

FROM GOOD MANAGEMENT TO GOOD GOVERNANCE “ A PARADIGM SHIFT IN MANAGERIAL RESPONSIBILITY ”

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Preamble

“A corporation is an artificial being, invincible, intangible, and existing only in the contemplation of the law. Being the mere creature of law, it possesses only three qualities which the charter of its creation confers upon it. However, the tendency of economic activity in a free society is to produce primeval chaos, in which men fought savagely for supremacy and countless sins were committed. Freedom was needed for economic society to function efficiently, but the resulting chaos generated inefficiency as well as sin” - “The History of American People” by J. P. Morgan

1. INTRODUCTION

Recently the terms “governance” and “good governance” are being increasingly used in management literature. Bad governance is being identified as one of the root causes of all evil within corporate entities and the societies at large. As with nations, governance matters profoundly in the success of individual commercial enterprises. An examination of businesses that have sustained success over long periods reveals Boards that have governed the affairs of the business effectively. Likewise, with the businesses that have gone “belly up” it is rather a common place to track the problems to the Boards of Management that have operated with personal agendas and egoism.

Corporate governance is commonly referred to as a system by which organizations are directed and controlled. It is the process by which company objectives are established, achieved and monitored. Corporate governance is concerned with the relationships and responsibilities between the board, management, shareholders and other relevant stakeholders within a legal and regulatory framework. The test for the effectiveness of governance is the degree to which any organization achieves its purpose. When individuals own and manage a business, one could presume that they will act in their own self-interest, making managerial decisions to support the achievement of their short-term and long-term goals. There is hardly an opportunity for a conflict of interest.

However, when individuals serve as directors of business, they represent the interest of other owners. In this situation, the potential for conflicts of interest would no doubt exist. The appointed/elected directors assume the obligation to represent the interests of those owners who cannot represent themselves, undertaking a serious fiduciary responsibility. Effective representation thus requires more than integrity. It also requires the competences, business acumen and pedigree to support good and timely decisions.

“When individuals serve as directors of business, they represent the interest of other owners.”

This is the regulatory challenge as John L. Colley says “that a well-intentioned incompetence can be as dangerous as dishonesty” (pp. 13, Corporate Governance, Tata Mc Graw-Hill Publishing Co. 2003).

2. HISTORIC BACKGROUND

The concept of “governance” is not new. It is probably as old as human civilization. Early on in antiquity, the labour of subsistence living was gradually transformed by the invention of tools – the beginin of technology. From the outset, humankind has sought to discover the best ways to make decisions to find ways to govern so as to resolve dispute, control destructive behaviour, and achieve mutual advancement. Historically the effectiveness of the approach to governance has determined the survival and prosperity of that society (*Sri Lanka visa- vie Singapore*).

Centuries of history has seen, governance being exercised by a privileged few who had gained power over many either through family power, inherited wealth or merely through deceptive political shrewdness. The powerful ruled until they were overthrown by a revolt which was an economically and humanly costly affair. With the development of new sources of energy, came the machines that dramatically improved productivity. The requisite driver of these evolutionary forces has been the advent of universal education.

As widespread literacy spawned education that has driven technology, there has been a comparable evolution in the way we govern our affairs. The resulting prosperity relied in the development of an economic system that embraces free enterprise, capitalism, and fierce competition. Free enterprise brought in creativeness of many minds, unleashing the pursuance of individual best interest.

“As individuals gained power, they increasingly ruled by oppressive force, often creating a backlash of revolution.”

However, despite all the ‘Hue and Cry’ nations, governments, societies, regulatory bodies and corporate bodies by and large are subject to tyranny, arrogance or anarchy. More typically there is incompetence, corruption and oppression of citizenry. The prevailing system of governance probably resulted more from the actions of individuals and not necessarily from the evolution of legal principles. As individuals gained power, they increasingly ruled by oppressive force, often creating a backlash of revolution.

The social revolution that followed by hunger for freedom, fair-play and more importantly by a sense of moral imperative of how people should be treated, upholding individual self-respect. Out of these revolutions grew the modern concept of democracy and eventually the doctrine of *Good Governance*.



