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APPROACHES TO CORPORATE GOVERNANCE

by

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Abstract

This paper explores the question "what is corporate governance?" It examines dominant theoretical approaches to the subject, and reviews influential legislative attempts to address the area in the United States as well as the United Kingdom. Inconsistencies between theoretical approaches to the subject and practical frameworks will be discussed, along with the implications of current frameworks in the US and UK. It will be concluded that legislative reform ought to address the dynamic nature of corporate governance by focusing on widening the scope of actors, and embodying a collaborative approach between businesses, governments, and other stakeholders.

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Introduction

In pursuit of growth in capital and future returns, many individuals invest in corporate stock and bonds, providing public companies with the capital necessary to fund growth and operations. By virtue of their capital investment, these individuals become "owners" or "shareholders" of the company. In exchange for shares and a stake in returns, shareholders provide an organization with capital and entrust responsibility for its operations to management.

The shareholder-management relationship requires a significant level of trust. Not only must shareholders' trust that their best interests are reflected in management decision-making, management must also be confident that shareholders are providing capital to the company as a long-term investment, and not just looking for short-term gains.

The discourse of management-shareholder relations is generally concerned with the rights of shareholders. That is, how can shareholders be sure that their interests are served by management decision-making? As a consequence of recent corporate scandals involving prominent companies such as Enron, WorldCom, and Tyco, as well as the resulting fall out for firms such as Arthur Andersen, management is viewed with a degree of scepticism in the public eye. Corporate governance frameworks and reforms have historically been offered as a solution to these concerns.

The discussion that follows will be presented in several sections. First will be introduction to the corporate model, and mechanisms of corporate governance. A second section will discuss the two dominant theoretical models of agency and stewardship theory. The contention that corporate governance is a field without a major paradigm will also be discussed, along with the implications of the changing corporate model and greater ownership concentration. A final section will provide a practical review of two influential frameworks of corporate governance. The rule-based model of the United States (Sarbanes-Oxley Act 2002) will be contrasted against the principles-based model of the United Kingdom (Cadbury Report/Combined Code 1992).

It will be proposed that future approaches to corporate governance should embody reforms offered by the Millstein Centre for Corporate Governance at Yale University, and should be developed using a collaborative approach. The creation of a framework sufficiently dynamic to evolve with the issues of corporate governance will be identified as a key consideration.

1. What is corporate governance?

The discourse surrounding corporate governance is growing rapidly. Owners and stakeholders alike have become increasingly concerned with the representation of their interests, in response to a number of incidents of fraud and scandal among once-trusted corporations. These events, involving companies such as Enron, Worldcom, and Tyco, destroyed billions of dollars of shareholder wealth, resulted in the loss of thousands of jobs, the criminal investigation of dozens of executives, and record breaking bankruptcy filings (Monks and Minow 2008, 2). In response to what was perceived as a growth in corporate scandal, there were calls for more robust corporate governance frameworks. Critical to building a definition of corporate governance is an understanding of the roles of shareholders, management and directors in the broader corporate framework.

1.1 Understanding the corporate model

Corporations are legal entities involved in the creation of wealth, with identities that are entirely independent of their owners and participants. The legal properties of the corporation (some of which will be touched on in this discussion) facilitate private contracting, and the raising of investment funds. As such the corporation has become prevalent in business. In the United States, corporations own 59 percent of property and employ millions of individuals (Blair 1995, 18).

Given the integral role of the corporation in the creation of wealth in an economy, management, charged with the task of controlling the corporation, are afforded

considerable power. As a means of oversight, shareholders' appoint a board of directors. The board presides over management decision-making, and acts as shareholders' assurance that management is responsive to their interests. Figure 1 illustrates the basic model of the corporation, with a focus on the management-shareholder-board relationship.

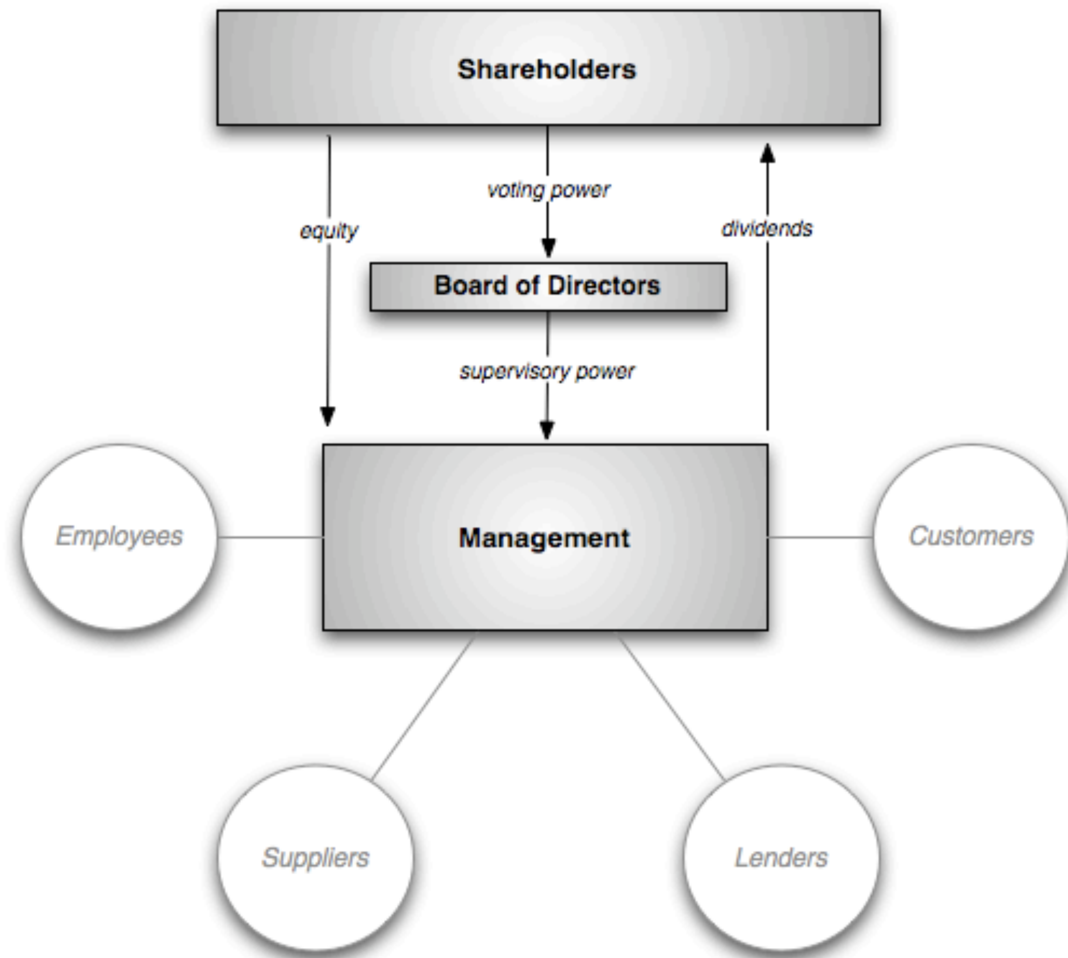

Figure 1 The Corporate Model (Adapted from Blair 1995)

Simply put, shareholders provide corporations with equity capital in exchange for a share of returns (dividends). Concurrently, they appoint a board of directors to preside over management. This relationship forms the basis for the corporate governance framework. Also shown in figure 1 is the role of other stakeholders, which are for the most part external to the management-board-shareholder relationship. Suppliers and lenders provide corporations with resources (capital and inputs) to facilitate operations, while employees and customers are participants in the exchange of goods or services through the corporation.

Shareholders are the owners of a company. They provide organizations with equity in exchange for a shares and a stake in returns (dividends). Shareholders have limited liability, which confines their responsibility for any of the corporations' debts to the amount of their shareholding, and allows them to delegate decision-making to management (Neale and Haslam 1989, 94). As limited liability restricts the extent to which shareholders are able to direct the affairs of the company, it also restricts their ability to prevent or rectify the organization's wrongs (Monks and Minow 2008, 95). The question of the most effective means of overseeing management is one of the central questions in the corporate governance debate.

1.2 Corporate governance, defined

Corporate governance encompasses the set of frameworks that preside over the activities of management. They are the mechanism through which management activities are supervised, and shareholders are assured of the alignment of management activities with their interests. The Organization for Economic Co-operation and Development (OECD) provides a definition in the OECD Principles of Corporate Governance (2004):

> Corporate governance involves 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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. (OECD Principles of Corporate Governance 2004, 11)

By this definition, on a practical level, these frameworks are the systems through which shareholders' delegate responsibility, and hold management accountable through appointing a board of directors. Viewed broadly, it is the lens through which the corporation's objectives are established, and performance is evaluated. Furthermore, it is also the framework through which management incentives and compensation are established and awarded. A number of internal mechanisms are utilized in this governance process.

1.3 Internal mechanisms of corporate governance

Board of Directors

Central to the architecture of corporate governance frameworks is the board of directors. As explained early, the board oversees management activities. They are mandated to perform this supervisory function in four areas; (i) strategy formulation; (ii) policy making; (iii) supervision of executive management; (iv) accountability to shareholders and other stakeholders (Tricker 2009, 37). Historically, directors were nominated and elected by shareholders, however this practise became less feasible as companies (and the body of shareholders) grew. Instead, while nominations are still ratified by a vote of shareholders or their proxy, it is the existing members of the board who nominate and appoint directors (Tricker 2009, 57).

Furthermore, we can also distinguish between the roles held by members of the board. Directors can be classified as executive, non-executive and independent non-executive. Executive directors are those members of the board who are also executive officers (managers) of the corporation, whereas non-executive directors are members of the board not performing any management function for the corporation. Similarly, independent non-executive directors are directors with no affiliation or relationship with the company (aside from their directorship), such as a major ownership stake, which could be viewed as influential to "the exercise of objective, independent judgement" (Tricker 2009, 50).

The distinction between executive and non-executive directors becomes increasingly relevant when the topic of chairman-chief executive duality is raised. This is the question of whether the chairman of the board must be an executive or non-executive member, meaning if the chairman and CEO roles should be combined, or separate. Whereas in US corporations these roles are often combined, in the UK, Principle A2.1 mandates that "the division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board" (UK Combined Code 2003). It is argued that duality (a separation of the roles of chairman and CEO) creates a mechanism of checks and balances, and avoids the concentration of power in the hands of a single individual (Tricker 2009, 58). Conversely however, arguments that favour combining the chairman and CEO roles emphasize the need for dynamic corporations to have a single leader (Tricker 2009, 58).

Board Committees

Additional components to the architecture of the board of directors are the audit, remuneration and nominating committees. Each committee presides over the performance of a key function of the board of directors.

The audit committee acts as a bridge between external auditors and the board of directors. Its main purpose is to manage the role of senior executives in the audit process and participate in recognition, allocation and valuation issues arising through the course of the audit. Corporate governance codes and stock exchange listing requirements mandate the audit committees of listed companies be comprised entirely of independent non-executive members (Tricker 2009, 68).

