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VALUE CREATION THROUGH CORPORATE GOVERNANCE

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Abstract: *Companies spend time and money in order to improve their corporate governance (CG) system and also do not forget to inform third parties about their efforts in this field. CG studies the separation of power at an entity level and the segregation of responsibilities between shareholders, management, and board of directors. As a mechanism CG helps to align management's goals with those of the stakeholders in order to avoid conflict and to sustain and develop a healthy company. The objective of this article is to show how corporate governance is defined, what does it stands for and why it is important or maybe better said why companies give it so much importance.*

Keywords: corporate governance; overall firm performance; financial scandals; codes of conduct
JEL Classification: F23; G30; G34; M48

INTRODUCTION

The literature on CG does not offer unanimous definitions in order to create understanding and to border this concept, below are presented the most pertinent definitions from my point of view.

- CG is a system that helps in managing and controlling a company, following the best practices in the field (Tabara and Briciu, 2012).
- CG is a way in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997).
- A simple definition of corporate governance would be that it represents the amount of systems and processes put in place to direct and control an organization in order to increase performance and achieve sustainable shareholder value (Miu *n.d.*).
- The importance of CG is to reduce conflicts between those who control and those who own the residual claims in a firm (Chaghadari and Chaleshtori, 2011).

In order to summarize CG stands for:

- best practices;
- efficiency and responsibility of all parties involved;
- transparency and credibility of financial data;

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- performance.

1. CORPORATE GOVERNANCE AND THE SCANDALS THAT SHOOK THE CONFIDENCE IN THE FINANCIAL SYSTEM

Corporate governance has reached the center of attention following a chain of events, more specifically, several high profile scandals that brought mistrust and uncertainty in the international capital market. The financial losses following these scandals and the social implications were the impulse for the enacting of the Sarbanes-Oxley Act in 2002, considered to be the most sweeping corporate governance regulations in the past 70 years (Byrnes et al., 2003 in Brown et al., 2004).

In order to grasp the implications of the downfall of several important companies the most representative are presented below.

The **Guinness share-trading fraud** (1986 - UK) involved an attempt to manipulate the stock market on a massive scale to inflate the price of Guinness shares (brewer of black stout beer since 18th century) and thereby assist a £2.7 billion takeover bid for the Scottish drinks company *Distillers*. Four businessmen were convicted of criminal offences for taking part in the manipulation. The European Court of Human Rights in Strasbourg later found that their trial violated the defendants' human rights by making improper use of statements. The scandal was discovered after the testimony as part of a plea bargain by the US stock trader Ivan Boesky. Ernest Saunders, Gerald Ronson, Jack Lyons and Anthony Parnes, the so-called "Guinness four", were charged, paid heavy fines and, with the exception of Lyons, who was suffering from ill-health, served prison sentences later reduced on appeal (Wikipedia, *Guinness share-trading fraud*). In what journalists called at that time “Guinness-gate”, falsifying accounting evidences and breaking Company’s Law led to disgrace among Britain’s business elite.

Polly Peck International (1989 - UK) a global trading conglomerate, developed rapidly in the 1980’ under the management of Asil Nadir. The entity was estimated to be worth $2 billion but surprisingly in the autumn of 1989 the value of the company shares crashed on the London market. After the bankruptcy procedures, evidences showed an internal conspiracy to present an unrealistic financial position and an overvaluation of the company’s wealth. After the discovery of discrepancies in the amount of $400 million, the CEO was accused of falsifying the books and of theft.

The publishing empire **"Maxwell"** (1991 - UK) suffered following the fraud involving the company's founder and CEO, Robert Maxwell. His death triggered the collapse of his publishing empire as banks called in loans. His sons briefly struggled to keep the business together, but failed as the news emerged that Maxwell had stolen hundreds of millions of pounds from his own companies' pension funds to save the companies from bankruptcy. The Maxwell companies applied for bankruptcy protection in 1992 and in a report about the scandal The Department of Commerce and Industry have criticized the external auditors (Coopers and Lybrand), the financial advisors, and also other third parties, as the management of the company had involvement from former politicians and business men.

The Bank of Credit and Commerce International (1991 - UK) in its peak period operated in 78 countries, had over 400 branches, and had assets in excess of $20 billion, making it the 7th largest private bank in the world by assets. The bank declared bankruptcy in 1991 with debts over £31 billion. Investigators in the US and the UK revealed that BCCI had been "set up deliberately to avoid centralized regulatory review, and operated extensively in bank secrecy jurisdictions. Its affairs were extraordinarily complex. Its officers were sophisticated international bankers whose apparent objective was to keep their affairs secret, to commit fraud on a massive scale, and to avoid detection". (Wikipedia, Bank of Credit and Commerce International). Bank of England internal memo in 1982 described BCCI as 'on its way to becoming the financial equivalent of the SS Titanic' (The Guardian, 2012).

