# A Governance Perspective

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## Abstract

Governance refers to the processes and structure used to direct and manage an organizations operations and activities. It defines the division of power, and establishes the mechanisms to achieve accountability between owners, managers and stakeholders, and the entity that is the organization. Governance helps the organization focus on the activities which contribute most to their overall objectives and to utilize their resources effectively and ensure they are managed in the best interests of their principal stakeholders. This paper examines the evolution of governance together with some of the issues associated with the practice of governance and stakeholder management. The paper also explores some of the key themes associated ethics within the governance model.

**Key words:** Governance, Ethics, Stakeholders, Risk, Power, Accountability

## Introduction

As many academics have noted countless business organizations are run on the basis of ideology more than anything else (Hawley & White 1996, McManus, 2006,). An ideology is a set of beliefs or assumptions about the proper state of things, particularly with respect to the moral order and political arrangements which serve to shape one's position on governance issues (Hornum & Stavish, 1978). The important thing to note in this concept is that the conception of morality provides the means to manage individuals from within by creating a criterion of propriety within each and every individual. From a governance perspective this is important because it provides the basis for the ethical management of individuals, and the managing of conflict with the minimum use of power or direct action (Foucault, 1988). It is important to recognise at this point that organisations and stakeholders have expectations which may not be synergistic in that stakeholders do not always share the same ideology. Ideological conflict, between the power seekers and stakeholders, is somewhat typical within organizations, even governments.

It could be argued that there is no dominant ideology, especially in an organization as complex as government. There are instead temporary alliances formed around issues and opportunities. Conflicting ideologies usually influence managers by creating goal ambiguity (McManus, 2006). An ideology also refers to a belief in something as true that is actually false, or at the base of it, containing a falsehood. Ideologies survive by putting a positive spin on something negative. According to Durkheim ideologies always rest on a lie (Durkheim, in Giddens, 1972). Ideologies are the opposite of the word "institution" because anything that reaches the level of social institution must rest on a kernel of truth. From a governance perspective all organisations are social institutions with hierarchies and power bases where business is managed by owners and managers who in theory are responsible for their own actions and the actions of their subordinates (McManus, 2004).

Before going on to examine some of the points raised above I would like to briefly discuss the emergence of governance starting with the work of Berle and Means (1932).

## The Evolution of Governance

The evaluation of governance can be traced back to the work of Berle and Means (1932). Berle and Means suggested that: the rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state... Where its own interests are concerned, it even attempts to dominate the state. The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organization. Berle and Means concern about the separation of ownership from control was not only about managers' lack of accountability to investors. It was also a concern about managers' lack of accountability to society in general. In the 1960s, a group of economists began to devise tests based on the idea that the motives of corporate decision makers would be reflected in firm performance, researchers such as Monsen (1968) and Palmer (1973), classified firms as either owner or management controlled, and then compared the profit rates of the firms in each group. According to Lintner a second major component of the managerialist thesis was that managerial autonomy increased as a result of increases in retained earnings, which freed managers from dependence on banks and other financial institutions for capital and give them the power to control and influence external events thus ushering in a dangerous era of concentrated economic power. Williamson (1964), a leading contemporary economist, used Herbert Simon's (1957), bounded rationality assumption to develop a model in which managerial goals, of which profit maximization was just one, could vary across conditions. In his subsequent work, Williamson (1975) drew in part on the historical analyses of Alfred Chandler (1962) to show the importance of managerial decision making. In the mid 1970's Jensen and Meckling begin by distancing themselves from some key managerialist claims, in particular the rejection of the profit maximization assumption. They acknowledge that managers might have motives that differ from those of owners. The issue, for Jenson and Meeking was one in which both managers and owners interests corresponded with one another. Clearly this involved some effective monitoring mechanism. One mechanism suggested Jensen and Meckling (1976) was the provision of equity to management. When managers own stock in the firm, they share interests in its performance with the remaining equity holders. Another important mechanism is to provide direct monitoring through the appointment of an expert board of directors, who are constrained to operate in the shareholders interest because of their need to maintain their reputations. A third monitor is the market, both in terms of its