A second committee formed of members of the board of directors is the remuneration committee. Charged with the supervision of executive remuneration packages, this committee is comprised either entirely or partly of independent non-executive members (Tricker 2009, 70). In light of continued controversy surrounding executive remuneration packages, this committee plays an important oversight function.

The nominating committee serves as a further mechanism of checks and balances designed to ensure fairness in appointments of new board members and executives. Through this mechanism the board recommends the replacement or addition of members. It is through the nominating committee that the board contends with the classic criticism of the board as an "old boys club'" (Tricker 2009, 72).

1.4 Why is corporate governance felt to be necessary?

As established previously, it is felt that the structure of the modern corporate model renders governance necessary as a means of overseeing the actions of executives. The value of corporate governance from a risk-management perspective is reinforced further in observing the continued growth and impact of corporations in shaping countless areas of the lives of individuals (Naciri 2008, 2). Other factors have also been said to confer the imperative of governance to corporations.

Value added by a board of directors

Generally speaking, the value of an institution such as a board of directions, essentially acting as a corporation's "watchdog", can be difficult to conceive of. However, Ahmed Naciri (2008) proposes four ways in which a corporation's board of directors can add value:

i. Approving and evaluating the strategic orientation of the company;
ii. Making sure that the company has suitable processes for the appreciation and the risk management (tendency toward) internal control;
iii. Ensuring the performance monitoring, with regard to some agreed benchmarks;
iv. Ensuring the integrity of information on financial performance. (Naciri, A 2008, 5)

Much of the content of Naciri's recommendations is inclusive of the mandated roles of the audit, remuneration and nomination committees. Consequently, he suggests a three-dimensional strategy-structure-design process for the board to rely on to effectively fulfil its governance role. That is, the board must support a process favouring strategic

orientation discussions, and must facilitate an organizational structure and organizational design conducive to the development of corporate governance (Naciri, A 2008, 6).

Performance outcomes for the firm

Drawing further importance to governance frameworks are numerous studies testing the relationship between governance and corporate performance. However, despite considerable research there is little consensus, and a number of studies have yielded divergent findings.

Several studies have drawn a connection between good governance and share price performance. In a seminal study in the area, Gompers, Ishii and Metrick (2003) assert good corporate governance to be strongly related to firm performance (Gompers et. al. 2003, 144). On average, for the period 1990 through 1999 they find firms with stronger shareholder rights to have higher firm value, higher profits, higher sales growth and lower capital expenditures (Gompers, et. al. 2003, 107).

In a similar study, Selvaggi and Upton (2008), test 361 companies on the FTSE all-share index over a period of five years, finding the returns on well-governed companies to be far less volatile than those of poorly governed companies (Selvaggi and Upton 2008, 31). They quantify good governance to deliver an extra return of 37 basis points per month, industry-adjusted (Selvaggi and Upton 2008, 31).

Though some empirical research shows a link between governance and a corporation's share price performance, there is little consensus with regard to the drivers of that link or whether there is any causal relationship from governance to performance.

Consequently, findings such as Gompers et. al. and Selvaggi and Upton have been also been met with disagreement.

For example, Bhagat et. al. (2007) disagree that a causal link can be drawn between governance and performance, instead suggesting that it is impractical to measure the relationship as there is not one single definition of corporate governance that is suited to all organization and industry types (Bhagat, et. al. 2007, 68). The efficacy of governance systems, Bhagat et. al. suggest, is largely dependent on the context in which the corporation operates. As such, they feel corporate governance cannot be deemed as a universally positive or negative force impacting performance.

Despite a lack of consensus with regard to the micro-impact of corporate governance on the firm, it is nonetheless important to recognize the generally observed correlation between governance and performance outcomes, which suggest that corporate governance may have value to the firm.

2: Theoretical Approaches

The study of corporate governance has been approached through multiple paradigms, generally borrowed from the realm of political economy. Two dominant models of corporate governance, agency theory and stewardship theory will be examined in this section.

2.1 Agency Theory

Corporate governance is perhaps most commonly approached from an agency perspective. At the core of the agency theory model of corporate governance is the agency dilemma, a theoretical starting point used across a number of disciplines.

The agency dilemma

The agency dilemma is founded on the issues of ownership and control. Jensen and Meckling (1976), in what has become a foundation for further research on the subject, provide a definition of the agency relationship:

> We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. (Jensen and Meckling 1976, 308)

Jensen and Meckling's definition of the agency dilemma essentially recognizes that although the agent is contracted by the principal to act on their behalf, that the

interests of the two may not be congruent. That is, that the agent may prioritize other interests. The principal-agent relationship is illustrated in figure 2:

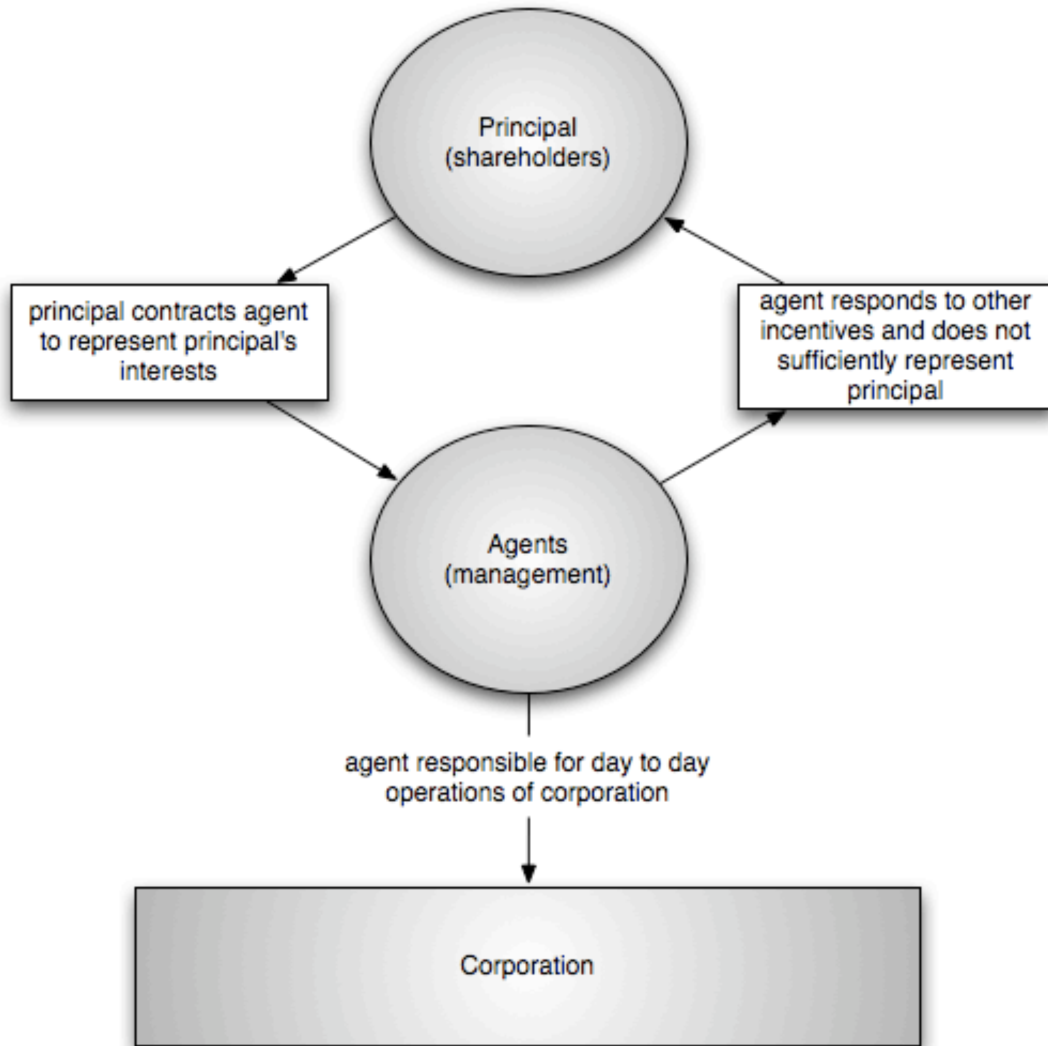

Figure 2 The principal-agent relationship (Adapted from Tricker 2009)

The risk that principles and agents may have diverging interests is well founded in other works. Applied specifically to the directors of companies, Adam Smith, in his influential work, The Wealth of Nations, suggests that "the directors of companies, being

managers of other people's money, cannot be expected to watch over it with the same vigilance with which they watch over their own" (Smith 1776).

Shleifer and Vishny (1997) extend this application, identifying the separation of management and finance as the agency problem (Shleifer and Vishny 1997, 740). That is, managers raise funds (to be put to productive use) from investors, who in turn rely on the manager's specialized human capital to generate return on their funds. The core of the agency problem, according to Shleifer and Vishy's definition, is a question of how investors can assure themselves they will receive a return on an investment (Shleifer and Vishny 1997, 737).

The principle agent relationship: problems for the corporation

Having established the basis of the principal-agent dilemma, it is also of note to understand the rationale by which management decision-making may not reflect shareholders' interests. That is, if management are the agents of shareholders, why, from an agency perspective, are their decisions not always reflective of shareholders' interests.

(i) Self-interest

First, it can be argued that management is self-interested. This is in line with the previously discussed reasoning of Adam Smith, suggesting that we cannot expect managers to regard the investment of shareholders as meticulously as they would their own. Whereas Smith suggests that management negligence may be the source of problems within the principal-agent relationship, Muth and Donaldson go further to suggest that management may actively maximize their own self-interest at the expense of organizational profitability (Muth and Donaldson 1998, 5). This reasoning is consistent

with much of what has been visible through recent corporate scandals such as the cases of Enron, Worldcom and Tyco, where management is accused of active fraud. Furthermore, it has even been said that the corporate model and separation of ownership and control, by nature, breeds management irresponsibility (Ireland 2008, 3).

(ii) Risk tolerance

Second, management and shareholders' interests may be divergent based on the different tolerance for risk of the two groups. Although using the agency theory definition, management are the agents of shareholders, the two groups are still likely to vary in their tolerance for risk. It is understood that management is to take calculated risk through business activities; however, it is also possible that they may have different views to their shareholders on corporate risk.

As explained by Tricker (2009), management may hazard corporate funds on riskier ventures than many of their shareholders would desire (Tricker 2009, 220). Shareholders are responsible for judging the suitability of their investments, however, generally speaking, they can only do so by looking at the company's prospectus and past performance (Tricker 2009, 220).

(iii) Access to information

Finally, the management-shareholder relationship requires trust between two parties with asymmetrical access to information. By virtue of their experience and role in the company, management are bound to know more about the company than shareholders. Shareholders therefore rely on managers to determine the information to which they should have access (Tricker 2009, 219). Given that management and

shareholders do not have symmetrical access to information, management decision-making may not necessarily reflect shareholder's interests. Consequently, a considerable amount of trust is required between the two parties.

The agency theory model of corporate governance

Practically speaking, there is the potential for the agency dilemma to occur in any situation where a separation exists between participants of a system and the governance body put in place to protect their interests (Tricker 2009, 218). Therefore, from the perspective of agency theory, the risks of the corporate model (explained in section one) present the challenge of ensuring that the actions of management (agents) reflect the interests or owners of shareholder (principals). In that case, specifically what does this model imply for the area of corporate governance?

