meetings and in decision-making.

An Annual General Meeting has to determine the policy and supervise the activities adopted by the company, while encouraging the involvement of the members entitled to vote, in order to ensure an effective management of the company.

The corporate governance principles appeared in the Romanian legislation, in normative acts as the Law of bankruptcy, the Tax Code, the Law of privatisation, the Law of trade companies or the Law of capital market. The application of the corporate governance principles should lead to a change in mentality, to the education and training of a class of owners in strong connection with the corporate governance requirements in order to emphasise its role and position in the company's management, as the quality of owner means a series of rights and obligations.

For Romania, the economic liberalization, the transfer of State property to the private sector and the creation of new private companies were not sufficient measures to ensure the functioning of companies, according to the

principles of a market economy, for the restructuring, revitalizing and enhancing of their competitiveness and profitability.

The privatization of State companies, promoted as a response to the need for change of the centralised system, aimed at the identification of owners willing to ensure a rational use of resources and the registration of benefits. The initiative of the transfer of ownership may influence the behaviour of managers if the new owners do not have the strength, motivation and the necessary means to control closely their actions and to ensure that they act in the company's interest without promoting only their own interests.

In other words, in addition to the transfer of legal ownership of companies' assets, a major interest was also in the transfer of the decision and control power, in the favour of the new owners in order to ensure an efficient corporate control.

For Romanian privatized or privatizing companies, the problem of corporate control and appropriate mechanisms to achieve it is even more important taking into account:

- structure and behaviour of shareholders as a result of the privatization process;
- the vagueness of property rights;
- the lack of appropriate mechanisms for the protection of minority shareholders;
- the keeping of some significant holdings of the State in some of the privatized companies and the inappropriate exercise by its representatives in the different bodies of management and administration of the company of their rights as majority shareholders;
- the reduced performance of many enterprises.

3. CONCLUSIONS

The concept of corporate governance has attracted the attention of the business environment, first in countries with developed market economy, in recognition of the fact that the financial and banking institutions exert a pressure on the companies that they finances.

The purpose of governance is the development of a culture at the level of entities based on the encouraging of best practices and the avoidance of inappropriate behaviour. The accounting of companies under corporate governance allows managers to create a strategy based on a realistic and intuitive assessment of potential competitors.

Statistics have shown that the reforms implemented in the field of financial accounting and tax administration have contributed to the progress of business management in recent years. The role of reforms was to ensure an effective protection against abuse.

Starting from the conclusion that different codes and practical models of governance show flexibility and there can be identified certain common elements within them, we consider that corporate governance has been an element of convergence both in the accession of Romania to the European Union and in the process of integration into the global economy.

REFERENCES

- [1] Ghiță, M., Iașco, C., Brezuleanu, C.O., Vorniceanu, M., Guvernanța corporativă și auditul intern, TIPOMOLDOVA, Iași, 2009.
- [2] Grigorie, H. J., Simms, M. E., Corporate Governance: What it is and why it matters, at http://www.transparency.org/iacc/9th_iacc (09.10.2011).
- [3] European Corporate Governance Conference Report, 2004, p. 66.
- [4] http://www.ecgi.org/codes/documents/executive_summary.pdf. (05.09.2011).
- [5] Rogene, A., Buchholz- Business Environment and Public Policy, Prentice Hall, 1992.
- [6] Cadbury, A., Cadbury Report (The Financial Aspects of Corporate Governance), 1992, <http://www.ecgi.org/codes/code.php>. (14.11.2011)
- [7] OECD, Principles of Corporate Governance, 2004, www.oecd.org/document/html (05.09.2011).
- [8] OECD, Draft Action Plan by the South East Europe Corporate Governance Roundtable to the Ministerial Meeting of the Investment Compact, Vienna, 26 -27 June 2006.