2. LITERATURE REVIEW

2.1 Definition of Corporate Governance

Hitt, Ireland & Hoskisson (1999) defined corporate governance as follows:

"Corporate governance is a relationship among stakeholders that is used to determine and control the strategic direction and performance of organisations. At its core, corporate governance is concerned with identifying ways to ensure that strategic responses are made effectively. Additionally, governance can be thought of as a means used in corporations to establish order between parties (the firm's owners and its top-level managers) whose interests may be in conflict."

2.2 Principles of Corporate Governance

The Organisation for Economic Co-operation and Development (OECD), a group representing 29 governments, sets a declaration of minimum acceptable standards for companies and investors around the world. The OECD Council in a meeting on 27-28 April 1998 called for a set of corporate governance standards and guidelines. A set of non-binding principles that embody the views of member countries was developed. The Council admitted that there is no single model of good corporate governance. At the same time, work carried out in Member countries and within the OECD has identified some common elements that underlie good corporate governance. The Principles build on these common elements and are formulated to embrace the different models that exist. The Principles presented in the first part of the document cover five areas:

i. The rights of shareholders;

ii. The equitable treatment of shareholders;

iii. The role of stakeholders;

iv. Disclosure and transparency; and

v. The responsibilities of the board.

2.3 The Rights Of Shareholders

The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to:

- secure methods of ownership registration;
- convey or transfer shares;
- obtain relevant information on the corporation on a timely and regular basis;
- participate and vote in general shareholder meetings;
- elect members of the board; and
- share in the profits of the corporation.

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

- amendments to the statutes, or articles of incorporation or similar governing documents of the company;
- the authorisation of additional shares; and
- extraordinary transactions that in effect result in the sale of the company.

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

- Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
- Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.
- Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

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

Markets for corporate control should be allowed to function in an efficient and transparent manner. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. Anti-take-over devices should not be used to shield management from accountability.

Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

2.4 The Equitable Treatment Of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

All shareholders of the same class should be treated equally.

- Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.
- Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
- Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

Insider trading and abusive self-dealing should be prohibited. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

2.5 The Role Of Stakeholders In Corporate Governance

The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected. Where law protects stakeholder interests, stakeholders should have the opportunity to obtain effective redress for violation of their rights. The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation. Where stakeholders participate in the corporate governance process, they should have access to relevant information.

2.6 Disclosure And Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

Disclosure should include, but not be limited to, material information on:

- The financial and operating results of the company.
- Company objectives.
- Major share ownership and voting rights.
- Members of the board and key executives, and their remuneration.
- Material foreseeable risk factors.
- Material issues regarding employees and other stakeholders.
- Governance structures and policies.

Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit. An independent auditor should conduct an annual audit in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

2.7 The Responsibilities Of The Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly. The board should ensure compliance with applicable law and take into account the interests of stakeholders.

The board should fulfil certain key functions, including:

- Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.
- Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
- Overseeing the process of disclosure and communications.

The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.

- Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.
- Board members should devote sufficient time to their responsibilities.

In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Their purpose is to serve as a reference point. They can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.

2.8 Corporate Governance Mechanisms

In the modern corporation, there are four internal governance mechanisms, and one external governance mechanism.

2.8.1 Internal Governance Mechanism - Ownership Concentration

Under this mechanism, the ownership of the corporation is separated from the control. Owners hire managers to make decisions that will maximise the value of their corporation. As decision-making specialists, top-level managers are expected by owners to make decisions that will result in the earning of above-average returns. Thus, modern corporations are characterised by an agency relationship that is created when the owners hires and pays top-level managers. Separation of ownership and control creates an agency problem when top-level managers pursues goals that in conflict with the principal's goals.

Ownership concentration is defined by the large number of large block shareholders and the percentage of shares they owned. With significant ownership percentages, these shareholders are actively using their positions of concentrated ownership to force managers and boards of directors to make decisions that maximises the firm's value. Thus, ownership concentration results in more active and effective monitoring of top-level managers.

2.8.2 Internal Governance Mechanism - Board Of Directors (BOD)

BOD is governance mechanism shareholders expect to represent their collective interest. The BOD is a group of elected individuals whose primary responsibility is to act in the owner's interest by formally monitoring and controlling the corporation's top-level managers. Thus, an effective and appropriately structured BOD protects owners from managerial opportunism.

2.8.3 Internal Governance Mechanism - Executive Compensation

The purpose of executive compensation as an internal governance mechanism is to improve the alignment of management and shareholder interests and reward managers for effort rendered through salary, bonuses, and long-term incentive compensation such as stock options. Although incentive compensation plans may increase firm value in line with shareholder expectations, they are also subject to managerial manipulation for short-term gains.

2.8.4 Internal Governance Mechanism - Multidivisional Structure

The multi-divisional (M-form) structure serves as an internal governance mechanism to control managerial opportunism (Oliver Williamson). The corporate office together with the BOD closely monitors the strategic decisions of managers responsible for the performance of the different business units or divisions that are part of the diversified corporation's operations.

2.8.5 External Corporate Governance Mechanisms - Market for Corporate Control

The market for corporate control is an external governance mechanism that becomes active when a firm's internal controls fails. The market for corporate control is composed of individuals or firms that buy ownership positions in (or take over) potentially undervalued corporations so they can form new divisions in established diversified companies or merge two previously separate firms. Thus when operating effectively, the market for corporate control ensures that managerial incompetence is disciplined.