(i) Board centrality

First, the board of directors is critical from an agency perspective. Governance mechanisms such as a board of directors are viewed as a valuable tool to "engender (management/agent) compliance through activities such as monitoring their behaviour, providing incentives to encourage agents to conduct in the principal's best interests, and even legal sanctions" (Badalescu and Badalescu 2008, 2). The board is thus viewed as an important tool to ensuring the alignment of shareholders' interests and management decision-making.

(ii) Board independence

Next, to be effective, it is important that the board be independent of management influence (Muth and Donaldson 1998, 5). Consequently, using the agency model the

integrity of the board is important and there is relevance to its composition. By this rationale, the number of executive versus non-executive versus independent members will be relevant to the board's functioning and should be considered in its formation.

Ultimately, it is recognized that mitigating the nature of the principal-agent relationship will entail costs to the firm. Jensen and Meckling recognize that it is possible for the principal (shareholder) to limit divergences by establishing appropriate incentives (Jensen and Meckling 1976, 308). However, they also concede that "in most agency relationships the principal and the agent will incur positive monitoring and bonding costs, and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal" (Jensen and Meckling 1976, 308).

Criticisms of agency theory

As an approach to corporate governance, agency theory is not without its critics, and has been criticized in several areas as insufficient to address the dynamics of such a complex issue.

(ii) Divergence of shareholder-board interests

Agency theory views the dealings of shareholders and management in terms of contracts between the two parties. Consequently, as a model of corporate governance it has received criticism for under-estimating the agency problems inherent in the board of directors. Instead it is argued that the behaviour of the overseers, the board, is influenced by "inter-personal behaviour, group dynamic, and political intrigue" (Tricker 2009, 222).

Warren Buffet, renowned investor having served on the boards of 19 public companies, has substantiated this argument:

> Why have intelligent and decent directors failed so miserably? The answer lies not in inadequate laws—it's always been clear that directors are obligated to represent the interests of the shareholders—but rather in what I'd call 'boardroom atmosphere'… My own behaviour, I must ruefully add, frequently fell short as well: too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence. (Monks and Minow 2004, 196)

Buffet's statement speaks to the atmosphere among board members. Just as Buffet indicates politics and collegiality among board members to be highly influential, the same can be argued, by extension, to be true of management-shareholder relations.

By this rationale, critics have argued that agency theory's "black-box" approach is too narrow in theoretical scope. Instead it is argued that board members may be influenced by numerous competing objectives, outside the scope of that which is beneficial to shareholders. Agency theory does not sufficiently address this concern.

(iii) Issues of board independence

Agency theory prescribes strong, independent boards. It is therefore implied, that the greater board independence, the better functioning the board. This extension of agency theory is also widely criticized.

Muth and Donaldson (1998) contend that independent directors do not necessarily increase board performance. Rather, they find that too many independent directors can detract from the performance of boards, or stagnate board efficiency. Instead, they argue there is an alternate factor, network connections, to influence board performance (Muth and Donaldson 1998). By Muth and Donaldson's reasoning, boards with well-connected

executive directors are better performing. Boards with already established connections, both internally within the corporation and externally within the community will perform better than those relying on independent non-executive directors.

Although a valid criticism, the impact of board networks on the partiality of a "connected" board must also be considered when evaluating Muth and Donaldson's argument. As depicted by Warren Buffet's account of his experience in the boardroom, boards can also fall short if an increase in connectedness comes at a cost of a board ability to be critical of management and of other board members. By nature, the agency theory model of corporate governance assumes all actors to be self-interested. Agency theorists would therefore have a similar opinion to Buffet, that well-connected boards could not be trusted to remain partial. Herein lies an important distinction between Muth and Donaldson's criticism, and one of the central assumptions to agency theory. Whereas agency theory assumes that self-interested individuals cannot be trusted, Muth and Donaldson disagree, and instead feel they can. This distinction provides the foundation for a second model of corporate governance, stewardship theory.

2.2 Stewardship Theory

Building on their criticism of agency theory, Muth and Donaldson are strong proponents of stewardship theory. Central to an understanding of stewardship theory however, is an understanding of its distinctions from agency theory.

Stewardship theory, assumptions

(i) Management can be trusted

As established, the agency approach is centred on the belief that management are self-interested actors. Stewardship theory however, takes an opposing stance. Instead, it is assumed that because management has a fiduciary duty to act as stewards of shareholders' interests (Tricker 2009, 224), managers understand this duty, and can therefore be trusted to act accordingly. So then, distinct between agency and stewardship theory, is that while both recognize that management and shareholders' interests may differ, stewardship, unlike agency theory assumes that management can be trusted.

Figure 3 adjusts the agency theory model previously provided in figure 2:

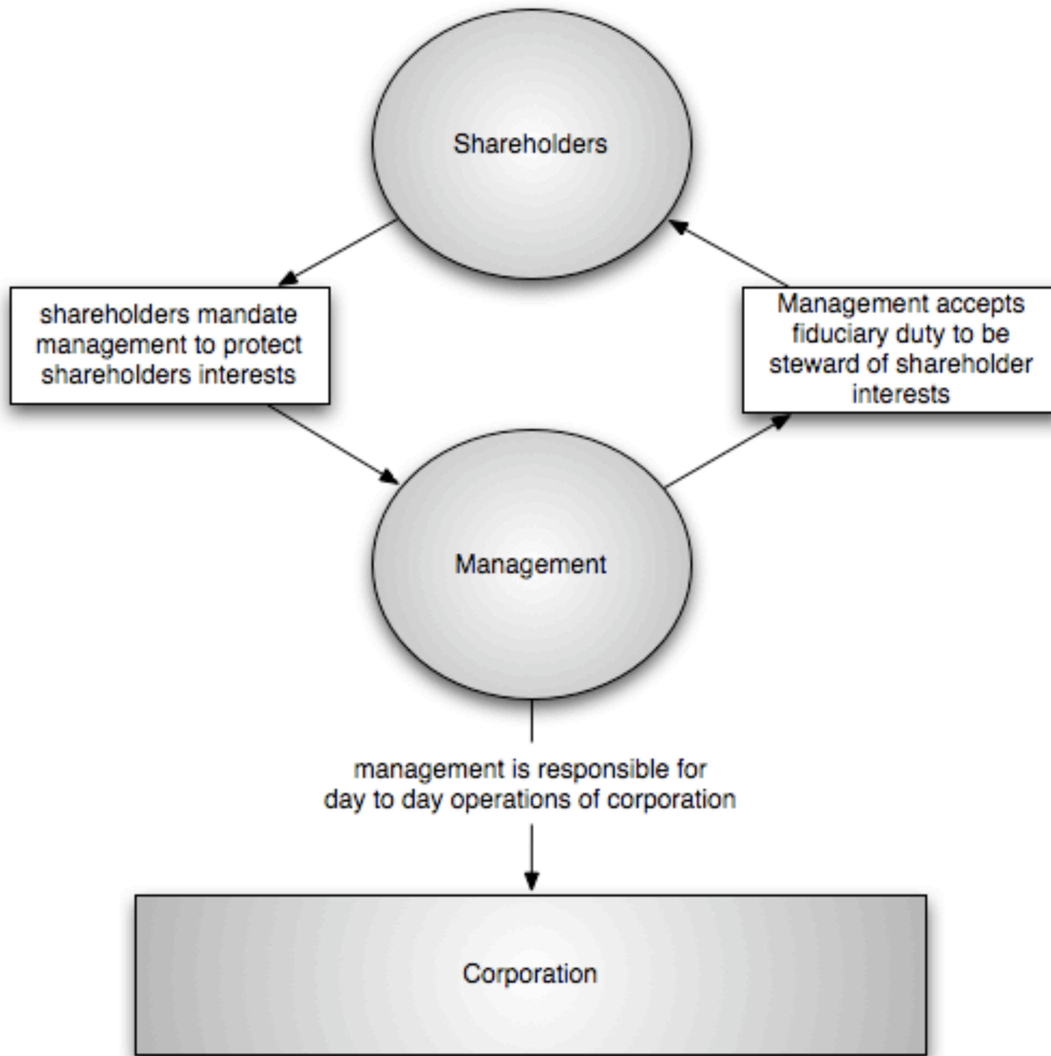

Figure 3 The principal-agent relationship, stewardship model (Based on Tricker 2009)

Stewardship theory therefore disagrees with the agency implication that management decision-making is detrimental to shareholder interests. Instead, it operates on the belief that management can be trusted to act as stewards of shareholders' interests.

(ii) Managements' incentives are not purely self-interested

Stewardship theory also operates on the assumption that management face a wide variety of incentives, and are not purely self-interested.

Organizational psychology and sociology provide alternate notions of conceiving of management incentives. Based on these theories, managers are viewed as motivated by "a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority and to gain recognition from peers and bosses" (Donaldson and Davis 1991, 51). Management are therefore not purely self-interested. To be successful, this group must also recognize the interests of customers, employees, suppliers, and other stakeholders (Tricker 2009, 224). As it is not feasible for this group to act purely in self-interest, management are therefore viewed as responsible and loyal stewards of the company.

The stewardship theory model of corporate governance

Stewardship theory assumes that management faces a wide range of motives and can be trusted. It therefore follows that the corporate governance mechanisms generally used to supervise self-interested, untrustworthy managers are inefficient. Because stewardship and agency theory hold different assumptions for the behaviour of management, the corporate governance recommendations for the two models will not be the same. Stewardship theory considers an alternate approach to corporate governance:

(i) Blanket controls are not efficient

First, blanket controls applied to all managers are considered inefficient (Muth and Donaldson 1998, 6). Whereas these measures, from an agency perspective, are

considered effective, they do not have the same value from a stakeholder approach. Managers are viewed as cognizant of, and responsive to shareholders' interests. Consequently, from a stewardship approach, uniform and all-encompassing corporate governance mechanisms will not act as safeguards of shareholder interests; management will perform this role on their own volition.

(ii) Network connections are important

Instead, insider-dominated boards are considered more effective. As introduced earlier, network connections can be an important component to board performance. Stewardship theory proponents, Muth and Donaldson, favour insider-dominant boards for "their depth of knowledge, access to current operating information, technical expertise and commitment to the firm" (Muth and Donaldson 1998, 6). Well-connected boards are viewed as a structure facilitating more effective control by management, and subsequently are better performing. Whereas agency theory criticizes well-connected boards for their lack of partiality, stewardship theory views managers to use their connections to further the interests of the company that employs them.

Criticisms of stewardship theory

(i) Management's poor track record as stewards

As established, stewardship theory is founded on the basis that management can be trusted. It has been argued however, that the increasing prevalence of corporate scandal has eroded this trust. Consequently, there is a view of trustworthy managers as the exception, not the norm.

