

Corporate governance: How can the legal owners of a firm be confident that managers are working in their best interests? Explain why corporate governance is an issue and illustrate your answer by critiquing and contrasting the Annual Reports of any two international companies currently quoted on the FTSE100.

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1.0. Introduction

Firms' corporate governance can be characterised as a set of rules of governance for firms to direct how they act, administer and control their operations (Milosevic et al., 2015). A firm's corporate governance is enshrined in its policies and processes, and in its ability to follow institutional norms to enhance firm accountability (Salvoni et al., 2018). The goal of corporate governance within a firm is to ensure that the organisation manages its relationship with different stakeholders while ensuring that there is true accountability of actions (Bain and Band, 2016). In particular, extant literature acknowledges that it is possible for firms to reduce the principal-agent problem that may exist within the organisation through corporate governance. Good corporate governance can establish the firm's brand image and improve the firm's competitive advantage (Aras, 2016). The purpose of this essay is to evaluate the importance of corporate governance as key to ensuring that the firm holds managers responsible and accountable for their actions. The essay begins with an overview of corporate governance and its key theories. This is followed by an assessment of specific corporate governance actions which can enhance managerial responsibility. Key elements from the corporate governance reports of two firms, British Petroleum and Tesco, are used to highlight these views. Additionally, evidence from other firms that are listed or operate in the UK is highlighted to illustrate the importance of an organisation's corporate governance actions.

2.0. Review of Theory

2.1. Definition of Corporate Governance

Over the years, there have been multiple definitions of corporate governance. For example, Milosevic et al. (2015) defined corporate governance as an action intended to supervise and oversee the activities of managers of the organisation by the board of directors to ensure that the owners' needs are represented. Steger (2015) presented a similar definition, arguing that corporate governance can help firms increase their responsibility by developing a code of conduct which is enforced and overseen by a board of directors. Solomon (2020) expanded on this view, indicating that this code of conduct will ensure that there is no mismatch between a firm's policies, regulations and expressed stakeholder interest, and managerial provisions to meet these goals. Tricker and Tricker (2015) concluded that the goal of corporate

governance is to enhance the firm's performance while ensuring that the right structures are in place to meet the goals of various stakeholders. They argued that corporate governance creates a set of procedures, goals and policies which will ensure that the managers of a firm work towards a variety of interests of firm stakeholders rather than simply focusing on a single outcome, financial performance (Aras, 2016).

The OECD (2014) presented a holistic view of corporate governance, highlighting various elements, and this definition is adopted in the current essay. The definition characterises corporate governance as the mechanism through which the objectives of an organisation are set while ensuring that social, regulatory and market environment contexts are addressed. The mechanism includes monitoring the firm's actions and policies, as well as evaluating the decisions taken by agents of the firm with respect to how they affect different stakeholders.

2.2. Agency Theory

The key theory attributed to the evolution of corporate governance is agency theory. Agency theory attempts to define the conflicts that may exist between one party (the agent) and another (the principal) (Glinkowska and Kaczmarek, 2015). Jensen and Meckling (1976), in their seminal research, argued that shareholders or owners of the firm may have different interests from the managers (i.e. the agents). This leads to agency problems. In particular, there are two types of problem that may arise. Firstly, there can be adverse selection problems, where there is a gap between the shareholder and the manager in terms of information flow. If the information flow is limited, it could lead to asymmetry in knowledge of firm activities (Panda and Leepsa, 2017). This makes it difficult for the owners or shareholders to know if their managers are working optimally (Mitnick, 2015). The second problem that may arise is characterised as moral hazard. Moral hazard is a result of opportunistic behaviour by the manager to further their own interests, which may not reflect the needs or values of the organisation (Bendickson et al., 2016).

These agency problems can create increased agency costs and can lead to loss of both financial performance and firm reputation. Managers who have limited oversight may expropriate the wealth of the firm, leading to loss of firm performance (Bendickson et al., 2016). In such cases, divergence of interest between managers

and shareholders should be addressed to overcome agency problems (Steger, 2015). Agency costs can include other challenges such as managerial risk aversion, managerial shirking, power-driven actions with no thought of consequences, and managerial focus on free cash flow over long-term strategic growth needs (Bosse and Phillips, 2016).