3. THE DIALOGUE IN GOVERNANCE

The concept of governance as we have seen is nothing new. It dates back to early human civilization. Simply put “governance” means: the process of decision making and implementation (or non implementation). Governance can be used in several contexts such as local governance, national governance, international governance, and corporate governance. Since this is the process of decision making and implementation of decisions, an analysis of governance would focus on the formal and informal factors involved in the making and implementing decisions, by both formal and informal structures.

The government is the very foundation that natures and hold the degree of good governance across civil and corporate societies. The societal division of rural and urban factors has varied dimensions of influences on the governance of a government. In the rural sector the landlords, peasants representative, the religious, and in some cases the NGOs. In the urban scenario however, there is a wider distribution of influencing factors: the urban elite, middle class, the poor, the media, the white and blue collar workers, the private financiers of the government and the corporate mafia.

Based on the above influences the following characteristics have evolved in formulating and sustaining good governance. Good governance is thus participatory, consensus oriented, accountable, transparent, responsive, effective and efficient, equitable and inclusive, and fundamentally follows the rule of law.

Presence of these characteristics ensures that corruption is minimized (not eliminated) the views of minorities and most vulnerable are accounted for and heard in decision-making. In effect the level of good governance at social, national or corporate level depends on the degree of presence of the above mentioned characteristics.

**Participation**

means freedom of association and expression in an informed and organized manner. Participation either direct or through legitimate intermediate institutions is a key cornerstone for good governance

Rule of Law

enforces a framework of impartiality, and provides full protection of human rights, particularly those of minorities. Impartial law enforcement needs independent judiciary and an incorruptible police force

Transparency

means that the information is freely and directly accessible to those affected by the decision. It also means that the decisions are taken and enforced strictly within the established rules and regulations

Responsiveness

is the concerns of those who are affected, those who implement, and those who integrate in the formulation of the decision.. To be responsive is also to provide feed back and address grievances spontaneously.

Consensus orientation

requires a long term perspective on what is needed for sustainable development. It also requires mediation on the different interests – historical, social, and cultural contexts.

Equity and inclusiveness

depends on ensuring that all members do not feel excluded from the main stream. Particularly the most vulnerable, have the opportunity to improve and maintain their well-being.

Effectiveness and Efficiency

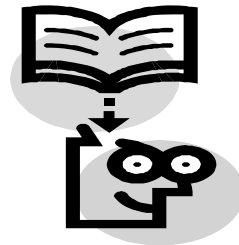
is the concept of doing the right things right. Direct obligations on the authorities to use the resources only for purpose of the investment. Ensure return value addition for the investor. Misuse of positions negates this factor.

Accountability

is the key for good governance. Decision makers are accountable to those who are affected by the decision and implementation. Accountability cannot be enforced without transparency and the rule of law.

4. WHAT IS CORPORATE GOVERNANCE?

The dialogue in corporate governance initiative aims to facilitate a better understanding of different approaches to corporate governance. It encourages dialogue around businesses, investment accountancy and policy issues relating to corporate governance. Difficulties arise in striving to achieve a single, global approach to corporate governance as there are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries and for all companies regardless of their stage of development and businesses. However, while there are different approaches to corporate governance at a national level, good practice can benefit financial stability and market confidence internationally.



Corporate governance is commonly referred to as a system by which organisations are directed and controlled. It is the process by which company objectives are established, achieved and monitored. Corporate governance is concerned with the relationships and responsibilities between the board, management, shareholders and other relevant stakeholders within a legal and regulatory framework.

In countries with widely dispersed shareholding the 'Principal / Agency' problem concerns potential conflicts arising between the owners of companies (as 'Principals') and boards of directors who have effective control over companies (as 'Agents') and who may allow self-interest to influence decision making. Countries with more concentrated ownership structures often have majority shareholders who significantly influence the board. Consequently, an 'agency' conflict arises between controlling 'majority' shareholders who may extract private benefits at the expense of minority owners.