Parmalat (2003/2004 - Italy) a global dairy and food giant had in 2002 sales over €7.6 billion and over 36.000 employees. But in 2003 bondholders learned that nearly €4 billion of funds in a Bank of America account are non-existent, the bank officials claiming that the transfer document is a fake. The debt of the company is estimated in 2004 at €14.3 billion, eight times what the firm had admitted. Trials involving management followed till 2011.

The Enron Corporation (2001 - USA), an American energy company based in Houston, Texas, has become in 2001 a bankrupt company that a few days back was worth $60 billion. By the use of accounting loopholes, unethical practices and poor financial reporting the management was able to hide failed deals and projects. Enron's employees had much to lose following the scandal, as they did not lose only their job but also most of their pension, as the company had a program through which pension contributions were equalized in Enron shares. Taking a quick look at how the Enron scandal developed it is easy to notice the political influences. Some experts accuse the federal government for the Enron

collapse, as during the period in which the energy industry was taken out from the state control and regulations, politicians received funds during election campaigns.

Worldcom (2002 - USA) developed rapidly, through takeovers, transforming from a local provider in one of the biggest players in the telecommunications industry, under the supervision of its founder Bernard Ebbers. Following a change of management, auditors discovered that the company's expenses were treated like capital investments leading to an overestimation of profits and increase of shares value. Like in the Enron case, the external auditor was one of the "Big Five" audit companies named "Arthur Andersen". Following a precarious management, lack of corporate governance and bad accounting almost 20.000 employees lost their job and the shareholders lost over $180 billion.

These scandals that led to financial losses, bankruptcy, trials and disbelief raised doubts on the possibility of investors to base their decisions on the information provided by corporations and by the market. Also people wondered if these companies were brought to collapse following the actions of several individuals in search for easy money and of doubtful integrity or the systems in place were easy to bend and not prepared to deal with the complexity of current transactions. Changes followed as regulations related to CG were under scrutiny and afterwards tightened and penalties became more severe.

2. CHALLENGES BROUGHT BY THE NEW PACE OF CHANGE

Globally the best solutions for implementing the best practices and principles of CG are the codes of conduct that are seen as guidance instruments. In the European Union 35 codes related to CG have been enacted and almost each country has at least one code (Ghita et al., 2009).

Currently, all entities and most of the countries are interested in having a CG code with strong rules and guidance for different situations that might appear and create suspicion. CG principles are elaborated in such way to determine top managers to fulfil their duties in a qualified and correct manner, so that the interests of the stakeholders are followed and protected.

The history of the CG codes has shown that firms and public authorities were interested in developing its principles and not the least to comply with them.

Adrian Cadbury Code (UK, 1992)

- sets for the first time basic rules related to companies' management;

- mentions the necessity of having audit committees and independent top management;
- received with concern by companies listed on the stock exchange, as the report considered as necessary for these firms to present their degree of compliance, but without any sanctions, excepting the disapproval and perhaps the withdrawal of financiers.

Paul Rutteman Report (UK, 1993)

- recommends that listed companies should issue reports on the financial internal control.

Lord Nolan Public Life Standards (UK, 1994)

- strongly advises on the necessity of developing an ethical environment in the public sector;
- includes 7 solid principles: altruism, integrity, objectivity, responsibility, sincerity, honesty, conduct.

Richard Greenbury Code (UK, 1995)

- issued by the Industry Confederation sustaining to have a committee of non-executive directors to establish the salaries of top management.

Ronnie Hampel Report (UK, 1995)

- The Hampel Committee (London Stock Exchange, The Industry Confederation in UK, Directors' Institute, National Association of Pension Funds, Insurance Companies Association) strived to improve the Cadbury Report;
- recommends that directors should verify the efficiency of the internal control but are not obliged to report it;
- stands for the implementation of internal audit.

Combined Code (UK, 1998)

- a combination of all previous codes;
- recommends the principle "comply or explain";
- the code is not mandatory, but it is used by the majority of the companies due to the financiers pressure on those who don't comply;

Vienot Report (France, 1998)

- comprises a list of recommendations, which will permit a soft adaptation of the boards of directors of French listed companies to the principles of CG.

Nigel Turnbull Report (UK, 1999)

- compliance with the Combined Code;

- directors have the obligation to keep good internal controls and to ensure the quality of financial reporting;
- annual review of the control systems;
- made a connection with the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Sarbanes-Oxley Law (USA, 2002)

- previous mentioned principle "comply or explain" is adopted;
- major elements: Public Company Accounting Oversight Board (PCAOB), Auditor Independence, Corporate Responsibility, Enhanced Financial Disclosures, Analyst Conflicts of Interest, Commission Resources and Authority, Studies and Reports, Corporate and Criminal Fraud Accountability, White Collar Crime Penalty Enhancement, Corporate Tax Returns, Corporate Fraud Accountability;
- mandatory provisions regarding the directors independence, audit committees, CG codes, disclosure controls;
- penalties for non-compliance are severe;

Revised Combined Code (UK, 2003)

- presents harsher principles and clauses regarding CG, that are adopted on a larger scale by public sector entities and not only.