Agency theory has been criticised for a lack of focus on the needs of other stakeholders of the organisation. This leads to the stakeholder theory. This theory holds that managerial actions should focus on various stakeholders, including shareholders, employees, customers and the wider community (Mohamad Yusof, 2016). Corporate governance policies will hold managers accountable for their actions in how they impact on such a wide stakeholder group (Naseem et al., 2017).

Both these theories show that the true aim of corporate governance policy is to increase the accountability of managerial action. Accountability within the context of corporate governance is intended to reduce agency costs. The following section evaluates key dimensions of corporate governance which can enhance managerial accountability. The study draws examples from established firms listed on the London Stock Exchange to highlight the presence (or absence) of these determinants.

3.0. Key Mechanisms of Corporate Governance Reducing Agency Costs

3.1. Corporate Governance Reporting

The UK Corporate Governance Code (referred to as the 2018 Code) calls for firms to make a statement on how they have applied corporate governance principles in a manner that can enable shareholders and other stakeholders to evaluate the efficacy of corporate governance policies (Financial Reporting Council [FRC], 2018a). The reporting is expected to include insights into how the board established the organisational purpose, future strategy expectations and the management of firm performance indicators (de Villiers and Dimes, 2021).

An example of a firm which has revised its approach to corporate governance after an environmental scandal is British Petroleum. The BP corporate governance report (CG Report BP, 2020) set a clear direction for the firm's actions. In particular, it responded to key challenges in the external environment (e.g. COVID-19) and

highlighted actions by the firm to address these challenges. The board recognised the firm's key strategy to include a focus on sustainable energy. Key targets to achieve sustainable growth were set (CG Report BP, 2020). The directors' assessment of BP's performance included a review of the financial and operational risks faced by BP and the executive response to these challenges (CG Report BP, 2020). Similarly, the 2018 Code called for the board to undergo external board evaluations to assess the performance of the board and to include these findings as part of the corporate governance strategy. For example, the audit committee had an external audit partner as a member of the committee. The external auditor was helpful in assessing the board's strategy and outlook. CG Report BP (2020) reported that the engagement of an external auditor was accompanied by establishing meetings with the auditor to appraise them of the board's activities.

Similarly, CG Report Tesco (2020) identified links between the firm's strategy or goals and the role of the board. For example, in the firm's efforts to meet the needs of customers, the role of the board is to provide further insights. CG Report Tesco (2020) reports:

Independent consumer research commissioned by the board each year helps identify where consumers and influencers think we should be focusing our attention and how well they feel we are addressing these issues currently (p. 26).

Another key aspect highlighted by the 2018 Code was to engage with the workforce through a formal workforce advisory panel. This was intended to increase board engagement in employee wellbeing and understand any workforce concerns (FRC, 2018b). CG Report BP (2020) reported on the establishment of a workforce committee to evaluate workforce wellbeing. A wide workforce survey was conducted to assess employees' views on existing policies, actions taken during the pandemic, and managing firm diversity.

3.2. Director Independence

Administering the management is the main aim of boards. According to empirical studies, the level of independency of boards is directly proportional to the level of effective administration (Johnson, 2019). This shows the importance of boards'

independence. Thus, boards' effectiveness becomes dependent on the number of outside directors on the board (Pérez-Calero et al., 2018). Compared to the directors who are internal to the company, outside directors show a strong intention to supervise managers and keep a constant check on them (Peter, 2020). Moreover, outside directors come from various organisations, have distinct backgrounds and bring varied experiences to the board. This helps the board enhance its skills pool, which can further help improve the board's effectiveness (Neville et al., 2019).

At Tesco Plc there are ten non-executive positions to three executive positions. The non-executive positions include nine non-executive directors and one non-executive chairman. Of the nine non-executive directors, there is one senior independent director who is expected to oversee the implementation of the 2018 Code (CG Report Tesco, 2020). BP has twelve non-executive directors and four executive directors. According to Cavaco et al. (2017), managerial accountability and enforcement of corporate governance activities can be enhanced through the inclusion of an independent director. An independent director has no links with the organisation, while a non-executive director may represent a major shareholder of the organisation. Independent directors are key to ensuring that any board-specific challenges are resolved. In particular, the independent director has the authority to facilitate any issues that may arise between the executive and the non-executive directors. Since they do not have anything to gain from the firm, they can oversee the firm's activities. Since all the non-executive directors of Tesco and BP are independent, there is greater oversight of managerial actions.

