

## **A Theoretical Aspect on Corporate Governance and Its Fundamental Problems: Is It a Cure or Another Problem in the Financial Markets?**

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### **Abstract**

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Corporate governance can be defined as an art of management for the business environment in the financial markets and it has recently been used as a key management strategy by both developed and developing countries. In particular, after some financial scandals, such as Enron or Parmalat, it has become an important issue in the financial markets. One question that needs to be asked, however, is whether it is really a cure for the main problems of financial markets. Corporate governance, in itself, is a controversial subject in terms of its definition or interest problem of its main participants. This is because; the corporate governance system can indicate some differences in the financial markets due to different historic, cultural and academic backgrounds. In other words, a *'one size fits all'* corporate governance model cannot be created for all corporations in the financial markets. Therefore, in order to understand the main role of corporate governance, it seems to be essential to focus on the common interest of corporations by considering the sectorial differences between corporations in the financial markets. In the corporate governance theory, there is an urgent need to address two main problems: "the value maximisation of shareholders and the role of stakeholders in the management system of corporations". These two problems constitute the fundamental problems of corporate governance and are defined as 'the agency theory and the stakeholder theory' in the literature. In this respect, the main purposes of this investigation are to explore; what defines good corporate governance, what are the main corporate governance models in the financial markets, what are the fundamental problems of corporate governance, and how these problems should be addressed, by creating a theoretical framework for the importance of corporate governance in the financial markets.

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**Keywords:** Corporate Governance, the Corporate Governance Models, the Agency Theory, and the Stakeholder Theory

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## 1. Introduction

Corporate governance has recently become a central issue for the success of corporations in the business environment. In particular, in the wake of a number of scandals, such as Enron, Parmalat, WorldCom or Lehman Brothers, its importance has been understood by both developed and developing countries. But, what exactly is corporate governance? A large volume of studies has been published describing the main definition of corporate governance in the literature. For example, Clarke and Roma stress that corporate governance is a system, which coordinates all participants in the company; regulates the objectives, rights and responsibilities; protects and develops welfare of the company; and finally serves the wider communities in corporations (Clarke and Roma, 2008). In general, corporate governance consists of shareholders, stakeholders, employees, boards of director, chief executive officers (CEO) and owners (Clarke and Roma, 2008).

In this respect, corporate governance can be accepted as an art of management, which provides a well-organised top-down communication between all abovementioned participants in a company. It is a widely held view that well-organised corporate governance is one of the main conditions to the success of corporations and, in parallel with this, for effective functioning of financial markets. It provides some advantages to both corporations and financial markets. For instance, Gompers, Ishii and Metrick emphasise the relation between a well-organised corporate governance structure and a company's performance, and claim that corporate governance may have a positive impact on a firm's value, improve the operating performance of corporations and increase high investment returns (Gompers, Ishii and Metrick, 2003). In addition, Bebchuk, Cohen and Ferrell explain this relation by considering the shareholders' rights. They demonstrated that 'voting powers, poison bills and golden parachute agreements' might help to improve the performance of corporations (Bebchuk, Cohen and Ferrell, 2009). In general, therefore, the main advantages of corporate governance can be listed as follows: better relations between all participants, better resource and capital allocation, increased accountability, the protection of distributed rights among players, more transparency and a better monitoring system and the intervention to a potential conflict in a timely manner. However, although corporate governance plays an important role in the company, sometimes it may also lead to some problems in corporations. This is because; corporate governance has a complex structure.

In this respect, it may be difficult to regulate who will control the employee, how much risk of investment will company stand, how company will take into account welfare of shareholder and stakeholder, how the board will be elected and who will be a member in the board (Clarke and Roma, 2008). These questions can be expanded and almost every corporation can face these problems in financial markets. In the legal literature, there are three kind of well-known corporate governance models, 'Anglo American Model, German Model, and Japanese Model' (Clarke and Roma, 2008). This variety of corporate governance may lead to some fundamental issues in the company and these problems will be identified with the theoretical explanations of corporate governance. For example, the separation of ownership and control can be accepted as the main problem of corporate governance, which is defined as 'agency theory' in the literature. According to the agency theory, the main problem is based on 'divorcing' of ownership and control in a company (Clarke, 2004). Fundamentally, when ownership and control of a company is separated, shareholders or owners may want to monitor the management system, since they are risk bearer in the company (Clarke, 2004). In other words, they do not want to lose their investments because of wrongdoing behaviours of managers (Hirt, 2005). However, monitoring manager or CEO may lead to some other problems. For instance, it may cause agency cost for the company or it can restrict the independency of managers in implementing their own decisions in the company.