Indeed, there is no shortage in examples of executives who have, contrary to the assumptions of stewardship theory, violated the trust of shareholders. In 2002 alone, consequent to the criminal investigation of numerous executives, seven of the twelve largest bankruptcies in American history were filed, resulting in the destruction of billions of dollars in shareholder wealth (Monks and Minow 2004, 1). Figure 4 illustrates the decline in the Dow Jones Industrial Average for the years 2001-2:

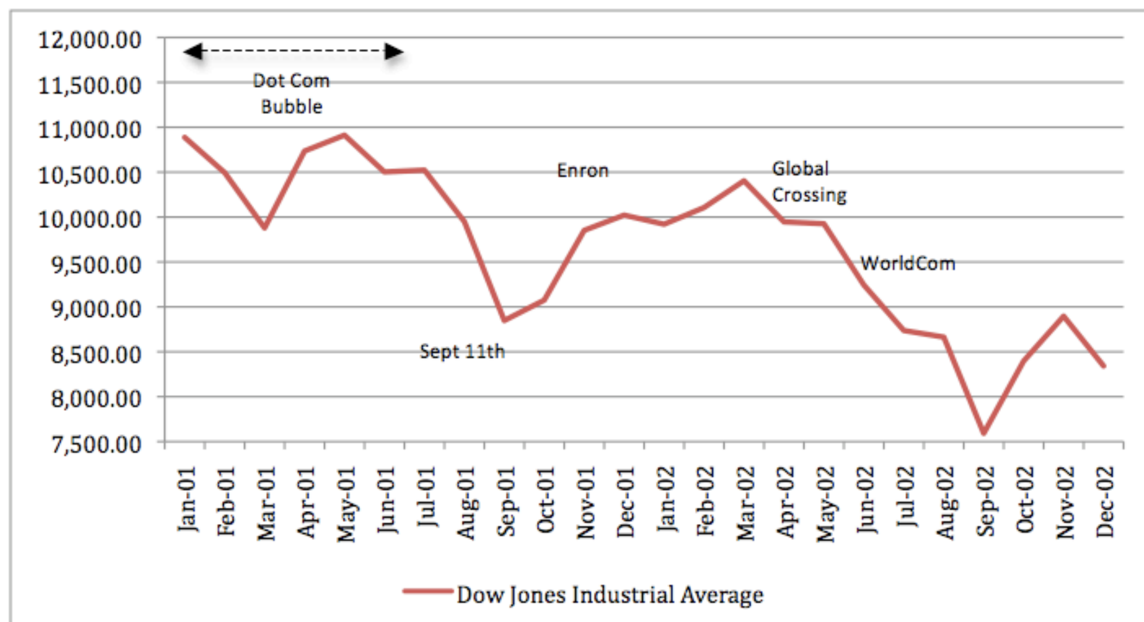

Figure 4 Dow Jones Industrial Average, Jan 2001 to Dec 2002 (adapted from Yahoo Finance)

The astonishing loss in shareholder value for these years shows the combined effect of the dot-com bubble, 9-11 terrorists attacks, and fall of major corporations such as Enron. Significant shareholder value was destroyed as a consequence to these events. In spite of these transgressions, it is important to question whether shareholders can still trust that management will act in their best interests. That is, can we consider the first assumption of stewardship theory, that management can be trusted, as valid?

2.3 Models of corporate governance

(i) Why is no single paradigm suited to the study of corporate governance?

Corporate governance is an increasingly salient topic among investors and regulators. Theoretically, however, the subject has yet to establish a solid foundation. At present, it appears that no one theory is sufficient. Each of agency and stewardship theory focuses on different aspects of the governance framework (Tricker 2009, 234). While agency theory concentrates on the relationship between management and shareholders, stewardship theory is concerned with the internal relationships and connectedness among managers and among boards. Table 1 compares the two theoretical models discussed in this paper:

Table 1 Agency and stewardship theory, compared

Agency Theory	*Stewardship Theory*
Agents cannot be trusted	Agents are trustworthy
Agents are self-interested	Agents face a range of incentives
Independent boards are critical to protect shareholder interests	Insider-driven boards are better performing

Agency and stewardship theory are founded on opposing assumptions. As such, it becomes difficult to reconcile a single model of corporate governance from the two. An appropriate theory, however, would also take into account the continuous evolution of the corporate model.

(ii) The changing corporate model

The original concept of the corporation views corporate governance mechanisms, such as the board of directors, as performing an intermediary role between a corporation's management and its investors (shareholders). Within this model is the assumption that investors are the ultimate beneficial owners of the investment. The evolution of the corporate model renders this assumption insufficient.

The beneficial owner of a security is the individual (or entity) with the equitable right to the security, regardless of the name in which the security is registered (SEDI, n.d.). The beneficial owner is contrast against the legal owner, who although holding title to the security, may not carry any rights to it as property (SEDI, n.d.). This distinction is important to understanding the evolving definition of the corporate model, as beneficial owners have become increasingly distant from the corporation.

Increasingly, there is the presence of layers of brokers, agents, shareholding companies, and institutional investors such as hedge funds, mutual funds, pension funds and banks between the corporation and its ultimate beneficial owners (Tricker 2009, 233). Figure 5 illustrates the differences between the traditional and evolved corporate models:

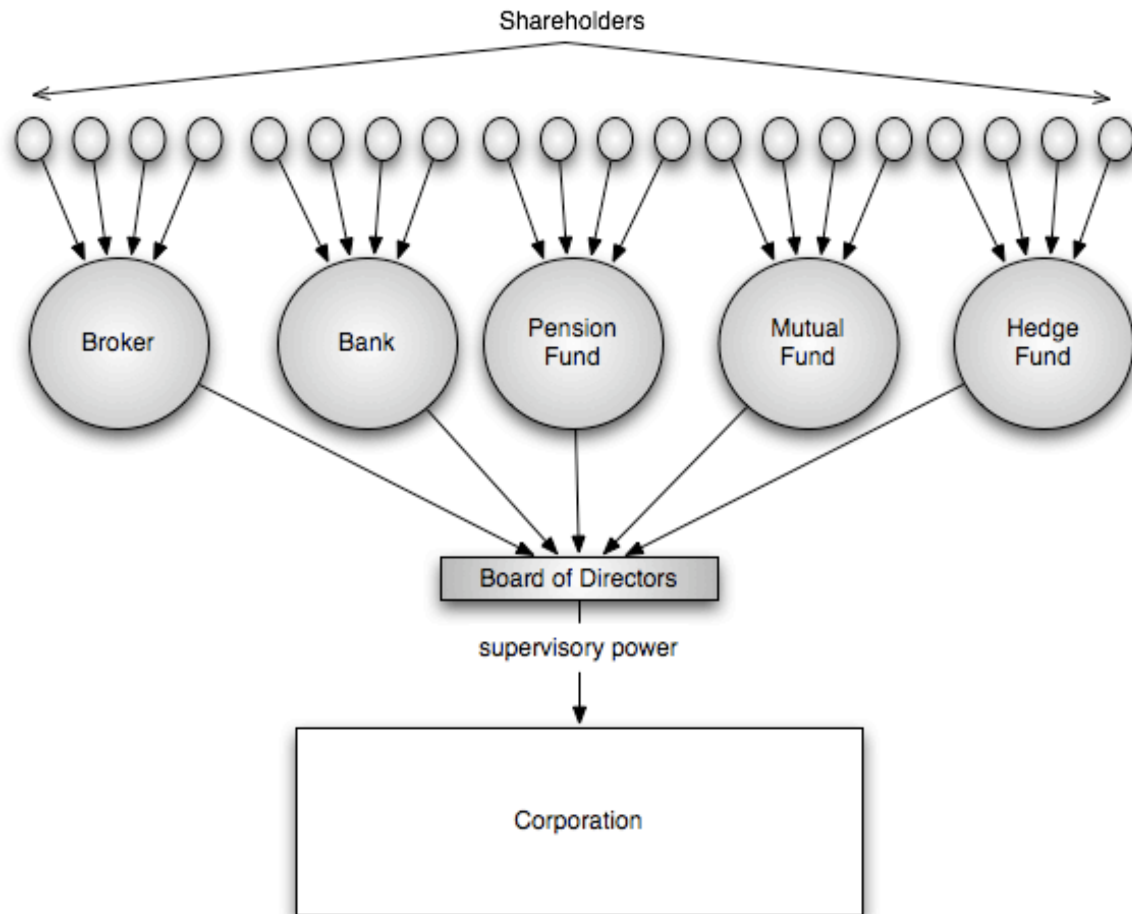

Figure 5 The corporate model, evolved (adapted from Blair 1995)

Practically speaking, this means there is a greater distance between investors and management. So whereas in the traditional model, the board of directors is charged with overseeing management activities according to the aggregated voice of shareholders (who are also beneficial owners), in the evolved corporate model this role changes. In the evolved corporate model, institutional shareholders such as mutual funds and hedge funds, representing their own shareholders, play an increasingly significant role. For the

board, this means a fewer number of shareholders (representing a broader base of beneficial owners), with a greater concentration of ownership.

(iii) Greater concentration in ownership

Given the described differences between the traditional and evolved models, to what extent is the evolved model descriptive of the current environment of corporate governance? Figure 6 illustrates the proportion of voting shares held by individuals, versus institutional investors (also inclusive of banks and government, holding companies and overseas investors) across Canada, the United Kingdom and the United States:

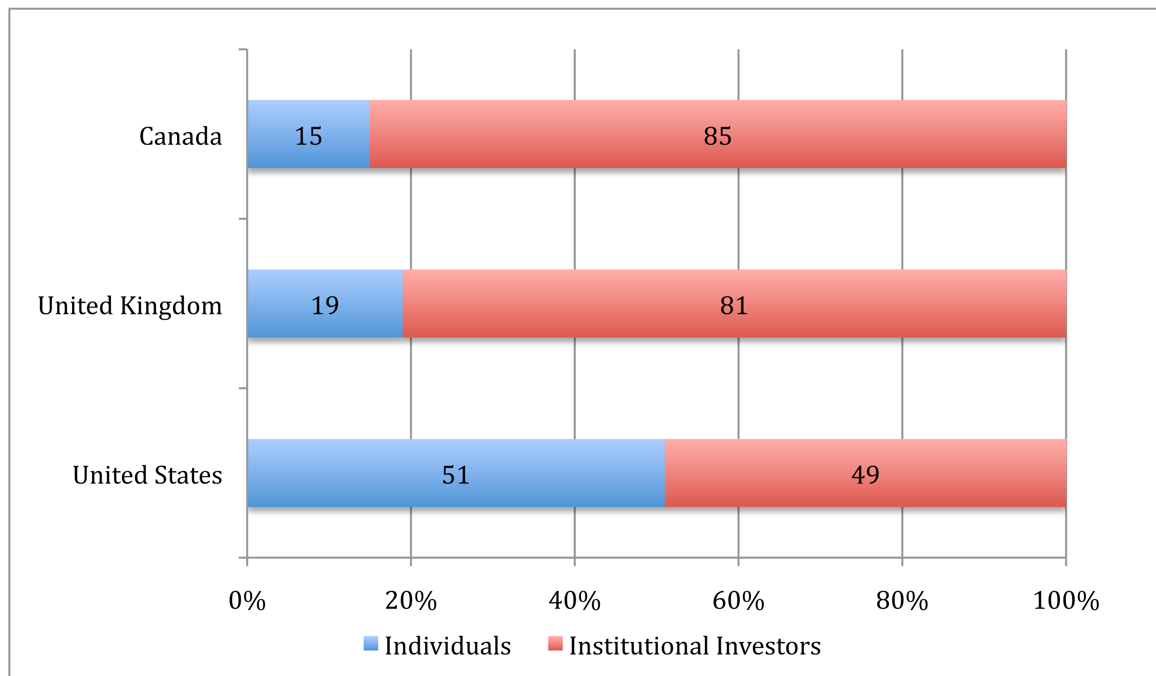

Figure 6 Balance of ownership, listed companies in Canada, UK, US (adapted from Tricker 2009)

As shown in figure 6, a significant portion of ownership in each of Canada, the United States and the United Kingdom can be considered institutional. From the perspective of the corporation, this has several implications.

