CHAPTER 2 LITERATURE REVIEW

References have being made from many sources, i.e. books, magazines, management newsletters, newspaper clippings and CD-Rom articles from the University Malaya’s main library, Faculty of Economics & Administration (FEA) library and Federation Of Public Listed Corporations’ collection. Some reviews are made as per following:

2.1 The Development of Corporation

The concept of company has evolved from direct ownership-management to a much more complex structure. In the nineteenth-century, the forms of corporate activities were quite simple; these consisted of:

(a) Sole Proprietorship - the sole trader contracting personally and bearing unlimited liabilities.

(b) Partnership - business proprietors working together and sharing profits/losses, bearing unlimited liabilities. Number of partners are limited and transfer of shares are regulated;

(c) The unincorporated company - operating under a trust deed and perhaps having non-executive ‘sleeping’ partners providing finance. All members (maximum number of shareholders are limited by law) bear a limited liability of corporate debts.
(d) The incorporated company - operating under an Act of Parliament,
under which it was incorporated and its members (unlimited numbers) have limited liabilities for corporate debts.

At the end of the nineteenth century, the structure of limited liability companies, i.e. type (c) and (d), became well established and popular. The issue of corporate governance arose in the structure of incorporated companies due to the separation of ownership and management, in which created the agency relationship between the owners (shareholders) and the hire agents who run the daily operations (Please see Figure A).

Figure A. An Agency relationship

Shareholder (Principals)
- Firm owners

Hire

Managers (Agents)
- Decision makers

Which creates

An Agency Relationship
- Risk-bearing specialist (principal)
Paying compensation to
A managerial decision-making specialist (agent)

Source: Strategic Management-Competitiveness & Globalization, by Hitt, Ireland & Hoskisson 1996
The above structure (Figure A) allows different parties to contribute capital, expertise and labor for maximizing benefits of all involved. The principals (shareholders) get the chance to participate in the profits of enterprise without taking responsibilities for the operations. The management (managers/agents) gets the chance to run the company without taking the responsibility of personally providing the funds. The managers are decision-making specialists (agents) who are hired and compensated by the principals. However, the separation between ownership and managerial control could result some agency problems. These problems surface because the potential exists for divergence between the interest of the principals and the agents. The lack of control by principals can lead to tendency of managerial opportunism, i.e. the agents seek for self-interest with guile. For example, agents may make strategic decisions that maximize their personal welfare and minimize their personal risk rather than priority to shareholders' interest. However not every agents act opportunistically, the inclination to engage in opportunistic behaviors vary among individuals and across cultures. The principals do not know which managers might act opportunistically because opportunistic behavior cannot be observed until it has taken place; should it happen it could be very costly to the corporation. Thus principals establish governance and control mechanisms on the basis of their perception that some agents might act opportunistically. In establishing the mechanisms, it involves agency costs, i.e. sum of incentive, monitoring, and
enforcement costs, and any residual loss incurred by principals because it is impossible to use governance mechanisms to guarantee total compliance by the agent. (Hitt, Ireland & Hoskisson 1996, Monks & Minow, 1990)

The major challenge addressed by corporate governance is how to grant managers enormous discretionary power over the conduct of the business while holding them accountable for the use of power. Shareholders cannot possibly oversee the managers they hire. The number of owners (shareholders) may in hundreds or thousands, diffused nationwide or worldwide. So shareholders are granted the right to elect their representatives to oversee the management of a company on their behalf i.e. the Board of Directors, whose purpose under the law is to safeguard the assets of the corporation / their right. The Companies Act 1965 imposes on the board a strict and absolute fiduciary duty to assure that a company is run in the long term interest of the shareholders.

2.2 Definition of Corporate Governance

The Cadbury Report (UK) has given a brief definition of Corporate Governance as: “the system by which companies are directed and controlled.”
Monks & Minow, in their book "Corporate Governance" have defined Corporate Governance as "the relationship among various participants in determining the direction and performance of corporation in long term. The primary participants are (a) the shareholders, (b) the management (led by the CEO), and (c) the board of directors. Other participants include the employees, customers, suppliers, creditors and the community." The authors have drawn a wide scope of stakeholders in corporate governance as indicated in Figure B (Monks & Minow, 1990, Mr. Phillip Koh, ROC Centennial Conference Paper, 1998). However for this paper, the discussion focused on the primary participants, i.e., the shareholders, the management and the board of directors.