Apart from the agency theory, stakeholder participation to the board of a company (the stakeholder theory) can be considered as another problem of corporate governance. Principally, this theory is about the situation of stakeholders in the structure of corporate governance. In fact, this problem can be highlighted as a controversial issue in the literature, because there are some differences between the corporate governance models. For example, the German Model aims to solve this problem by having an employee representative in the board of directors. However, in the Anglo-American model, value maximisation of shareholders seems to a primary objective of a company. Therefore, there may not enough regulations in the Anglo-American corporate governance models to solve this problem in corporations (Gold, 2009). This paper aims to explain the main role of corporate governance in corporations and financial markets by providing a theoretical approach on this issue.

In this respect during this paper, the definition of corporate governance will be provided by considering the views of well-known scholars in the literature; the corporate governance models will be examined; the fundamental problems of corporate governance will be analysed and the possible solutions will be addressed.

## 2. Definition of Corporate Governance

The definition of corporate governance can be accepted as a controversial subject, because it seems that there is no consensus on its meaning in the literature. This is because; the system of corporate governance can show an alteration from country to country due to different historic, cultural, financial and academic backgrounds. It can be seen that there is a large volume of published studies describing the meaning of corporate governance; however, it has differing definitions in the literature. Therefore, it may be essential to consider a few definitions instead of touching on one meaning of it. In this respect, it can be useful to consider the definition of Sir Adrian Cadbury in order to understand the general meaning and objectives of corporate governance. He highlighted the importance of corporate governance for the success of corporations and financial markets by publishing the Cadbury Report and hence, helped to improve the awareness of corporate governance for financial markets.

According to him (Cadbury, 2000 cited in Gonencer, 2008, p.3): 'Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interest of individuals, corporations and society'. In this definition, Cadbury highlights the main objectives of corporate governance and emphasises the accountability principle of corporate governance. This definition can be accepted as a good starting point in order to understand the general issue in corporate governance. However, in our complex financial markets, it may not be good enough to provide essential solutions for all problems of corporations. In particular, this definition seems to fail to explain the quality structure and the main advantages of corporate governance. Therefore, it is essential to update the definition of corporate governance in the literature. In this respect, Yuksel's definition can be more useful to understand the specific details with regard to the main advantages of corporate governance.

He states that (Yuksel, 2008, p.101): '*High quality status of corporate governance means low capital cost, increase in financial capabilities and liquidity, ability of overcoming crises more easily and prevention of the exclusion of soundly managed companies from the capital markets*'.

In this definition, Yuksel focuses on the potential advantages of corporate governance in the financial markets and accepts a well-organised corporate governance structure as an invisible guard for the unexpected events. However, this definition can be also criticised. As it can be seen from the definition, he clearly indicates the main role of corporate governance in financial markets by considering the economic contributions of it, but he does not provide any information about its legal perspective. As it was mentioned before, there are numerous studies to have attempted to explain it. However, in these rapidly changing financial markets, the old definitions may fail to indicate the main mission of corporate governance. It may be claimed that in order to have a better definition, it seems to be essential to include both the legal and economic perspective of corporations. In addition, in order to improve its universality, the main corporate governance principles, '*transparency, accountability, reliability and fairness*', should be covered in the definitions. From this point of view, corporate governance can be defined as a management system that covers a body of rules in terms of transparency, accountability, reliability and fairness in order to create a smooth working environment for all participants in corporations.

### **3. The Models of Corporate Governance**

As mentioned before, due to historic, cultural and financial differences between nations, there are some different corporate governance systems in the financial markets. In the legal literature, three kinds of well-known corporate governance systems, 'Anglo American Model, German Model and Japanese Model', take the leading position. However, every different model leads to different problems in the financial markets. In this part, these well-known corporate governance models will be analysed and the fundamental problems of each model will be examined.