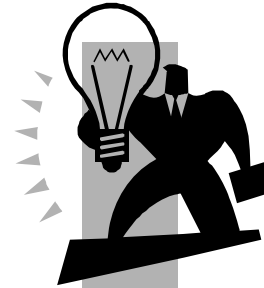
Corporate governance aims to protect shareholder rights, enhance disclosure and transparency, facilitate effective functioning of the board and provide an efficient legal and regulatory enforcement framework. There is no 'one size fits all' approach to corporate governance. A number of countries in continental Europe tend to adopt an inclusive 'stakeholder' approach where companies are considered 'social institutions' with responsibilities and accountability – not just to shareholders – but to employees and the wider community in general.

The directors who approve the strategic direction of the organisation within a framework of prudent controls are responsible to employ, monitor and reward management. Accountability of the board to shareholders who have the right to receive information on the financial stewardship of their investment and exercise power to reward or remove the directors entrusted to run the company. The disclosure of financial and operational information and internal processes of management oversight and control enable outsiders to understand the organisation.



5. WHY IS CORPORATE GOVERNANCE IMPORTANT

Corporate governance aims to protect shareholder rights, enhance disclosure and transparency, facilitate effective functioning of the board and provide an efficient legal and regulatory enforcement framework. It addresses the 'Principal / Agency' problem through a mix of company law, stock exchange listing rules and self-regulatory codes. Corporate governance is a key element in enhancing investor confidence, promoting competitiveness, and ultimately improving economic growth. It is at the top of the international development agenda as emphasized by James Wolfensohn, President of the World Bank:



'The governance of companies is more important for world economic growth than the government of countries.'

Cultural, political and economic norms influence the way in which a society approaches corporate governance and its impact on board leadership, management oversight and accountability.

The challenge for policy-makers is to reach an appropriate balance of legislative and regulatory reform, taking into consideration international best practice to promote enterprise, enhance competitiveness and stimulate investment.

While a multiplicity of factors affect the governance and decision making processes of firms, and are important to their long-term success, the principles focus on governance problems that result from the separation of ownership and control. However, this is not simply an issue of the relationship between shareholders and management, although that is indeed the central element. In some jurisdictions, governance issues also arise from the power of certain controlling shareholders over minority shareholders. In other countries, employees have important legal rights irrespective of their ownership rights. The Principles therefore have to be complementary to a broader approach to the operation of checks and balances. Some of the other issues relevant to a company's decision-making processes, such as environmental, anti-corruption or ethical concerns are also taken into account.

Corporate governance is affected by the relationships among participants in the governance system. Controlling shareholders, which may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can significantly influence corporate behaviour. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in some markets.

Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. Creditors play an important role in a number of governance systems and can serve as external monitors over corporate performance. Employees and other stakeholders play an important role in contributing

to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance.

Much of the recent emphasis on corporate governance has arisen from high-profile corporate scandals, globalisation and increased investor activism.

Corporate Scandals – High profile corporate collapses due to a number of circumstances including financial reporting irregularities leading to a lack of investor confidence and public trust.

Globalisation – Improved technology and private sector development increasing capital flows to large developing economies such as China. Developing markets in particular need to demonstrate good corporate governance to instill investor confidence thereby encouraging access to the global capital necessary for job creation and economic growth.

Shareholder Activism – Institutional investors pursue good corporate governance when managing long-term investments and often take an active role in bringing under-performing companies to task.

Recent new legislative and self-regulatory corporate governance requirements have helped to instill global market confidence.

This includes improved integrity and oversight of management, scrutiny over board composition and independence, effective use of internal and external audit functions, higher levels of disclosure and transparency and greater engagement with investors.

6. GOVERNANCE, WHO'S RESPONSIBILITY, IS IT?

There is evidence that investors value companies with good corporate governance. McKinsey surveyed over 200 institutional investors and found that 80% of respondents would pay a premium for well-governed companies, from 11% in Canada to 40% in Egypt (*Global Investor Opinion Survey, 2002*). As with nations, governance matters most profoundly in the success of individual commercial enterprises.