effect on the firm's stock price and the related market for corporate control. This last approach is potentially the most threatening, since it raises the possibility that managers (that is directors or officers of the firm) could be ousted or dismissed by the board or its shareholders. However, Mace (1971), in his classic work on boards, suggested that the "powers" of control usually rest with the president- not with the board… It is the president who, like the family owner-managers in the small corporation, determines in large part what the board of directors does and does not do. Fredrickson, Hambrick, and Baumrin (1987) presented a model of factors that might account for the dismissal of CEO (or director) or senior officers of the firm, several of which involved board structure and behaviour.  According to Finkelstein & Hambrick, (1996) the increased risk of dismissal early in a CEO tenure is due to the fact that boards will be risk adverse and more vigilant in their early evaluation of the CEO as the costs of making a bad CEO selection decision are likely lower when the poor decision is discovered and remedied quickly. The growing emphasis on risk, governance and board issues among business academics during the 1980s[2] and early 1990s reflected the widely held belief amongst stakeholders (and the public at large) that managerial ethics and discretion had seriously declined over the previous two decades (Shen and Cannella, 2002). The consequence of which have been played out in the media in many a corporate scandal (including Enron, World Com, Vivendi, Parmalat and many others vividly show the problem). New reforms such as the Sarbanes-Oxley Act (2002) introduced in the aftermath of Enron and the Cadbury (1992) and Turnbull (1999) reports in the UK have done little to tend the tide of governance scandals on both sides of the Atlantic. It could be argued that regardless of the governance practices applied the responsibilities carried out by the board depend mainly on deficient legal regulations, dispersion of ownership, directors' attitudes, directors' willingness to take responsibilities, directors' attention to duty, directors' ability to assess the firm's environment, organisation, personnel and political affairs as well as the resulting financial accounting practices and directors' remunerations. The lower than expected efficiency of the governance function is due to the deficiencies in some or all of the stated factors (MacAvoy and Millstein, 2003).

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[2] For example, in the early 1980s the UK, Prudential Assurance Company fought an expensive legal action against some directors who had allegedly committed breaches of duties. Although institutional investors clearly have a general interest in well run companies and clean markets the economic reality is that it is not in their interest to spend much time on getting involved in corporate governance.

## Progressive Governance

As previously stated the governance function has been divided into two organisational functions: governance, making mostly decisions for protecting owners' interests; and management, coordinating business activities and managing stakeholder relationships in a most efficient way with the purpose to attain objectives and goals set by governance. Conceptions of governance and stakeholder involvement are varied (Floyd & McManus, 2004) there is a multiplicity of interpretations of governance and the role stakeholders should play (Turnbull, 1997). According to MacAvoy and Millstein (2003), historically, throughout its development, a firm has had one basic objective, that is to carry out business activities with a view toward enhancing corporate profit and shareholders gain. The recent development is the view that other stakeholders should also participate in governance and that they should make major strategic decisions together with owners as well as supervise managerial decisions and participate in decisions on profit sharing. The progressive proposals for governance offered by MacAvoy and Millstein included:

- Complete separation of Chair and CEO[3]
- Sarbanes-Oxley certification of financial statements extended to the board
- Board takes responsibility for strategy, risk management and financial reporting
- Board must assure itself of the integrity of management
- Board to appoint internal auditors, and also own consultants, advisors and councillors

The inference here is that the role of management and stakeholders in the governance function will be improved if its importance and power are linked primarily to the level of knowledge and skills and not so much their position in an organisation. However, if managers are responsible for balancing stakeholders' interests it seems reasonable to assume that they must maintain influential and powerful roles in the organisation albeit within an ethical framework or coded guidelines.

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[3] Many governance guidelines and codes seek to institute independent leadership by recommending a clear division of responsibilities between Chairman and CEO. In this way, while the CEO can have a significant presence on the board, the non-executive directors will also have a formal independent leader to look to for authority on the board. Documents that place less emphasis on the need for a majority of independent directors seem to place more emphasis on the need for separating the role of Chairman and CEO.

## Governance and Risk Management

As MacAvoy and Millstein note a key element in securing the delivery of any governance programme is in the implementation of its strategy which needs to encompass an effective system of risk and stakeholder management (2003). As previously noted stakeholder management within the governance programme is by no means risk free. In the context of governance stakeholder management is about managing strategy and risk to achieve its governance objectives and benefits, (take in Figure 1). The evaluation of the objectives and benefits of stakeholder input has an important ethics component (McManus, 2006). As Saner (2002) points out the use of stakeholder input in the governance decision-making process is not always straightforward because of two intrinsic issues (or dilemmas). If for example the advice from external stakeholders must be followed then they, arguably, may have too much power and may undermine democracy; and if the advice from external stakeholders may be ignored, how do you keep them motivated and how do you assure a just and defensible process? At the same time, there exists a clear need and desire to communicate important coming issues to stakeholders (Clarkson, 1995). Communication binds stakeholders together for a specific period of time and during this time each person will be operating under a legal and ethical framework. As with most ethical issues, legality is considered to be a relevant issue and, in some instances, a measuring stick for what is considered to be ethical. Although ethics and legality are two separate issues, it is almost impossible to talk about one without the other. Organizations and their managers have few options when it comes to deciding what is legal or what is not. With governance structures codes of ethics are more frequently being introduced to encompass the legal and social responsibilities of employees and other stakeholder groups. Ethic codes and guidelines reduce risk and protect managers and others from themselves, as well as from those who, they perceive, abuse the power of their position.