#### **3.1. Anglo American Model**

Anglo American model is preferred and implemented by great deals of country, such as the US, the UK, South Korea or Chine, because both the US and UK have a strong capital market in the world (Clarke, 2009 and see also Miles and Goo, 2013).

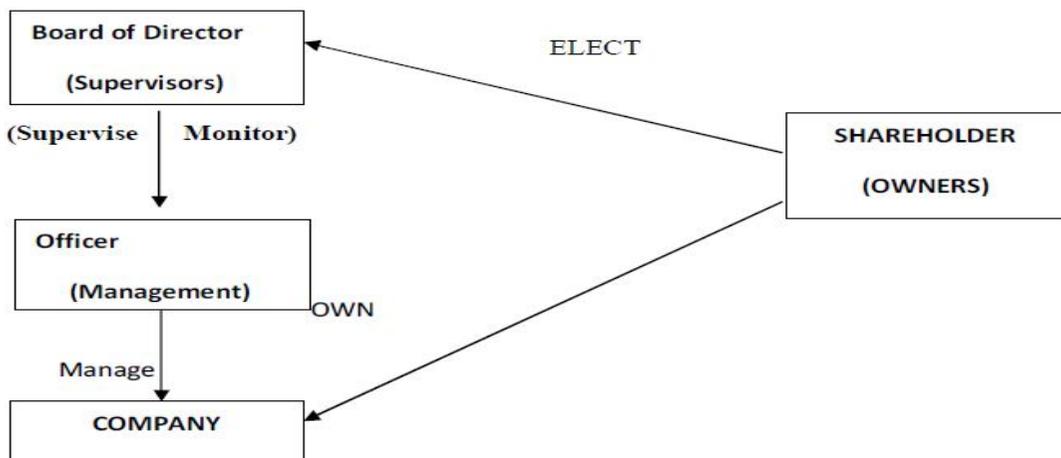
In this model, ownership and control is separated, and the primary objective of this model is to increase the interest of shareholders (Muir and Saba, 1995). The shareholders are known as an owner of the company. They invest their capital to companies; therefore, they are accepted as risk bearers (Muir and Saba, 1995).

As it was mentioned before, the value maximisation of shareholders is the primary objective of this model. Therefore, shareholders have very important rights in the company. For example, they have a right to adopt or change the rules; may obtain dividend income from the profits; have a right to inspect and they may take some strategic decision, such as merger or acquisition. However, in this model it is believed that shareholders may not have enough ability to run the company in a professional manner. In this respect; on the one hand, they need an external agent for the management of the company; on the other hand, they continue to monitor them in order to ensure that whether external agent works for the benefit of the company (Coyle, 2005). These relations between shareholders and external agents are accepted as the most important problem of the Anglo-American Model, which is defined as 'the principal-agent problem or agency problem' in the literature. The agency problem can be explained as a conflict of interest between inexperienced shareholders and professional external agents in the company (Enriques and Volpin, 2007). This problem will be analysed in the following part. Principally, the main features of this model can be listed as follows: The ownership and control are separated in the company.

Shareholders are accepted as the owner of the company and they delegate some external agents in order to run the company in a professional manner. And the model primarily focuses on the value maximisation of shareholders (Fernando, 2006). In order to clearly understand the Anglo-American Model, it can be useful to touch the main participants of this model. As mentioned before, shareholders play a key role in this model and they have some certain rights in the company. They generally delegate a director (CEO) in order to be run the company; however, even if the shareholders entitle a director, they also keep monitoring the directors, which lead to the agency costs in the company (Coyle, 2005). Secondly, the board of directors has an important impact in the company. This model consists of a single board of directors (one-tier) system (Salacuse, 2004). The board of directors is selected by shareholders and their main responsibilities are; to control the performance of the company, to select, monitor and remove external agents, to approve the essential payments and to delegate some committees, such as the audit committee (Muir and Saba, 1995).

Third participant of this model is the external agent. External agents are liable for controlling the "*day to day affairs*" of companies (Muir and Saba, 1995, p.70).