An examination of businesses that have sustained success over long periods would reveal Boards that have governed the affairs of the business ethically. Likewise with businesses that have performed poorly, it is rather common place to track the absence of ethics and value system within such failed enterprises.

For example during the past decade one could draw clear evidences from the Banking sector how the banks in the new league virtually went belly up. One actually did! As mentioned earlier when individuals serve as directors of public owned companies, they represent the interest of "All" other investors. The elected directors assume the obligation to represent the interest of those investors, (who cannot represent themselves) undertaking a serious fiduciary responsibility.



Effective representation however needs, not only mere integrity but also the competence to stand up against the undue influences of the so called “major” share holders. The cases that have reached the Colombo commercial courts are probably an indication of the independence of the directorates of our companies. As John L. Colley Jr. (2003) puts it “*Directors who are dumb but honest (or loyal to some) fail to fulfill their obligations; well-intended incompetence is as dangerous as dishonesty*”.

“a well-intentioned incompetence can be as dangerous as dishonesty”

It is therefore the default that the boards of directors are solely responsible for upholding good governance within a corporation. According to most literature on the subject of governance the legal obligations of directors (and management) can be broadly described as:

- **The Fiduciary Duty** - Being trustworthy in acting in the best interest of all stakeholders and broadly in every thing that contributes to strengthening the economic effort and the value of the organization.
- **The Duty of Loyalty and Fair Dealing** - by assuming office, the corporate director commits allegiance to the company and acknowledges that the best interest of the company and the stakeholders must prevail over individual director's interest. Basically, the duty of loyalty is that the directors (manager) should not use his corporate position for personal advantages or gains.
- **The Duty of Care** - A director or officer has a duty to the company to perform the director's officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interest of the company, and with care that an ordinary prudent person would be expected to exercise.
- **The Duty of Supervision** - Addresses what the directors should know about the operations of management, how and what they should know and prompt action on issues of serious nature.

The board is therefore required to articulate and document the articles of association, the core values of the company, the HR related policy such as recruitment, career progressions and the remuneration, the administrative and operational policies so that there will be no cause for grievances. This is usually accomplished by the boards delegating the policy formulation to specific structured committees. Such partitioning of work allows the directors to make maximum use of the expertise in the board. In more recent times structured committees that are formed with the purpose of policy formulation incorporates the members of the corporate management as well.

Despite these efforts, more often than not, in failed companies one could find such policies are practiced in the breach.

As a matter of practice the board delegates most of the decisions to the management. Consequently the corporate/senior management becomes the incumbent to uphold good governance within the company.

7. THE ROLE OF REGULATORS

“Anti-corruption tailored to the specific circumstances of a particular society should be devised in order to effectively deliver practical solutions” -
Final Declaration, Global Forum II



In several countries around the world, opportunities have emerged for the launching or reinvigorating of national anti-corruption programs and policies. In many ways the corrupt forces in these countries are said to be facing more anti-corruption forces who are less discrete and more organized than before. Across developed countries, previously dispersed and silenced elements from within and outside governments appear to be overcoming problems of collective action as they create coalitions against corruption.

These developments can be attributed to several reasons. First, from a growing body of research and analysis about the consequences of corruption, citizens have learned that the problem is more costly than previously imagined (we don't have to look beyond our noses to pick a national example). Secondly and more importantly, reform oriented officials in the public sector (in developed countries) have also found, that the risks challenging corruption are as high as before. This is mainly due to the increasing number of international donors are demanding that the development assistance are used honestly. Third is probably, public officials are seeing corruption has become more riskier than before as they see changes in the political landscape where corrupt behaviours have led to the ouster of politicians and high officials. Despite these developments, sadly, in some developing countries corruption continues to be a way of life.