A growing institutional shareholder will affect the ability of the board to exercise control over the company (Tricker 2009, 182). For example, where there is a widespread base of individual shareholders the board will have a greater ability to act on its own initiative (Tricker 2009, 182). That is, where the body of shareholders is more diverse, the board is less likely to receive pressure from an aggregated shareholder voice. Conversely, a board that is dominated by a significant block of investors with a single voice (a large institutional shareholder) will have less freedom to act on its own volition (Tricker 2009, 182). In such cases, there is the possibility of the board facing greater pressure to be responsive to shareholder demands.

Not only can a large institutional investor influence a corporation directly through its ownership of a particular holding, it can also exercise considerable indirect influence in its trading of shares (Gillan and Starks 2003, 4). This considerable influence is recognized by the UK Financial Services Authority (FSA) ban on the short selling of 30 financial stocks (Treanor 2009). The FSA short selling ban was introduced in response to the detrimental impact of speculative trading on the part of hedge funds on financial corporations such as HBOS Plc in the UK (Bloomberg 2009). Institutional investors such as hedge funds have considerable leverage to influence not only the direction of a single company, but the market as well. Institutional shareholders trade in much larger blocs than individual shareholders, and can move markets with a single trade. Consequently, these entities can have a sizeable impact on shareholder value.

The growing influence of institutional shareholders has changed the corporate landscape significantly, as illustrated in figure 5. This evolution has yet to be sufficiently addressed by the dominant theoretical models of corporate governance. The composition

of the body of shareholders has evolved, and so must theoretical approaches to the area. An institutional shareholder will have a significantly larger stake in a corporation, and consequently will demand a greater voice. As the corporate model continues to evolve it will be increasingly important that sufficient attention is devoted to the power and influence of these groups in both theoretical and legislative approaches to the topic.

3: Dominant legislative approaches to corporate governance

In spite of the lack of consensus between the two models of corporate governance, several dominant approaches have emerged. Among developed markets, the United States and the United Kingdom can be viewed as “first-movers”, having been early adopters of corporate governance regulations. Viewed in comparison to other systems worldwide, the US and UK models are highly similar. Clear differences are evident between these models and other prominent models, such as those of Japan, Germany, France and China. For the purposes of this discussion, however, a narrow view will be taken, examining only the US and UK frameworks.

Sources of different national systems of governance

Clear differences can be observed between the frameworks of nations, however there is often little explanation of the basis for these differences. Tricker 2009, identifies context and culture as key influencers of a nation’s corporate governance model.

(i) Context and governance

Context refers broadly to the patterns of ownership, corporate control and financing in a corporation, and the resulting implications these factors hold for governance (Tricker 2009, 181). As previously established, patterns of shareholder ownership in a corporation will impact the ability of, and means by which the board exercises control over the company. Similarly, the market for corporate control is determined by the pervasiveness of mergers and acquisitions activities. The greater the

corporation's susceptibility to takeover, the greater the incentives for the board to exercise its duties to ensure good performance. Finally, the means by which a corporation finances operations will also affect the power of the corporation versus shareholders. That is, the board of a corporation reliant on the financing of its shareholders, will have less autonomy than the board of a corporation with many other financing options (Tricker 2009, 182-183). A board may not have the same need to appease shareholders, if owner (shareholder) financing can easily be replaced with other sources.

(ii) Culture and governance

A second factor, culture, also holds governance implications. The behaviour of the board of directors will vary across different cultures, as will the expectations of the board, and board relationships. Tricker 2009 argues that while cultural differences may create differences in governance practices, they should not be used as a basis on which to defend poor practices (Tricker 2009, 183).

Although difficult to measure, the context and culture within which corporations operate are central to evaluating individual models of corporate governance. Analysis of the US and UK models will also touch on both, however will emphasize context-related factors.

3.1 The US Rule-based model

Given the size and scope of American business around the world, the US model of corporate governance has been viewed as influential on systems worldwide. Furthermore, the high profile of US corporate transgressions in recent years has created a

corporate governance imperative in the eyes of regulatory authorities. Major reforms to the US system have been implemented as a response to this growing imperative.

Corporate structure and ownership

In the United States there are close to 15,000 publicly traded, and 15 million privately held corporations. By state law requirements, all corporations must have a board of directors (IOD, et. al. 2005, 179). Whereas in the case of public companies, the boards are functional, generally with designated audit, remuneration and nominating committees, the boards of private companies are often in name only (IOD, et. al. 2005, 180).

The ownership structure of US companies has changed in recent years, following a structure similar to that described as the "evolved" corporate model in section two. Figure 7 depicts the ownership structure of US corporations:

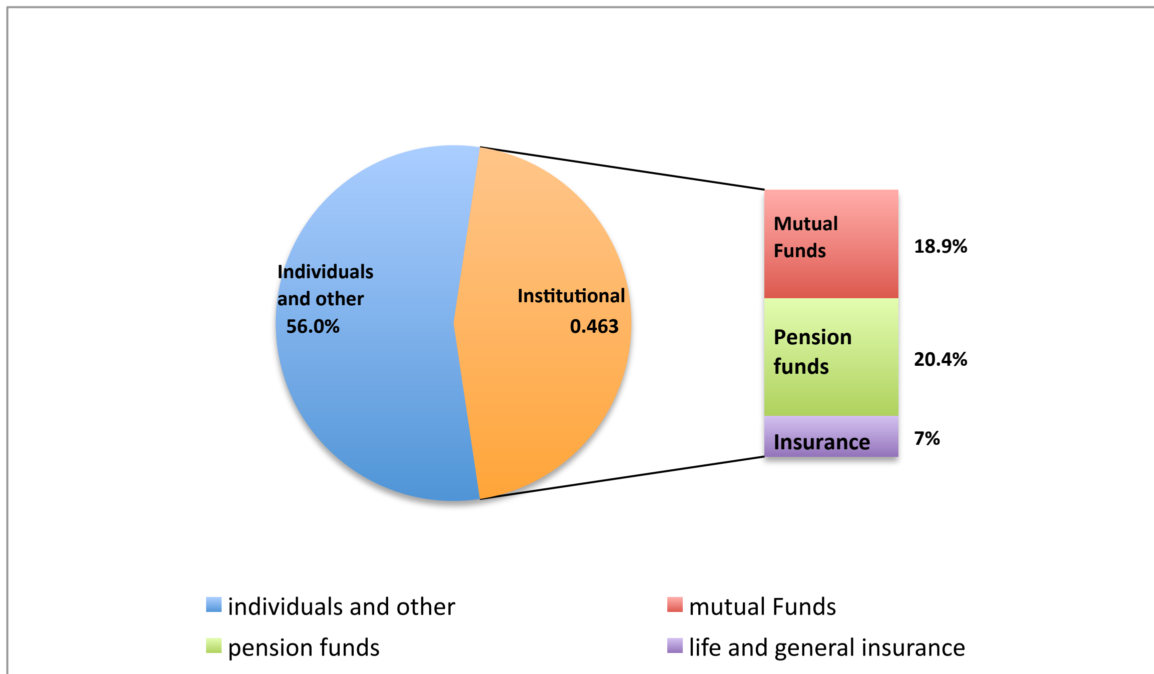

Figure 7 Ownership of US shares, June 2003 (based on IOD et. al. 2005)

As depicted in figure 7, institutional shareholders hold close to half of the shares of US companies. Consequently, boards are responsible to fewer shareholders, however as institutional shareholders will have larger holdings, these owners are comparatively more powerful than any single individual shareholder.

Legal framework

As per state law and the Model Business Corporation Act (which presides over the operations of corporations), managers and directors are charged with the duty of care, and duty of loyalty to shareholders. Duty of care requires that managers act in good faith and with due diligence in decision making, while duty of loyalty requires managers make decisions in the interests of the corporation and its owners, and maintaining an awareness of potential conflicts of interest (IOD 2005, 180).

Generally speaking, however, duty of care and duty of loyalty have been viewed as insufficient mechanisms in themselves to preside over a corporation's management. Consequently, alternate frameworks have been established to fill this gap.

Sarbanes-Oxley 2002

The Public Accounting Reform and Investor Protection Act of 2002, known as Sarbanes-Oxley (SOX) after its sponsors Paul Sarbanes (Democrat, Maryland) and Michael Oxley (Republican, Ohio), has been considered landmark legislation, influential throughout the US and worldwide (IOD, et. al. 2005, 181). Distinct about SOX from other legislation, is the pervasiveness of its requirements, covering topics from analyst conflicts of interest to document shredding, and the mandated criminal penalties for

major transgressions such as fraud (IOD, et. al. 2005, 181). SOX includes several key areas pertinent to corporations.

(i) Section 302: Corporate Responsibility for Financial Reports

Section 302 outlines SOX provisions pertaining to the internal controls of corporations. For each quarterly or annual report, the corporations officers must certify that the report as well as any financial information has been reviewed by officers as well as the audit committee, and that any changes to recognition or internal controls has been documented (SOX 2002, Section 302, pg 33). More broadly, the provisions of Section 302 essentially state that officers are "responsible for establishing and maintaining internal controls" (SOX, Section 302, pg 33). SOX Section 302 in its entirety can be found in the appendix.

(ii) Section 404: Management Assessment of Internal Controls

Section 404 details perhaps the most onerous provisions of SOX legislations. That is, it requires management to document the aforementioned internal controls in an 'internal control report' as a part of the quarterly or annual report (Tricker 2009, 157). Within this internal control report, SOX requires that management identify and document the corporation's internal controls and procedures for internal reporting, and evaluate the effectiveness of this system (SOX 2002, Section 404, pg 45). Furthermore, the public accounting firm that issues the audit report must also attest to and report on management's assessment (SOX 2002, Section 404, pg 45). Therefore, Section 404 requires not only that management report on internal controls, but also that an

independent auditor attest to management's assessment. Section 404 in its entirety is also included in the appendix.

(iii) Why are Sections 302 and 404 considered necessary?

SOX consider the disclosure of a corporation's internal controls (Section 404) as well as the certification of these processes as a fair representation (Section 302) necessary, due to the potential impact of controls, such as revenue recognition and cost allocations to the corporation's financial statements. For example, changes to recognition and allocation methods have the potential to depict the corporation in a very different light from one year to the next. Consequently, SOX considers it necessary that management fully disclose and certify these processes as a fair representation of actual activities.