Jaap Winter Report (France, 2002)

- elaborates the final report for "The Companies Law in Europe";
- tackles with issues like: executive and non-executive directors, management's salaries, responsibility for financial statements and audit system.

European Union Commission (2002)

- considers that is not necessary to be issued a CG code for Europe, but an approach based on the SOX Law.

Organization for Economic Co-operation and Development - OECD (2003)

Global principles elaborated by OECD are as follows:

1. Promoting transparent and efficient markets, which are consistent with the rule of law and which clearly articulate the division of responsibilities among supervisory, regulatory and enforcement authorities;

2. Protecting and facilitating the exercise of shareholders' rights;

3. Ensuring the equitable treatment of all shareholders, who should also have the opportunity to obtain effective redress for violation of their rights;

4. Recognizing the rights of stakeholders established by law or through mutual agreements and encouraging active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises;

5. Ensuring that timely and accurate disclosure is made on all material matters regarding the corporation, including its financial situation, performance, ownership and governance;

6. Ensuring 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 (OECD, 2008).

The above presented codes and reports show the interest in the matter of CG and for sure we have not seen the last code, law, principle related to this issue as heated debates continue and stakeholders ask for their rights to be respected.

What stands out is the difference in the ownership and control of companies across countries. *Outsider systems* (considerably UK and USA) are characterized by wide dispersed ownership, where the basic conflict of interest is between strong managers and widely-dispersed weak shareholders. On the other hand *insider systems* (mainly Germany and Japan) are distinguished by concentrated ownership or control, with basic conflict between controlling shareholders and weak minority shareholders.

3. STAKEHOLDERS INTEREST IN CORPORATE GOVERNANCE

Bankruptcy of companies seen as pillars of the community and most of all considered wealthy had determined the issuing of several codes that would ask from parties involved for transparency, correctness, honesty. Participants in the daily activities of the firms have different or common interests and expect these interests to be fulfilled. The information presented in Table 1 sheds some light on this subject.

Table 1 – The interaction between internal and external company's environment and related interests

No.	Influence factor	Interests
1	*Shareholders*	- control over decisions; - net profits; - dividens; - investment recovery; - notoriety and recognition; - increase of share value etc.
2	*Employees*	- safe jobs; - attractive salaries; - motivation (promotion, bonus); - good work conditions; - health insurance etc.
3	*Creditors*	- loan repayment in time; - interests, commissions; - profitability; - creditworthiness etc.
4	*Customers*	- quality; - small prices; - correct and timely information; - fair and equal treatment etc.
5	*Suplliers*	- orders and contracts; - payment in due time; - trust; - loyal competition etc.
6	*Government*	- investments; - compliance with the law; - environment protection; - tax payment etc.
7	*Community*	- jobs; - local market development; - healthy environment; - sponsorships etc.

Source: Ghita et al., 2009

Many people are interested in finding out which of the developed CG systems works the best. The three systems that stand out are the ones of United States, Germany and Japan, but neither could be considered the best; nonetheless they are the ones that could be analyzed in detail following the amount of writing dedicated to them. *The US model* is based on the domination of independent persons and individual shareholders that are not connected to the company through any business relation and the joint stock is divided to multiple shareholders. *The German model* stands out through a high capital concentration and the majority shareholders have common interests with the firm and take part in the

management and control of the company. *The Japanese model* shows an active role of the state and cohesion at entity and business level for industrial groups (holdings). Shleifer and Vishny (1997) state that, despite a great deal of controversy, neither the theory or the evidence tells us which of the three is the best and in this regard, they are not surprised to see political and economic pressure bring the three toward each other.

CONCLUSIONS

The world crisis (financial, economic, social) has determined the shaping of a new vision on how a business should be organized and managed; market instability, fierce competition, lack of liquidities, the uncertainty of tomorrow were few of the reasons that led to a reanalysis and to a new attitude towards risk. Alongside risk, the business reputation remains a key factor, as it can bring up or destroy a firm, and in the internet era, the info, good or bad, travels with the speed of light.

Constant change determines companies to seek new opportunities, and to consider as main objective, in such a tumultuous capital market, their survival, and only afterwards to think at prosperity. The current society is governed by uncertainty and complex transactions so the rhythm of change and the capacity to adjust to it have become the key of performance and of maintaining entities competitiveness. Balance is the most important word in these troubled times.

Corporate Governance is part of the companies struggle with the business and political environment. CG does not border itself to systems and procedure needed to direct and control an organization but sees as final goal maximizing company's value and increase performance. We should not get lost in the ethical view or social responsibility of CG but see the equilibrium between compliance and performance.

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