**Figure B: Stakeholder View of Firm**

Source: M. Philip Koh, Responsibilities of Corporate Governance & the Control of Corporate Powers, ROC Centennial International Conference On Corporate Governance, Jul 98
The board of directors (led by a Chairman) is a crucial part of the corporate structure, it is the link between the shareholders and the management (paid managers). This means the board is overlapped between (a) a small, powerful group that runs the company, i.e. the management team which led by a CEO, and (b) a huge, diffuse and relatively powerless group (i.e. the shareholders) that wants to see the company runs well. The tripod relationships among these primary participants are: The management is accountable to the CEO. The CEO is accountable to the board. And the board is accountable, through its chairman, to the shareholders (Dimma, 1997)

There are certain functions that must be carried out by the board if it is to prosper (A Practical Guide For Non-Executive Directors, by PRO NED)

(a) Strategy

The board must determine the main aims of the company and agree on the strategy to achieve them.

(b) Policy

The board is the initiator of policies for the successful implementation of the agree strategy and for ensuring that action taken by the executive on the operation of the business falls within the guidelines determined by the board.

(c) Resources

It is the board's task to allocate resources, both financial and human, and to
ensure that the company’s resources are adequate to pursue its policies.

(d) Performance

The board is responsible for monitoring progress against the company’s strategic and financial goals and for initiating any necessary corrective measures.

Corporate governance is not to be confused with management of a corporation. It is concerned with the duty of the board of directors to oversee and control the executive actions of the management. The primary objective is to enhance long term value for shareholders.

In sum, a board’s primary role is to monitor management’s conduct, empowered by the shareholders. A crucial factor in ensuring governance in corporations is the key in finding the right system of checks and balances between the board and management in achieving the corporation purposes, in the best interest of its all stakeholders (not only towards interest of a small group). However it is difficult to formulate an ideal system as corporations consisted of wide variations, differing in composition, size, nature of business communities they serve and extent of commerce. The circulation of Director’s Monthly (US) quoted “Effective corporate governance ensures that long term strategic objectives and plans are established, and that the proper management and management structure are in place to achieve those
objectives, while at the same time making sure that the structure functions to maintain the corporation's integrity, reputation, and accountability to its relevant constituencies."

2.3 Issues on Corporate Governance

The 1987 world-wide stock market crash not only rocked the financial communities but also raised the concern on corporate governance. Failure of corporations and fraud suit cases have highlighted the abuse of power and trust by the corporate controllers, e.g., arranging or shifting of assets around and away from the companies and corporate groups into their own hands, improper of financial reporting, controversy over director's pay, have kept corporate governance in the preface (Koh,1994)

In the year of 1991, Sir Adrian Cadbury was invited to chair a Committee on the Financial Aspects of Corporate Governance, initiated by private sponsors of United Kingdom financial community. They were worried about the lack of public confidence in both financial reporting and the ability of auditors to provide the safeguards sought and expected by users of company reports (Harvard Business Review, 1993). Since the committee was formed, public interest in corporate governance issues has grown sharply, and subsequently many reports were followed to enhance study of the same area such as Toronto Report, Greenbury Report and Hampel Report.
Cadbury Report contains sections dealing with the role of the board (Executive Director / Non-Executive Director), the auditors, and the shareholders. Its proposals for corporate boards have generated much interest and are set out in a Code of Best Practice (please see Appendix II). The following recommendations were made by the report:

(a) There should be a clearly accepted division of responsibilities at the head of a company to assure a balance of power and authority.

(b) The caliber and number of outside directors on the board should be such that their views carry significant weight in the board’s decisions. To assure the independence of the outside directors, they should be appointed through a formal selection process.

(c) The board should establish an audit committee with a majority of independent outside directors, who will work with the auditors in accessing the financial report of a company.

(d) Companies should provide full and clear disclosure of board and management’s total compensation and explain the basis used for performance evaluation.

The Cadbury Report suggested that no system of corporate governance can ever be totally proof against fraud or incompetence. The door can never be
completely closed. But that does not mean that systems cannot be installed to prevent abuse of process. The test is how far such aberrations can be discouraged so that they are inhibited from arising, and if it occur, how quickly they can be detected. By establishing a code of best practice in corporate governance the risks can be minimized by making the participants in the governance process as effectively accountable as possible. (Chan, 1997).