Sarbanes Oxley, implications for US-listed corporations

SOX has been responsible for the development of the Public Company Accounting Oversight Board, a private, non-profit corporation responsible for ensuring that financial statements are audited in accordance with independent standards (Forbes 2003). As legislation, it focuses on reporting and internal controls as a primary mechanism of maintaining integrity in the corporation's activities. Furthermore, SOX uses a rules-based approach to enforcement, mandating fines as high as $5 million, 20 years in prison, or both as penalties to non-compliance (Forbes 2003).

For the most part, SOX was prompted by a series of corporate scandals, including those of Enron, Tyco, Global Crossing, and Arthur Andersen (Forbes 2003). Understanding that SOX is a framework of legal repercussions, created largely in

reaction to a series of corporate scandals, what impact has the framework had in the area of corporate governance since its implementation?

(i) Compliance costs

One of the most obvious implications of SOX was an increase in costs for the corporation, both in the area of internal controls, and audit fees. As discussed, sections 302 and 404 in addition to other components of SOX, mandate extensive compliance requirements. With the introduction of SOX, corporations therefore became responsible for the cost of meeting new standards of internal controls. On average, corporations have experienced an estimated increase in compliance costs of 77 percent, or $16 million, and large conglomerates such as GE have reported spending as much as $30 million on internal control requirements alone (Dunwoodie 2004).

The new compliance requirements, and specifically the internal control report also became a source of fees for auditors. The requirement that auditors certify and attest to management's assessment of internal controls involves not only additional work, but also a new risk assumed on the part of auditors (Cosgrove and Niederjohn 2006, 3). Consequently, the direct costs of an audit also increased as a consequence to SOX provisions.

Changes to auditor independence requirements are also speculated to be a source of increased audit costs for corporations (Cosgrove and Niederjohn 2008, 32). Prior to SOX, the audit practices of accounting firms had long been considered "loss leaders… through which they lure clients and then pitch them more lucrative consulting work" (Coleman and Bryan-Low 2002). The introduction of auditor independence requirements

however, prohibited auditors from providing certain other services to clients for whom the firm was also the external auditor.

Cosgrove and Niederjohn (2008), posit “if auditors were using external auditing services as a loss leader before SOX, this practice would likely be limited or cease post-SOX as they would not have as great an opportunity to recover their auditing costs with fees for consulting and other services” (Cosgrove and Niederjohn 2008, 32). Consequently, it is not only the direct requirements of SOX on corporations that are considered as holding implications for compliance costs. If accounting firms, faced with revenue losses as a result of new auditor independence requirements, opt to recoup the loss through audit fees, the impact will be felt by corporations. Consequently, the broader systemic requirements of SOX are also viewed to have created additional compliance costs for corporations.

(ii) Firms opting to go private

Figure 8 shows the compliance costs for companies with annual revenues less than $1 billion, both prior, and subsequent to the 2002 introduction of SOX.

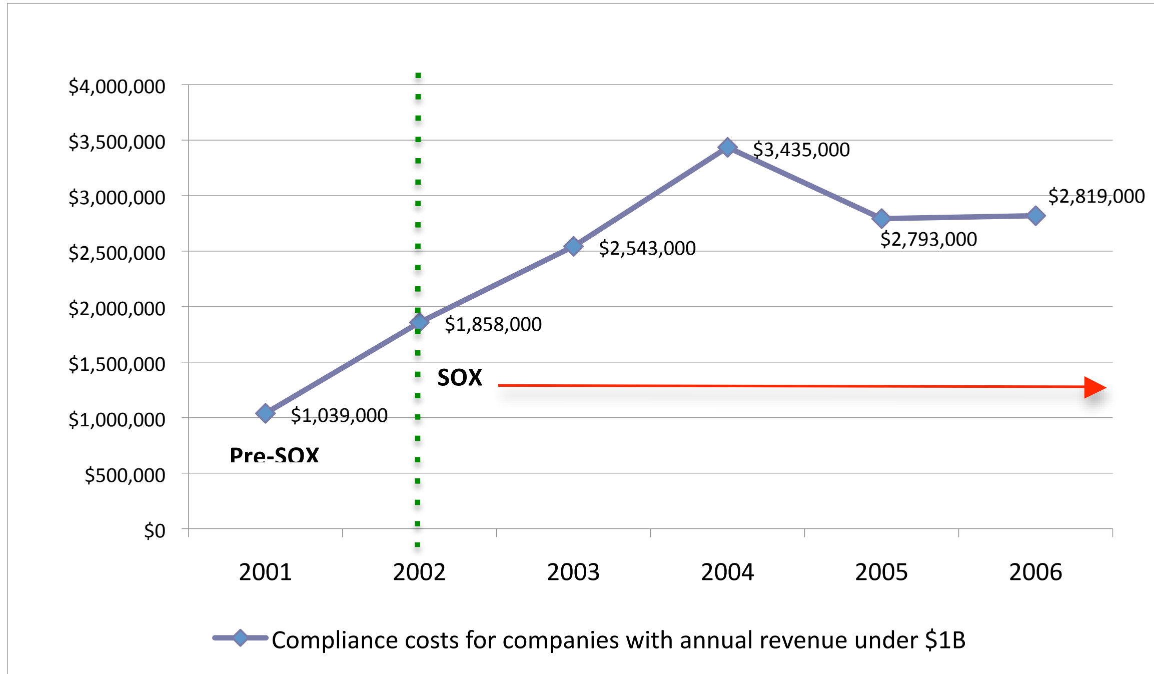

Figure 8: Costs to public listing for firms with annual revenue under $1 billion (Hartman 2005)

For the corporation, these cost depicted in Figure 8 effectively represent the cost to remaining a publicly traded corporation. Compliance costs were shown as steadily increasing for the years 2001 through 2004, however decrease for the year 2005. Hartman (2005) finds that despite the decrease, companies of all sizes experienced a significant increase in SOX compliance costs, with costs associated with Section 404 of the act responsible for a majority of that increase (Hartman 2005, 1).

Unable to contend with new compliance costs associate with SOX, there has been some concern that public companies may go private. Engel, Hayes and Wang (2004), study this tendency among public corporations. They argue that in response to new compliance and transparency requirements, some firms may "reconsider their choice of organizational form" (Engel, Hayes and Wang 2004, 23). That is, in avoidance of the new requirements and costs, some companies have made the decision to go private.

Engel, Hayes and Wang find this behaviour characteristic of smaller firms who are unable to cope with SOX compliance costs. Specifically, those firms for which the pre-SOX net benefit of being a public corporation was small were the most likely to make the decision to go private (Engel, Hayes and Wang 2004, 23).

Undoubtedly, the substantial cost to public listing has resulted in firms considering other options. According to a survey by Hartman, in 2007, 23 percent of respondents were considering going private, 16 percent were considering selling, and 14 percent were considering merging with another company (Hartman 2005, 3). SOX efficacy in light of the costs levied on corporations must remain a consideration among regulators.

Evaluating the US Model

The corporate scandals preceding SOX were viewed as a result of insufficient disclosure practices and a lack of satisfactory internal controls (Bergen 2005, 3). SOX is a rule-based framework enacted to address these concerns through mandated reporting and disclosure requirements, attestations, and strict penalties for non-compliance.

As an approach to corporate governance, SOX is relatively new, and much of its effect has yet to be measured. To date however, it has received mixed reviews. First, SOX focuses very narrowly on internal controls, financial reporting and disclosures. Whereas these areas were of central concern to pre-SOX corporate transgressions, governance concerns are continuously evolving, and becoming increasingly broad. Second, as discussed earlier, fulfilling the disclosure and reporting requirements is a process so onerous and cost intensive to firms, that it has created an incentive for some to

go private. In light of these intensive costs there is also much debate as to the efficacy of encouraging good corporate governance practices through a rules approach, that is, by penalizing non-compliance.

(iv) Narrow Focus

SOX was enacted in the wake of Enron, in an environment where financial disclosure was of increasing concern to shareholders and regulators. Given that financial statements are considered a reflection of a corporation's performance, disclosure and reporting enhancements were therefore viewed as an effective means to encouraging good governance. Over time however, this focus has expanded.

Corporate governance concerns have expanded beyond the traditional focus on financial accounting. Instead, the discourse of governance has expanded to include topics such as executive compensation, securities ratings, and analyst recommendations (Millstein Centre 2009). Furthermore, corporations are not viewed as the only actors involved in governance. Hedge funds, private equity, credit rating firms, brokers, and regulatory bodies are also viewed to have definitive roles in maintaining good governance.

Evaluated against the increasingly broad focus of corporate governance, the emphasis of SOX on financial reporting appears narrow.

(v) Rules approach

The rules approach of SOX has been criticized along two trajectories. First, for the considerable sunk costs to implementation, and second for the insufficiency of a framework that may only encourage compliance with the minimum standard.

(a) Compliance at the cost of innovation

SOX compliance is mandatory for all public companies. As established, firms must therefore allocate resources to cover the considerable costs of implementation. Not only is SOX compliance resource intensive, it may also require management to divert from strategic decision making to preside over the implementation process. That is, for firms, this may result in the diversion of resources away from potentially profitable areas, and instead toward compliance (Bergen 2005, 5). Consequently, there is a risk that fulfilment of the extensive requirements of Sections 302 and 404, could result in a loss of value or innovation for firms (Bergen 2005, 5). There is a concern that compliance could stifle innovation.

Small-and-mid-sized firms, which may not necessarily have the capacity or wherewithal to handle such changes, may be most profoundly affected. Professional costs, and managerial time vary little with company size. As a result, small-and-mid-sized firms may in fact, be forced to allocate a higher percentage of revenue to SOX compliance (Bergen 2005, 5). Not only is there a perceived risk that compliance may come at the cost of innovation, this cost is disproportionately levied on small firms that may not necessarily have the ability to carry such costs. Therefore, there is a concern that compliance costs for small-and-mid-sized firms may therefore be so substantial that they are prohibitive to the firm's ability to go or remain publicly traded.

While there is a concern that compliance costs may be prohibitive to the ability of smaller firms to remain public, it must also be acknowledged that for a small firm to meet listing requirements to begin with, it must be relatively resilient. To list on either the New York Stock Exchange (NYSE) or NASDAQ, a firm must meet stringent

requirements in a number of areas including earnings, cash flows, and market capitalization (NYSE 2009; NASDAQ 2009). Furthermore, the fees to listing can be as high as $500,000 (NYSE 2009). Arguably, a small firm able to meet such onerous requirements should also be sufficiently robust so as to withstand increased compliance costs.

It has been argued that the compliance and implementation costs of SOX are so substantial as to potentially erode profitability or stifle innovation, both of which are areas that generate shareholder value for many firms. Governance frameworks are designed to protect shareholder value. As such, a framework that jeopardizes this end could potentially be viewed as contradictory.

