Corporate Governance

by Student's Name

Code + Course Name

Professor's Name

Institution of Learning

City, State

Date

Introduction

The claim thats "We rely on shareholders to impose morality in the global marketplace" is valid since the ultimate benefits of corporations rests on the owners. With weak interventions and internal control of the operations of firms including the existence of information asymmetry between the agent- principle arrangements, leads to an adverse effect where agency problem creeps in. Companies' executives and managers amass much wealth and benefits when the incentives to do so exist. This paper seeks to identify the validity of the claim and the solutions proposed as alternative corporate governance strategies and their possible positive and negative implications to the corporations and society."

Validity of the claim

The concept of corporate governance concerns the management of relationships between different corporate shareholders (Malek 2004, p. 46). The concept is all about the management of the principle- agent relationship that aims at maximising the shareholders' long term interest (Goodpaster1991, p.53-73). With slack and undefined directions of the company, the interests of the share-holder and the agents (management team) may conflict leading to an agency problem. Activities like tax evasion, interest rates rigging, illegal consumer products inflation and "horsemeat sales in place of beef'' are some of the institutional abuses that arise when measures to regulate the companies/ corporations activities are feeble or non- existent or when there is an incentive of divergence of interest between the principle and the agents (Schwalbach et. al, 1997, p. 3) .

The cost of illegitimate and unethical corporate dealings whose liability rest entirely on the shareholders could be very high if intervention is not taken into consideration (Waygood

2006.). Companies like Enron and Worldcom in US are just but examples of companies that lost their glory and the shareholders long- term interest buried.

Shareholders have therefore been considered accountable over the action and activities of their companies since they are the ultimate owners (Schwalbach et. al 1997, p. 3). Erturk et. Al (2006) points out the assumptions that the shareholders and the owners of a company who bear risks have a function to monitor the agents. The study further points out that ownership rights enforcement does create shareholders' value as claimants of residuals. They should therefore monitor the managers' actions that aim at value creation to minimise wastages and facilitate growth.

Although the general assumption is that the shareholders are held accountable upon any misalignment of the corporations' objectives, study shows that there exists a limitation to such reality on the basis of the law. According to Mitchell(2009, p. 171), the law excepts the shareholders and creditors from the corporations duties and the productive entities based on the doctrine of limited liability- a situation that has risen ethical concerns. To strengthen the isolation of the shareholders from the blame of moral depravity in the market place, Freeman et. al (2004, p. 364- 369) suggest that managers and executives should inculcate values necessary for doing business. These will define the clarity of the strategies used to achieve corporate performance and the kind of relationships to create with the stakeholders to deliver their objectives.

Over the years, the incentive to align the management interests and effort with the shareholders interests has seen to an increase of management compensation. A study done by Erturk et al (2006) on the comparison of workers and executive pay in UK and USA found out that the pay-ratio between the executive and the workers rose from 50 to 109 from 1980 to 1990 and 109 to 525 from 1990 to 2000 in USA. In UK the ratio rose from 9 to 54 from 1978/79 to 2002/03.

For far too long, the shareholders have been relied to "impose morality in the global marketplace", although it comes with a cost the appointment of non- executive directors to help in scrutinising of companies dealing on behalf of the share- holders. Having the non- executive director share the same legal responsibility with the executive directors places them all accountable to the shareholders. Rotational retirement and democratic elections too have been used to regulate the activities of the directors. The directors are task with the responsibility of managing performance, compliance, control and behaviour within an organization. The shareholders therefore are responsible for the companies' compliance with all regulatory measures and standards. Therefore the general claim that it's the responsibility of the shareholders to define and ensure companies' morality within the marketplace is not in question since the shareholders are expected to monitor the firm managers activities in shareholder's value creation at all cost.

Failure to commit to the mandate and the responsibilities expected of the shareholder, a company risks not only non- compliance cost implication imposed by the government, accounting or legal abodes but also its survival. A company like Andersen was sentenced for obstruction of justice acting through its employees and received a fine of $500,000 (Ireland et. al 1999); levels I type of cost valued at about four billion dollars was not such weightier to Andersen since its financial portfolio was intact and mature to sustain it. The survival of Andersen was guaranteed still even after the incidence.

To maintain the lawyers' services and agents including expensive auditors Andersen had to manage the level 2 costs. These cost that Andersen incurred were much greater than the level

1 cost. These costs ran in multiple millions of dollars that although the costs were high, Andersen was able to manage it based on its financial base.

Level 3 costs which were considered most detrimental to the organisation were not only much high but were linked to its survival status. A loss of reputation, employees, defection of customers, and cynicism of the government and tight regulation of the government were much devastating to the company than any other moments before. Investors, customers, and employees holding expectation of performance of the business form the basis of stakeholder's costs .These cost implicative activities were at the discretion of the companies' managers that least informed the shareholders (Thomas 2004, p.56-66).

