Corporate Governance and Business Financial Performance

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Organisations have to be in compliance with the regulatory landscape of the jurisdictions that they operate in. The other guiding aspect for an organisation is the internal rules and regulations otherwise known as corporate governance. The Cadbury report (1992) explains corporate governance as 'the system by which companies are directed and controlled'. Corporate governance has become an important topic especially in light of events such as embezzlement and company collapses. Scandals of note include Lehman brothers that had over 50 billion dollars' worth of bad loans and the fuel company Enron, America's 5th biggest company in 2002 according to Forbes, that let losses amount to over $74 billion in hard currency. Against this backdrop is there is then the need to explore the relationship between corporate governance and business financial performance.

Corporate Governance, according to the Chartered Governance Institute, is defined as the way in which companies are governed and to what purpose. It identifies who has power and accountability, and who makes decisions. It is, in essence, a toolkit that enables management and the board to deal more effectively with the challenges of running a company. Corporate governance ensures that businesses have appropriate decision-making processes and controls in place so that the interests of all stakeholders (shareholders, employees, suppliers, customers, and the community) are balanced.

Corporate Governance is very much a relevant topic in this day and age where companies have the scope and potential to become behemoths that compete with the GDP's of entire countries. According to the 2017 IMF data, Walmart would have been ranked 24th in the world by GDP if it were a country just basing off its annual revenue of $485,873 million. Given this upswing of the possibilities that can occur with good leadership, a lot of research on conducted on corporate governance with the term first being coined in the 1970s, when the Securities and Exchange Commission (SEC) brought the issue of corporate governance to the forefront when they brought a stance on official corporate governance reforms. There are various theories that describe the relationship between various stakeholders of the business while carrying out the activity of the business. The main ones are the following:

Agency Theory

Agency theory refers to the relationship between the principals (such as shareholders of the company) and agents (in this case the board of directors of an organisation). According to this theory, the principals of the company hire the agents to perform work on their behalf. The principals then delegate the work of running the business to the executive management of the organisation, who are also agents of shareholders. The shareholders expect senior management and the board to act and make decisions on their behalf.

Problems that arise from this setting is that the trustees at times may be susceptible to self-preserving, opportunistic behaviour and fall short of expectations of the shareholders. The key feature of agency theory is the separation of ownership and control. The theory prescribes that people or employees are held accountable for their duties and responsibilities in corporate governance.

Stakeholder Theory

The Stakeholder theory has its roots from psychology and sociology and is defined by Davis, Schoorman & Donaldson (1997) as “a steward protects and maximises shareholders wealth through firm performance because by so doing, the steward’s utility functions are maximised”. It incorporates the accountability of management to a broad range of stakeholders. It states that executive management in organisations have a network of relationships they must be mindful of – this includes the suppliers, employees and business partners. The theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests is assumed to dominate the others. Stewardship theory suggests that managers are motivated by a desire to achieve and gain intrinsic satisfaction by performing challenging tasks; hence, their motivation transcends monetary rewards.

Resource Dependency Theory

The resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella, and Paetzold (2000) contend that the resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organisation through their linkages to the external environment.

These three theories make up the bulk of the research that is available on corporate governance from first principles. In practice, there are varied ways that organisations enact their corporate governance strategies. Corporate governance is, therefore, company-specific and a result of what the board of a company does and how it sets the values of the company, and it is to be distinguished from the day to day operational management of the company by full-time executives.

For the most part, there are generic ways to determine the level of corporate governance practices of an organisation. Aspects that feed into determining this are;

Fairness

The role of agents enlisted to manage companies is to ultimately create value for the shareholder. A fact in the business world is that diversity can be found in the shareholder body and that can present conflicting needs for them. The Fairness principle would dictate all shareholders should receive equal consideration for whatever shareholdings they hold and implications on all other shareholders considered.

Accountability

Corporate accountability according to the Pearse trust, refers to the obligation and responsibility to give an explanation or reason for the company’s actions and conduct. This covers maintaining viable prospects for the organisation, keeping sound risk management and internal control systems and communicating with stakeholders at regular intervals, a fair, balanced and understandable assessment of how the company is achieving its business purpose.

Responsibility

Ultimately, the board of directors are the stewards of the organisation and should be able to have a comprehensive understanding of the current position of the organisation and vouch for all the decisions that were taken by the executive.

Transparency

A principle of good governance is that stakeholders should be open about the company's activities, what it plans to do in the future and any risks involved in its business strategies.

Whilst there are many ways of measuring the corporate governance practices of a company, it is worth mentioning that there are also objective Corporate Governance Scores ('CGS'). Of note is Standard & Poor's Corporate Governance Scores ('CGS') which is based on a synthesis of international codes, governance best practices, and guidelines of good governance practices. The potential score ranks from 1 to 10 basis (with 10 being the best possible score).

Given that an organisation will be sound in governance, and get a good Corporate Governance Score, there are more likely chances that they will receive funding as the creditors trust that there is less likely to go into bankruptcy. There is then a very high chance of a positive correlation between good corporate governance and the financial position of the company.

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