(b) Challenges of a rule-based approach

SOX is one of the few rules-based approaches in the world that specifically and explicitly addresses corporate governance. In addition to criticisms of the substantial cost to compliance, are concerns that as a rule-based framework, it incites firms to make only the minimum effort towards compliance

With a rule-based approach such as SOX, all firms are required to meet a uniform standard, and there are penalties for non-compliance. Beyond meeting this minimum standard, there is little incentive for firms to engage in any further measures to improve governance, particularly if there is a cost involved (McNamara, 2004, 3). Any incentive to exceed the standard is therefore external to the framework (for example, pressure from stakeholders). The rule-based approach therefore tends to create an environment where it is acceptable to conform to the “letter of the law” (McNamara 2004, 3). That is, it becomes acceptable for participants to seek out loopholes, and methods to bypass rules,

so as to achieve a desired outcome within the provisions of the regulatory framework. By this rationale, it is possible for a firm to be operating in strict compliance with the rules of SOX, however to be engaging in behaviours that are contradictory to the "spirit" of the law.

For these reasons, the US is one of the few jurisdictions to opt for a rules-based approach. SOX represents but one approach to the corporate governance goal of maintaining integrity in the activities of corporations. In evaluating the SOX approach it is important to understand that while the framework may not necessary prevent transgressions, it establishes consequences and penalties. Alternate approaches, such as the principles-based model of the UK, centred on a code of best practices, will be discussed in the next section.

3.2 The UK Principles-based model

The United Kingdom was among the first nations to establish a code of corporate governance. A principles-based approach, similar to that of UK accounting standards, has been adopted. Despite similarities to the US model, the UK model does not approach corporate governance with the same emphasis on rules, and penalties for transgressions, as the US model.

Corporate structure, ownership and legal framework

The corporate structure of the UK is very similar to that of the US. Of 1.8 million companies, 12,400 are publically listed, and 2,700 of those are listed on the London Stock Exchange (IOD et. al. 2005, 154). In a trend similar to that of the US and other

developed markets, ownership of UK shares in recent years has trended away from the individual and toward corporations. Figure 9 offers a further description of UK share ownership patterns over time:

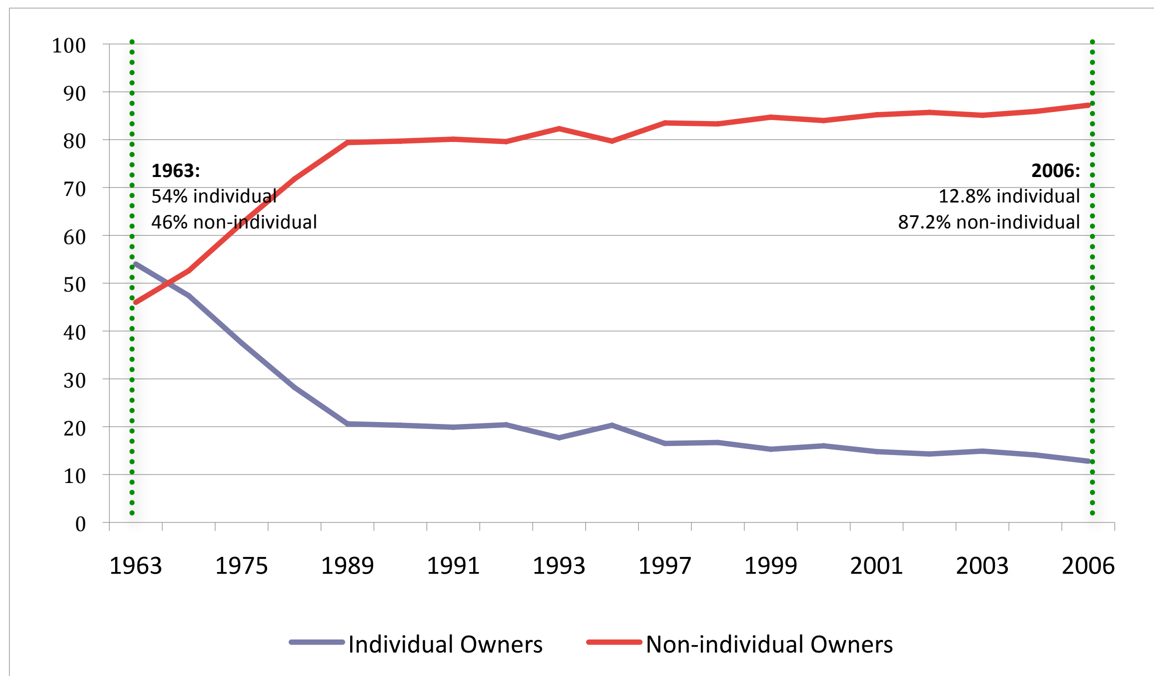

Figure 9: Individual versus non-individual ownership of UK shares, 1963-2006 (based on ONS 2007)

Whereas in 1963, individuals owner 54 percent of shares in UK companies, this had fallen to 12.8 percent by 2006 (ONS 2006, 9). Given the strong presence of non-individual ownership in the UK, there is a growing concern that institutions (owning 46 percent of shares in 2006) will have an ability to use concentration of ownership to influence boards (IOD et. al. 2005, 155; ONS 2006, 9).

The UK does not operate using one single system of law, rather, the three systems of England and Wales, Scotland, and Northern Ireland. For the most part, principals of company law are consistent between England and Wales and Scotland, however procedural differences do exist (IOD et. al. 2005, 155). Similar to the US system,

managers and directors are obligated to operate with duty of care and skill (IOD et. al. 2005, 155).

Given the similarities in context between the US and UK, it is therefore particularly interesting to observe the differences in corporate governance frameworks adopted by the respective nations.

The Cadbury Report

The Cadbury Committee was established in response to a series of corporate scandals in Britain in the 1980s (Boyd 1996, 170). The committee produced a report titled The Financial Aspects of Corporate Governance (referred to as the Cadbury Report) in December 1992, which contained a series of recommendations to improving the state of corporate governance of UK corporations. Table 2 summarizes the governance issues deemed as most pertinent by the committee, and the Cadbury recommendations:

Table 2 Governance issues and recommendations of Cadbury Committee (adapted from Boyd 1996)

Governance Issue	***Cadbury Code Recommendation***
Separate CEO and chairperson	Recommended, but not compulsory
Nomination of directors	Formal board process via nomination committee dominated by outside directors
Outside directors	Minimum of 3 non-executive directors
Independence of directors	Majority of non-executives to be independent
Rotation of directors	Directors to be appointed for specified terms with non-automatic reappointment
Pay and bonuses	Annual report to reveal disaggregated directors pay; remuneration committee of board to be dominated by outside directors

Independence of the auditor	Audit committee of the board to be formed, comprised exclusively of outside directors
Flow of information to the board	Board to have formal schedule of decisions; directors to have paid access to outside advice
Greater scope of auditing	Auditors to review compliance to the code, including directors' statements on going-concern and on internal audit effectiveness

The recommendations in table 2 were presented as a code of best practices, describing how corporations ought to govern themselves. The code of best practices can be found in its entirety in the appendix. This emphasis on best practices is descriptive of the UK's principles based approach to corporate governance. The underlying approach of Cadbury is therefore one of voluntary compliance among corporations, this approach widely regarded as an attempt to maintain a system of self-regulation in the face of threatened legislated control (Boyd 1996, 172).

As a means of enforcement, it is proposed that corporations be required to issue an annual statement of compliance, identifying and explaining any areas of non-compliance (Boyd 1996, 172). Effectively, corporations must either comply with the code, or explain why their efforts fall short of compliance. For the firm, the motivation for full compliance is assumed to be the fear of public exposure and criticism for deviations from the code (Boyd 1996, 172). Generally speaking, Cadbury takes the approach that the criticism firms would face for non-compliance is an equally strong deterrent as the repercussions mandated by SOX.

Evolution toward the Combined Code

The Cadbury Report represented the first of a series of reports on the subject of corporate governance in the UK. Cadbury effectively served as the prototype for the UK Combined Code (2000), which builds on Cadbury, and encourages compliance using the same "comply or explain" basis. Given that the basis of much of the Combined Code is in the original Cadbury Report, discussion of the UK code of corporate governance will refer primarily to the original principals of Cadbury.

The Cadbury Report and Combined Code: Criticisms

(i) The focus on principals as opposed to rules

Cadbury's self-regulation approach has been criticised as insufficient when compared with more pervasive mechanisms such as SOX. Much of this criticism is founded in the belief that, if given the option (as in the case of Cadbury's self-regulation approach), managers are not likely to comply with a code of best practises. This criticism appears to be founded on an agency approach to corporate governance, which assumes that management cannot be trusted to act in the best interests of shareholders. This criticism does not properly take into account the view of stewardship theory, which, as established previously, takes the opposite approach that management can be trusted as shareholders' representatives.

The response to this criticism opts for a stewardship approach to corporate governance. That is, Boyd 1996 offers, "corporate governance is more about commitment than compliance… the real solution resides within the board which must lift its integrity and raise its standards and its performance" (Boyd 1996, 172). In this view, because management can be trusted to sufficiently represent the interests of shareholders,

strict regulation is ineffective as it encourages compliance only with the "letter, rather than the spirit of the law". By extension, a code of principals goes further than a set of rules, in that compliance requires a concerted effort on behalf of management to adopt the principals in the act (or otherwise justify areas where the corporation falls short of compliance).

(ii) The focus on external directors

A key recommendation of the Cadbury Report pertains to the appointment of non-executive members:

> "The board should include non-executive directors of sufficient calibre and number for the views to carry significant weight in the board's decisions" (Cadbury Report 2002, Code of Best Practice, 1.3)

Cadbury views the non-executive director as of special importance in setting and maintaining standards of corporate governance (Cadbury Report 2002, 4.10). The centrality of non-executive members is based on the belief of the Cadbury committee, that these members bring an independence of judgement to board deliberations. For that reason, it is also recommended that the majority of non-executives on the board be independent of the company (Cadbury Report 2002, 4.12). The suggestion that a minimum level of independent non-executives is critical to the integrity of the board has also generated criticism.

Boyd (1996) contends that "in the UK, the outside director has generally been regarded as insignificant in the governance process, no more than a mere window dressing chosen to enhance the image of the firm" (Boyd 1996, 174). Furthermore, the feasibility of this recommendation is questionable. Given the number of public

corporations in the UK, this component to the Cadbury Code imposes an exceptionally onerous requirement on corporations, particularly those not currently meeting the minimum standard.

(iii) Cadbury requirements for small firms

Like SOX, Cadbury does very little to distinguish between small and large firms. This has generated further criticism, in that the report requires that small firms conform to corporate governance standards, designed to guard against transgressions observed among large firms (Boyd 1996, 176). Consequently, compliance with the requirements of the code of best practices are criticised as imposing a significant burden on small companies, and being unsuited to their operations.

Both SOX and Cadbury have been criticized in this light. Important to note however, is that whereas SOX penalizes non-compliance, Cadbury requires only that firms provide an explanation for non-compliance. With Cadbury, corporations therefore have more flexibility in their adherence to the code.