2.31 Checks And Balances In the Boardroom

The Report has recommended and stressed on empowerment of the independent directors in establishing good corporate governance. It suggested if a chairman is also the CEO of a company, it is essential that the independent directors provide a strong and independent counterweight to ensure a balance of power and authority. This view was supported by intelligentsia in their writing. Lorch in his article “Empowering the Board” (Harvard Business Review, Jan-Feb 1995) has suggested empowerment of independent directors in CEO performance evaluation and corporate strategy. Horton in “Selecting the Best for the Top” (American Management Association, Jan 96) indicated that the proportion and importance of independence directors have increased over the past few years. The independence directors are given active roles in running various sub-committees in the board such as audit committees, nominating committees for exercising check and control function.
Lorch (1990) in his book entitled "Pawns or Potentates: the reality of America's corporate board" has revealed that in 85% of United States public companies, the chairman and CEO are one of the same. The CEO has the dominant power in influence on the selection of directors, to create the board's agenda, determine what information directors receive, control of boardroom discussions and compensation scheme. Hence, there are reversal of power between the governors (directors) and governed (management team led by the CEO) due to the over power of the CEO. Lorch also commented that some of the outside directors are 'part-timers' who have other responsibilities (e.g. 63% of them are CEOs of their own companies), and since they meet only five to six times a year, they are unable to delegate themselves in complex business issues with which they must deal. He argued that many boards of directors now lack the power and sense of common purpose to effectively fulfill their roles as overseers of companies they serve.

2.32 Selection of board candidate

Some accused the senior executives do often do not understand the fundamental of their responsibilities. They critic on corporate board is a 'cozy club' in which the chairman/CEOs packed their boards with their 'cronies' who merely act as 'rubber stamping board'. Due to their personal interest, they are afraid to question and challenge the CEO in his/her decision or conduct. They neglect to ask central questions, such as what precisely is their companies' core
expertise, what are the reasonable long and short term goals, what are the key
drivers of profitability in their competitive situation. How are they supposed to
perform their duty to act on the interest of the all the shareholders.

2.33 Compensation to the board

Another important issue in corporate governance is the mechanism in
determining the executive compensation. There are always accuses that the
executives are being overpaid. How much is enough for the boards' pay (in
particular for the CEO) to keep the finest corporate leaders. Is the executive
compensation program designed to align the management interest with the
primary corporate goal: enhancing the corporation's ability to maximize profit
over the long term? (Wallman, 1992). On this matter full and clear disclosure is
required should there is any issue raised, separate figures should be given for
salary and performance-related elements and the basis on which performance is
measured should be explained/justified. But who is monitoring this?

2.4 Models of Corporate Governance

The systems of corporate governance existing in the industrial and developing
countries reflect different legal and institutional arrangements, the historical
development of the country, and the structure of the financial system. The
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outsider model and a representation based insider model. (Clarke, 1998)

In situation where the government of a nation follows centralized or planned type of economy, the government is actively involved in its business sectors. The government also plays the role as goods and service provider. The state-owned establishments are run by the officials directly appointed by the government and the government introduces/implements various regulations to govern/control these business activities. For this model, the system governance is regulation based.

2.41 Model I: Market-Based Governance

In this model boards are closely allied with managers, and discipline is exercised by the capital market. Shares are owned by dispersed investors, and if the company is poorly managed or shareholder value is neglected, investors will react by selling shares, depressing the share price, and exposing the company to hostile takeover (by corporate raider). This model assumes good information flows, full disclosure of information, adherence to trading rules and liquid stock markets. It is the Anglo-Saxon model of the United States and UK, and the Netherlands, Sweden and Switzerland appear to be moving towards this model.
2.42 Model II: Representation-Based Governance

This model relies on the representation of interests on the board of directors which is expected to play a strong monitoring role over management. Diverse groups of stakeholders are recognized, including workers, banks, other companies with close ties (intra-corporate shareholding), local communities, and the national government (often close ties to a political/administrative elite).

Stable investments and cross shareholdings reduce the discipline power of the securities market, and similarly the market for corporate control is weak, with hostile takeovers rarely occurring. In this system managers are relatively free from external monitoring and tend to work in the basis of internal consensus.

2.43 Model III: Regulation-Based Governance

The regulator (government) is very much involved in the decision making on operations and strategic formations for the establishments. Example of these establishments are statutory bodies. Their activities are geared toward the succession of the nation’s vision such as promote the economic growth of the nation and improvement of standard of living. They are very dependent to the public fund and free from intervention of external power.