Solutions to relying on shareholders to impose marketplace morality

Different solutions have been suggested to solve the problem of relying on shareholders' imposition of marketplace morality. This rises from the reality that the executive have an incentive to drive a company beyond its optimal level which increases their power of control of the resources (cited by Jensen 1986, p.1). Even with the legal requirement of executives taken a second option participation in the purchase of shares, there exists insider dealings instigated by the managers when such incentives arise. Clarke (2009, p.4) points out that chief executives who are the agents if chairing the boards can prevent the challenge of their position and too aggregate to their own substantial increase in the companies' wealth share through inflation of salary and growing stock. The executives do take maximum advantage of the shareholder- agent information asymmetry if it does exist on the management team to maximize their long-term enterprise values (Schwalbach et. al 1997, p. 3)

The need for immediate changes arose with the challenges that were too way out of hand. Clarke (2009, p.8) identifies these challenges that include; uncontrollable rise in executives' compensation; unethical and functionally damaging disparity of executive- worker rewards; the rising agency problem with executives taking proportionately large shares of corporations earnings; and the immodest bench- marking of executives compensation gradually building.

One of the adopted solution to these agency and societal challenges is the enactment of the Sarbanes-Oxley Act of 2002 (SOX) which came after the collapse of Enron and Worldcom in US- as Perino, (2002, p 212) terms it; 'the Enron legislative aftermath. This came as a state's reaction to safeguard the citizens who own stocks directly or indirectly through retirement funds and pensions (Coates 2007, p. 91- 116). The Act came to address the reallocation of risks to the perpetrators and further isolating the shareholders from liabilities. To eliminate the auditors' agency problem, the duty to appoint the external auditor's (agents) services is the principals (shareholders) auditing the corporate management and executives (Gavious 2007, p. 451- 467). The Act recognises the independence of the auditors and mitigates management interference. The Act does increase the risk of the directors hence reducing the supply of them while increasing outside directors demand (Linck et. al 2009, p.3287-3328). The concerns of the implementation though of the SOX are divergent since companies that face agency problem have the company insiders lobby against the implementation while investors lobby for the full implementation (Linck et. al 2009, p.3287-3328).

Advantages and Disadvantages of the Solution

Some of the advantages of the adoption of SOX as identified include; the act helps to decrease the incentive of fraud collusion between the management and the auditors (Gavious 2007, p. 451- 467). With the provision of the audit- firm rotation unlike the audit- partners' rotation, and the time-window expedition between audit and the non-audit services, the Act seeks to address the joint- agency challenge. With this in mind SOX will help in the improvement of the financial statements within companies (Li. et. al 2008, p.111-134).

Additional advantages identified by include: the standardization of processes among companies of the same characteristics; effective exploitation of convergence opportunities; strengthening internal weak links that may include human resource management, wages regulation and taxation processes (Wagner 2006, p.133.)

Some of the identified disadvantages are that; The legislation imposes significant cost on firms (Leuz 2007, P. 146-165). These cost include the increase in the pay of the directors and executives (Fried 2011, p.722-751.), increased internal control mechanisms (Zhang 2007 , p.74-115) and increase cost of equity (Ashbaugh 2009, p.1). As observed by Carney (2006 p.141), that cost of .these regulations do exceed the benefits n some companies.

There also exist concerns on the discrimination of the application of the Act. The act is framed to apply to the listed level 2 and 3 but not 1 and 4 (Litvak 2007, p.195-228). This discriminates a universal control of companies' alignment to the market integrity and limit this to few companies that have a high purchase value and agency risks. As points out by Wang (2010, p.885-920), CFOs within companies with high internal control receive high wages as compensation which results to a increased cost of control under SOX.

Conclusion

Corporate governance, a concept focusing on the management of the relationships between different corporation shareholder has been moulded by a myriad of challenges among which agency problem is paramount. The divergence of interest between the principals and agency has attracted incentives to engage in illegal corporate practices at the managements' discretion. These practices range from consumer product quality deprivation, environmental unfriendly practices, tax evasion, and insider trading that deprive democratic market participation. Among some of the solutions advocated and adopted include re-allocation of risks to the perpetrators mostly the agents. Legislation like SOX Act in US came as a result of corporations' indulgencies in unethical dealings.

The emergence of SOX in US brought to rise to missed reaction- the principals as pro-adoption and implementation of the bill while agents interests been greatly affected. The main areas within the Act include: the external auditors independence and rotational contracting; executives' risk- bound high compensation and shareholders isolation to corporate liabilities instigated by managers.