3.3 Distinguishing the US Rule-based and UK Principles-based models

The US and UK approaches to corporate governance have very similar origins, in that both were prompted by corporate scandal. In the UK, the original Cadbury Code (and subsequent codes leading to the Combined Code) was a response to management abuses of the 1980s. In the US, SOX is viewed as a response to a growing number of corporate scandals, including Enron, Global Crossing, and Tyco. Despite these similarities in origin, the two frameworks have distinctive approaches to the area of

corporate governance. Table 3 outlines several of the key distinctions between SOX and the Cadbury Code:

Table 3 Sarbanes Oxley 2002, Cadbury/Combined Code 2000, Comparison

Sarbanes Oxley 2002	***Cadbury Code (1992) and Combined Code (2000)***
Enacted into US law for publically listed corporations in the US	Code of best practices for publically listed corporations in the UK
Requirements in Key Areas of: (i) auditor independence (ii) internal controls (iii) financial disclosure	Recommendations in Key Areas of: (i) non-executive directors (ii) director remuneration (iii) audit requirements
Corporations are legally required to comply	Corporations must comply or explain why requirements have not been met
Rules-based: *"Is this legal?"*	Principals-based: *"Is this right?"*
Underlying assumption that managers cannot be trusted	Views management as trustworthy to a greater extent than is the view of SOX

In opting for a principals-based approach, Cadbury affords management a degree of discretion in determining the suitability of each of the recommendations to the corporation's business. Although not a perfect fit[1], this approach is most closely aligned with a stewardship approach to corporate governance. That is, there is an underlying assumption that management will act as stewards of shareholders' interests. Consequently, Cadbury offers only a set of recommendations, and relies on management discretion to either comply, or provide rationale for non-compliance.

[1] Whereas stewardship theory advocates well-connected boards, Cadbury recommends externally dominated boards.

To the contrary, the rules-based approach of SOX provides management with comparatively little discretion. Rather, SOX mandates a corporation's compliance, and imposes strict penalties for non-compliance, to the corporation, and even director's personally. Viewed alongside Cadbury, this approach is best suited to an agency view of corporate governance. A key underlying assumption to this approach is that management discretion alone is insufficient to maintaining the integrity of corporate governance. Consequently, an agency view that management cannot be trusted is assumed, and a set of requirements established with which management must comply.

The two frameworks face many of the same criticisms, generally trending toward the theme that the requirements / recommendations of the act / code impede the corporation's ability to compete. This reality is recognized in the Cadbury Report:

> "Had a code such as ours been in existence in the past, we believe that a number of the recent examples of unexpected company failures and cases of fraud would have received attention earlier. It must, however, be recognised that no system of control can eliminate the risk of fraud without so shackling companies as to impede their ability to compete in the market place" (Cadbury Report 1992, 1.9)

Ultimately, no approach is immune to criticism. Of particular note however, is that despite similarities in the context and culture of the US and UK, we observe different approaches to corporate governance.

4: Conclusions and considerations

Corporations are increasingly pervasive, and continually evolving. Governance frameworks, by comparison, are much more restricted, and evolve at a much slower pace. Consequently, adapting static frameworks to a dynamic issue has classically proven problematic.

Corporate transgressions appear to have served as an impetus to regulatory change in the past. The Cadbury Committee was established in 1991, in response to management abuses of the 1980s. Similarly, a series of corporate scandals pre-empted the enactment of Sarbanes-Oxley in 2002. As the corporate landscape and nature of transgressions evolve, so do the calls for governance. Amidst the recent US capital market turmoil are calls for new reforms to restore integrity to US capital markets. Faced again with large-scale transgressions, we observe calls for amendments to the frameworks governing corporations.

A number of alternatives have been proposed. The Millstein Centre for Corporate Governance and Performance at the Yale School of Management offers ten reforms to enhance the accountability and transparency of market participants (Millstein Centre 2009). A complete list of these reforms is presented in Appendix E. Distinct about these recommendations is a focus that is much broader than previous frameworks. Both SOX and the Cadbury/Combined Codes emphasize board mechanics and financial reporting/disclosure as the source of maintaining capital market integrity. Perhaps this emphasis is insufficient.

Instead, the Millstein reforms take a view that looks beyond the corporate model. These reforms take into account actors in the corporate system (regulators, credit rating firms, brokers, boards, public sector), as well as the nature of transactions that take place (hedge funds, private equity, derivatives, credit default swaps, retirement savings plans). Furthermore, the Millstein reforms tend toward a principles-based model along the lines of Cadbury/Combined code, as opposed to a rule-based model as the US has generally opted for in the past.

Ultimately the reforms emphasize a need to be “shovel-ready” (easily and quickly implemented), and “built-to-last” (with an ability to evolve along with issues of corporate governance) (Millstein Centre 2009). This emphasis acknowledges an important concern—static frameworks are often insufficient to capture constantly dynamic governance issues.

In addition, it is recommended that future reforms embody a collaborative approach. In a recent report, Deloitte (2009) discusses the future of collaborative government, and asserts that the traditional approaches of regulators are ineffective in a globalized world, where policy challenges transcend conventional jurisdictional boundaries (Deloitte 2009, 1). Instead, a more collaborative approach that leverages networks, and the technologies of Web 2.0, “will help governments improve how they work together both globally and locally to solve complex problems that would otherwise be impossible to resolve” (Deloitte 2009, 1). An approach integrating governments, academics, corporations and other stakeholders is made more feasible as technology continues to facilitate communication between these groups.

Ultimately, given the shortcomings of current regulatory frameworks, the lack of consensus among theoretical approaches and the continual evolution of corporate governance issues amplify calls for new reforms. To be effective, future reforms should address the issues identified as pertinent by the Millstein Centre, using a collaborative approach as outlined by Deloitte.

Appendices

Appendix A: Corporate fraud—some facts

Mechanisms of corporate governance are considered a means of deterring corporate fraud. Below are some facts on corporate fraud in the United States according to the US Congress' General Accounting Office:

- Fraud and abuse cost US organizations more than US$400 billion annually
- The average organization loses more than nine US dollars per day per employee to fraud and abuse
- The average organization loses about six percent of its total annual revenue to fraud and abuse committed by its own employees
- The median loss caused by males is about US$185,000; by females, about US$48,000
- The typical perpetrator is a college-educated white male
- Men commit nearly 75 percent of the offenses
- Median losses caused by men are nearly four times that caused by women
- Losses caused by managers are four times those caused by employees
- Median losses caused by executives are 16 times those of their employees
- The most costly abuses occur in organizations with fewer than 100 employees
- The education industry experiences the lowest median losses
- The highest median losses occur in the real estate financing sector
- Occupational fraud and abuses fall into three main categories: asset misappropriation, fraudulent statements, and bribery and corruption.

(Leeds 2003, 78)

Appendix B: Major corporate scandals

Adapted from Forbes magazine, this table outlines major corporate accounting transgressions:

Company	*Date scandal went public*	*Allegations*
Adelphia Communications	*April 2002*	Founding Rigas family collected $3.1 billion in off-balance-sheet loans backed by Adelphia; overstated results by inflating capital expenses and hiding debt.
AOL Time Warner	*July 2002*	As the ad market faltered and AOL's purchase of Time Warner loomed, AOL inflated sales by booking barter deals and ads it sold on behalf of others as revenue to keep its growth rate up and seal the deal. AOL also boosted sales via "round-trip" deals with advertisers and suppliers.
Arthur Andersen	*November 2001*	Shredding documents related to audit client Enron after the SEC launched an inquiry into Enron
Bristol-Myers Squibb	*July 2002*	Inflated its 2001 revenue by $1.5 billion by "channel stuffing," or forcing wholesalers to accept more inventory than they can sell to get it off the manufacturer's books
CMS Energy	*May 2002*	Executing "round-trip" trades to artificially boost energy trading volume
Duke Energy	*July 2002*	Engaged in 23 "round-trip" trades to boost trading volumes and revenue.
Dynegy	*May 2002*	Executing "round-trip" trades to artificially boost energy trading volume and cash flow
El Paso	*May 2002*	Executing "round-trip" trades to artificially boost energy trading volume
Enron	*October 2001*	Boosted profits and hid debts totaling over $1 billion by improperly using off-the-books partnerships; manipulated the Texas power market; bribed foreign governments to win contracts abroad; manipulated California energy market
Global Crossing	*February 2002*	Engaged in network capacity "swaps" with other carriers to inflate revenue; shredded documents related to accounting practices
Halliburton	*May 2002*	Improperly booked $100 million in annual

		construction cost overruns before customers agreed to pay for them.
Homestore.com	*January 2002*	Inflating sales by booking barter transactions as revenue.
Kmart	*January 2002*	Anonymous letters from people claiming to be Kmart employees allege that the company's accounting practices intended to mislead investors about its financial health.
Merck	*July 2002*	Recorded $12.4 billion in consumer-to-pharmacy co-payments that Merck never collected.
Mirant	*July 2002*	The company said it may have overstated various assets and liabilities.
Nicor Energy, LLC	*July 2002*	Independent audit uncovered accounting problems that boosted revenue and underestimated expenses.
Peregrine Systems	*May 2002*	Overstated $100 million in sales by improperly recognizing revenue from third-party resellers
Qwest Communications International	*February 2002*	Inflated revenue using network capacity "swaps" and improper accounting for long-term deals.
Reliant Energy	*May 2002*	Engaging in "round-trip" trades to boost trading volumes and revenue.
Tyco	*May 2002*	Ex-CEO L. Dennis Kozlowski indicted for tax evasion. SEC investigating whether the company was aware of his actions, possible improper use of company funds and related-party transactions, as well as improper merger accounting practices.
WorldCom	*March 2002*	Overstated cash flow by booking $3.8 billion in operating expenses as capital expenses; gave founder Bernard Ebbers $400 million in off-the-books loans.
Xerox	*June 2000*	Falsifying financial results for five years, boosting income by $1.5 billion

(Forbes Magazine 2002)

Appendix C: Sarbanes Oxley 2002, Section 302

SEC.302. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS.

(a) REGULATIONS REQUIRED- The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that--

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers--

(A) are responsible for establishing and maintaining internal controls; (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared; (C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)--

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and (B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) FOREIGN REINCORPORATIONS HAVE NO EFFECT- Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the

issuer from inside the United States to outside of the United States.

(c) DEADLINE- The rules required by subsection (a) shall be effective not later than 30 days after the date of enactment of this Act.

Appendix D: Sarbanes Oxley 2002, Section 404

SECTION 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED- The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall--

> (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
>
> (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Appendix E: Millstein Centre, recommendations for restoring capital market integrity

Suggested Reforms:

- Empowering financial regulators to apply credible, seamless oversight to hedge funds and private equity.
- Improved oversight of key derivative products, including whether a credit default swap settlement mechanism should be adopted.
- Mandating stepped-up standards and supervision of credit rating firms.
- Authorizing new regulation of mortgage brokers, consumer credit matters and similar issues.
- Ensuring that "access" rules crafted by the Securities and Exchange Commission are protected under federal law, so that investors can more easily nominate candidates to corporate boards.
- Mandating that all public companies offer annual advisory shareowner votes on compensation policies („say on pay‟).
- Calling for independent, non-executive chairmanship of corporate boards, upon succession, or explaining with appropriate reasons why another model is preferable.
- Legislating creation of a permanent, broad-based commission to develop, refresh and oversee a US code of corporate governance best practice principles.
- Merging the Commodity Futures Trading Commission into the Securities and Exchange Commission.
- Requiring the Department of Labor to ensure that America's retirement savings plans feature peak accountability and disclosure, and that such funds act as engaged owners at portfolio companies to safeguard value.

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