Figure 1 Governance and Stakeholder Framework
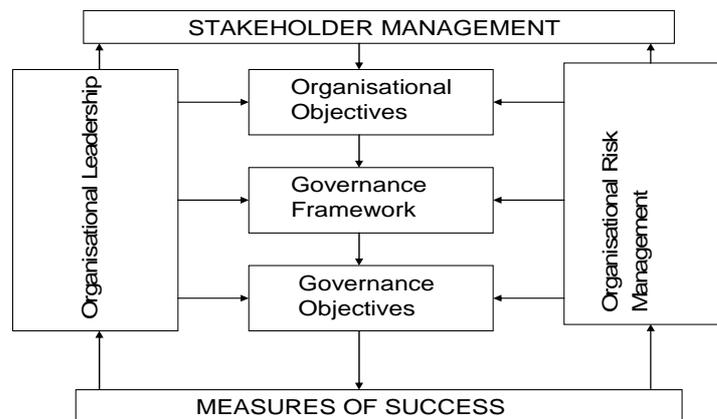


## Governance and the Managerial Interface

It is clear from Cadbury (1992), and Turnbull (1999) that industry and commerce is not always benevolent, and regulation can be an effective way to serve societal objectives MacAvoy and Millstein (2003). Regulating industry and commerce however, can be challenging and can have unintended consequences, which may be troublesome to society as the problem of regulation, is intended to prevent corporate misdemeanors. The underlying proposition in governance is that we share enough common values and owners and managers can agree on what are good governance procedures and drive changes in the governance process. As we have witnessed in practice, however, only dramatic failures such as Enron provide the basis for change, and this basis is known to be poor. The model defined in Figure 1 suggests governance places considerable accountability on owners, managers and other stakeholders to make adjustments to their way of conducting business and applying measures of governance in synchronization with the organizations objectives. In making business decisions and adjustments to governance measures owners, managers and stakeholders need to consider the implications of their actions (McManus 2004).

Governance decisions and all subsequent actions lie with the board and its management representatives and when standards, procedures, and expectations are not well established, owners and managers may not safely delegate their authority or expect stakeholders to be led or well served. According to (Floyd & McManus, 2004) managers often fail to recognise the importance of meeting

stakeholder expectations and many fail in offering ethical and governance leadership. Evidence would suggest (Cadbury, 1987, Bennis, 1989, Blanchard, 1989, Fulton, 1998, & McManus, 2004) that being an ethical person and making sound ethical decisions is enough; furthermore, some assume that good managers are by definition ethical leaders.  This does not necessarily mean the leader is a real moral or spiritual leader in a sense he or she commits no misdemeanour, but someone who can perhaps hold the leash on subordinates who might put their morality to their business transactions. Fulton states that the dilemma we all face every day, having to choose between action that benefits our own self-interest, and action that addresses our obligation to one another: our self-interest, including the need to profit from our dealings with others, versus the "moral" perspective, the social contract that binds us to others (Fulton, 1998). In essence the manager as a moral person is characterised in terms of individual traits; as a moral manager, he is thought of as conveying an ethics message that others take notice of in their views and behaviours. The basis of ethical leadership is being an ethical person. Stakeholders must think of you as having certain traits, engaging in certain kinds of behaviours, and making decisions based upon ethical principles. Moreover, this ethical self must be authentic. From a governance perspective ethical traits relating to trust include: moral order, integrity, honesty, fairness, and fulfilment of obligations. While these traits are clearly important, behaviours are equally important. Behaviours include: doing the right thing, showing concern for people and treating people right being open and communicative, and demonstrating morality in one's personal life.  In the decision-making role, managers should have a set of ethical values and principles; they should aim to be unbiased and reasonable (Hawley & White, 1996).  In terms of governance a manager's decision should look beyond the balance sheet; the 'moral person' represents the essence of the ethical manager. Research by Atherton and McManus (2004) highlight the need for owners, managers and stakeholders to recognize the importance of proactively putting ethics at the forefront of their governance agenda. Mangers need to make the ethical dimension of their leadership explicit and salient to their subordinates. The ethical manager achieves by serving as a visible and vocal role model for ethical conduct and ethical management can be achieved using a reward system holding all accountable to ethical governance standards.

## Conclusion

Research shows that we need to further develop the governance model. What is needed to address the issues in this paper is a renewed attention to the research and study of governance and control; that is the ways in which this control affects, and is affected by, stakeholder relations; the power and behaviour of the firm elite and the nature of business political activity, including analysis of how such activity relates to the character of governance relationships between owners, managers and stakeholders.

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