Although the benefits of the adoption of SOX are tangible, realistic and corporate-redemptive, there have been cases of negative implications of SOX. Discrimination of the application of the Act to companies and increased cost through advanced internal control and executives' wages are among the challenges associated with the adoption of SOX. This among other solutions have been identified and adopted to mitigate the problem of agency.

Reference

Ashbaugh-Skaife, H., Collins, D.W. and Lafond, R., 2009. The effect of SOX internal control deficiencies on firm risk and cost of equity. *Journal of Accounting research*, *47*(1), pp.1-43.

Carney, W.J., 2006. Costs of Being Public after Sarbanes-Oxley: The Irony of Going Private, The. *Emory LJ*, *55*, p.141.

Coates, J.C., 2007. The goals and promise of the Sarbanes-Oxley Act. *The Journal of Economic Perspectives*, *21*(1), pp.91-116.

Freeman, R.E., Wicks, A.C. and Parmar, B., 2004. Stakeholder theory and "the corporate objective revisited". *Organization science*, *15*(3), pp.364-369.

Fried, J.M. and Shilon, N., 2011. Excess-pay clawbacks. *Journal of Corporation Law*, *36*, pp.722-751.

Galie, P.J. and Bopst, C., 2006. Machiavelli & Modern Business: Realist Thought in Contemporary Corporate Leadership Manuals*. *Journal of Business Ethics*, *65*(3), pp.235-250.

Gavious, I., 2007. Alternative perspectives to deal with auditors' agency problem. *Critical perspectives on Accounting*, *18*(4), pp.451-467

Goodpaster, K.E., 1991. Business ethics and stakeholder analysis. *Business ethics quarterly*, *1*(01), pp.53-73.

Ireland, R. D., & Hitt, M. A. (1999). Achieving and maintaining strategic competitiveness in the 21st century: The role of strategic leadership. *The Academy of Management Executive*, *13*(1)

Ismail E., Julie F., Sukhdev J., Adam L. And Karel W. Agency, the romance of management pay and an alternative explanation: CRESC Working Paper Series: Working Paper No. 23

Jamnik, A., 2011. Business ethics in financial sector. *Economic Research-Ekonomska Istraživanja*, *24*(4), pp.153-163.

Leuz, C., 2007. Was the Sarbanes–Oxley Act of 2002 really this costly? A discussion of evidence from event returns and going-private decisions. *Journal of Accounting and Economics*, *44*(1), pp.146-165.

Linck, J.S., Netter, J.M. and Yang, T., 2009. The effects and unintended consequences of the Sarbanes-Oxley Act on the supply and demand for directors. *Review of Financial Studies*, *22*(8), pp.3287-3328.

Litvak, K., 2007. The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US. *Journal of corporate Finance*, *13*(2), pp.195-228.

Li, H., Pincus, M. and Rego, S.O., 2008. Market reaction to events surrounding the Sarbanes-Oxley Act of 2002 and earnings management. *Journal of law and Economics*, *51*(1), pp.111-134.

Michael C. J., 1986. Agency costs of free cash flow, corporate finance, and takeovers: Harvard Business School

Mitchell, L.E., 2009. Morals of the Marketplace: A Cautionary Essay for Our Time, The. *Stan. L. & Pol'y Rev.*, *20*, p. 171.

Perino, M.A., 2002. Enron's legislative aftermath: Some reflections on the deterrence aspects of the Sarbanes-Oxley Act of 2002. *Columbia Law and Economics Working Paper*, (212).

Schwalbach, Joachim, Conyon and Martin J.,1997. European differences in executive pay and corporate

SEC.. Gavious, I., 2007. Alternative perspectives to deal with auditors' agency problem. *Critical perspectives on Accounting*, *18*(4), pp.451-467.

Thomas C., 2009. A critique of the anglo-american model of corporate governance: Vol. 05 No. 03 (2009)

Thomas, T., Schermerhorn, J.R. and Dienhart, J.W., 2004. Strategic leadership of ethical behavior in business. *The Academy of Management Executive*, *18*(2), pp.56-66.

Wagner, S. and Dittmar, L., 2006. The unexpected benefits of Sarbanes-Oxley. *Harvard business review*, *84*(4), p.133.

Wang, X., 2010. Increased Disclosure Requirements and Corporate Governance Decisions: Evidence from Chief Financial Officers in the Pre-and Post–Sarbanes-Oxley Periods. *Journal of Accounting Research*, *48*(4), pp.885-920.

Waygood, S., 2006. *Capital market campaigning: the impact of NGOs on companies, shareholder value and reputational risk*. Risk books.

Zhang, I.X., 2007. Economic consequences of the Sarbanes–Oxley Act of 2002. *Journal of Accounting and Economics*, *44*(1), pp.74-115.