In any society anti-corruption policies and programs need to be crafted on the basis of a careful analysis of the severity, the patterns of corruption and the nature of the government of a country. To know what strategies and tools might work in a particular environment, it is important to understand the ground situation. The national governance setting is probably the key in determining the likely effectiveness or for that matter ineffectiveness of any anti-corruption measure. By drawing insights from research and diagnostic studies the analysis of country governance should focus on the drivers of corruption: political, legal, economical and social dimensions. Within these dimensions setting a ground for an anti-corruption program would encompass the following factors:

- *Political system governing how state power is exercised, decisions are taken, and accountability is enforced*
- *Constitutional and legal framework concerning corruption*
- *Media freedom and civil liberty*
- *Behaviour and value system in the private sector*



- *Independence and integrity of the judiciary*
- *Independence and integrity of the regulatory bodies*
- *Extent of political corruption*

One of the most widely referred piece of work against corruption was adopted at the convention the ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) in Paris in Paris on 14th December 1960, which came into force on 30th September 1961. The OECD resolved to promote policies designed to:

- achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy
- contribute to sound economic expansion in member as well as non-member Countries in the process of economic development;
- contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

In most Asian countries the national commitment towards curbing corruption is reflected in the statutory bodied formed for that purpose. For example, Singapore has the "Corrupt Practices Investigation Bureau"; Thailand has "National Counter-Corruption Commission"; Korea has the "Korean Independent Commission Against Corruption"; China has "Central Disciplinary Inspection Committee, and even Macao has the "Independent Commission against Corruption. (*Source Quah 2000*). In Sri Lanka, we have our Bribery Commission; probably it is assumed only accepting bribes are considered an act of corruption, so far. The good news is the Security Exchange Commission together with the Institute of Chartered Accountants are currently engaged in putting together some guidelines or rules for good governance, which is understood, would be made an issue of compliance for listed companies. The enactment and its effectiveness is yet to be seen.

As far as the Banking industry is concerned the Bank Supervision Department of the Central Bank has taken the lead in establishing the Code of Corporate Governance (27th June 2002) drawing references from preferred literature on the subject including the ODEC principles. This work of a National Task Force on Corporate Governance, comprising highly respected business personalities has been imposed only as a "strong Recommendation" and not as a regulation. It is earnestly hoped that with the formalization of the new Banking Act, which also dedicates a fair share of its content to good governance will enable the Central Bank to enforce the principals of good governance.



8. ROLE OF LEADERSHIP AND MANAGEMENT

The mere existence of law is no assurance for the absence of crime. There can be volumes of enactments, collection of commissions, revolutionary reforms and even formation of anti-corruption coalitions. Results eventually come only when people who walk their talk are in positions that matters. As in any national or corporate scenario the key problem is the absence of leadership. One single characteristic of integrity and the self-givingness of the national or corporate leaders, in the likes of Lee Kuan Yew or Nelson Mandela would determine the destiny of a nation. Where we are today, after 50 years of independence and franchise, can only be blamed upon us for failure to recognize and harness the leadership that the nation or the body corporate deserves. It is not that there is a dearth for people, but the absence of maturity to accept and sharpen the prospects who will determine the destiny.

9. CONCLUSION

The final thoughts on the topic of good governance is composed in an atmosphere heightened distrust and deception. The number of appalling abuse of position, power and breach of trust have resulted in unpalatable business failures.

In the aftermath of the East Asian financial crisis that began in 1977, combatting corruption has become a top priority for many countries in Asia. This change has been driven by the painful realization by a growing number of people that corruption imposes, economical and social costs. The shift in perceptions and attitudes about corruption portrays or at least pretends, a shift in managerial landscape changes the structure of behaviour of people with authority and vested interest.

We often find ourselves wondering if these problems are caused simply by a few corporate offenders or whether it is an indication of the weakness in the system; national, social and corporate. A simple and sincere reflection by every person in authority, at the end of the day's work would be a first step in a long journey. Before you leave work, place your right hand on your chest and ask "Am I guilty of deception, breach of trust, undue gains and misuse of power?". That's the starting point my friend!

"Corruption is one of the greatest inhibiting forces to equitable development and to the combatting of poverty....For many years it constitutes the difference between life and death...We must reinforce our efforts....to deal with this scourge." – James D Wolfensohn



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