Remuneration Committee

A key agency problem that has been highlighted is the managerial focus on incentives rather than assessing firm performance. To overcome this managerial challenge, corporate governance mechanisms suggest the adoption of a remuneration committee. The remuneration committee is responsible for making decisions on CEO pay (Zraiqa and Fadzil, 2018). The purpose of the committee is to determine if performance-oriented compensation is in place, to evaluate CEO compensation and to identify the right performance criteria for other senior executives within the organisation (Kent et al., 2018). CG Report BP (2020) remarks that the primary objective of the remuneration committee is to "recommend to the

board the remuneration principles and policies for the executive directors while considering remuneration and related policies for employees below the board and the executive team" (p. 105).

The FRC (2018a) called for corporate governance to address potential managerial incentives to increase their own interests at the expense of other employees. CG Report BP (2020) highlighted the need to address the gap in pay without identifying effective metrics.

Audit committees are also considered key tools which can enhance a firm's corporate performance (Oussii and Taktak, 2018). These committees provide oversight of the annual auditing process and oversee the system of internal controls which are compliant with the laws of the country (Ghafran and O'Sullivan, 2017). Extant literature also acknowledges that the presence of an audit committee can reduce the incidence of earnings management (Alqatamin, 2018). Both BP and Tesco acknowledge the presence of an audit committee and identify its importance in addressing audit compliance. Despite the presence of such a committee, corporate governance failure was observed in the case of Tesco. In 2017, Tesco had to pay £235 million to settle investigations by the Serious Fraud Office, when the company overstated its profits by £263m after revenue recognition irregularities (ACCA Global, 2018).

These findings show that a remuneration committee, an audit committee, independence of the board of directors and efforts to meet the corporate governance code of the firm all influence the efficacy of corporate governance. These tools further help firms oversee managerial actions regarding manager greed, accounting policies, and the strategy and purpose of the firm. Therefore, accountability is enhanced.

4.0. Sceptical View on Corporate Governance Oversight

There are some authors who take a sceptical view of corporate governance oversight. A challenge highlighted by Keay (2014) is that managers are allowed some forms of earnings manipulation which are not strictly forbidden by accounting standards. The complexities of existing financial instruments lead to firms manipulating valuations and hiding losses, creating opacity. A good example of

corporate governance failure can be seen in the practice of Carillion (Lessambo, 2016). Carillion used opaqueness in corporate reporting to assume liberal goodwill and did not give any explanation of its book-to-bill ratio. The board of directors at Carillion claimed that the practices of the firm did not break the corporate governance code (UK Parliament, 2017). The firm also made use of external consultant Deloitte to advise it on risk management and financial controls. Deloitte was unable to identify financial risks, however, leading to major challenges in operations. Clearly, the presence of external advisors and the presence of independent directors did not foresee the compulsory liquidation of the firm in 2018 (Riggins, 2019). The firm had issued three profit warnings and was able to get HRMC to defer £22m in tax liabilities. Therefore, Admati (2017) contended that as long as there is opacity in reporting expectations there will continue to be challenges linked to corporate governance.

Another sceptical view associated with corporate governance concerns delays in the identification of corporate fraud and misrepresentation. According to Zingales (2015), such misrepresentations may remain hidden for long periods. In particular, it can be argued that in large MNC organisations it becomes difficult to pin responsibility and intent to an individual(s) and to take relevant actions. There may also be insufficient incentives within corporations to uncover such fraud or deception. One example of a firm where such an action occurred is Volkswagen. The Volkswagen emissions scandal took years to detect despite the presence of a strong corporate governance code (Crete, 2016). This was attributed to the inherent challenges of large organisational hierarchies and bureaucracies.

5.0. Conclusion

This essay identifies that agency problems and conflicts between owners and managers can lead to improper corporate management practices. Corporate governance is intended to resolve this challenge. Managerial accountability can be enhanced through specific corporate governance practices, including publication of a corporate governance report; creating committees, including a remuneration committee and an audit committee; and enhancing the independence of directors. There remains some scepticism as to the efficacy of corporate governance policies amongst some scholars. This is because there is room for some accounting

manipulation and there can be difficulties in achieving true accountability in large organisations. Nevertheless, it is important that there is constant improvement in corporate governance codes to reflect market and regulatory context needs.

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