Fundamentally, they monitor the performance of corporations, adopt investment policies and aim to increase the interest of shareholders (Salacuse, 2004). Taken together, the outstanding features of this model can be summarised as follows; the ownership and control are divorced and the primary objective is to increase the value maximisation of shareholders. In this respect, the Anglo-American Model can be demonstrated with a figure below:



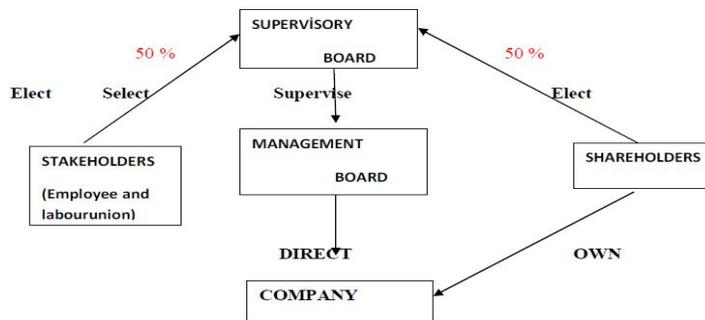
**Figure I: Anglo American Model of Corporate Governance**

(This figure was prepared by evaluating the following book: Muir and Saba, 1995, p.62)

### 3.2. The German Model

This model is also known as a Continental European approach, because German model is implemented by many European states, such as "*Germany, Holland and France*" (Fernando, 2006, p.54). In contradiction to the Anglo-American Model, the German model has two-tier board structure in corporate governance. Two-tier board refers to two kinds of board structure in the company; upper board, in other words, supervisory board, and executive board or management board (Fernando, 2006 and see also Muir and Saba, 1995). In this model, shareholders accepted as owner of company again, but difference is they cannot completely select supervisory board (Fernando, 2006). Half of the members of Supervisory board are elected by shareholders, and the other half are selected by stakeholder (Fernando, 2006).

In this respect, it can be claimed that stakeholders also play an important role in this model; therefore, managers of company not only focus on the interest of shareholders, but also protect interest of stakeholders. It can be useful to briefly identify who stakeholders are in the company. It is generally known that stakeholders consist of employees, customers, institutional investors and creditors. Fundamentally, supervisory board elects and supervises the Management board and the Management board directs the affairs of company and also runs day-to-day processes of the company (Fernando, 2006 and see also Muir and Saba, 1995). The main system of this model can be illustrated from the figure below:



**Figure II: The German Model**

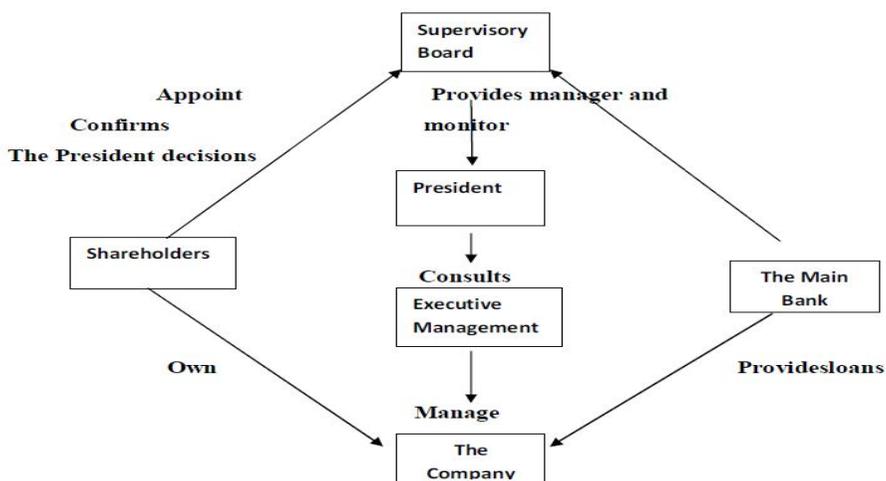
This figure was prepared by evaluating the following book: Fernando, 2006, p.54

### 3.3. The Japanese Model

The Japanese Model focuses on the long-term interest of the company instead of the short run shareholder's interest (Muir and Saba, 1995). In this model, the boards are generally accepted as a huge and exceptionally executive (Fernando, 2006). In the Japanese model, members of the board generally consist from the majority of shareholders (Bradley and others, 1999). In particular, "*former senior and middle management*" of the company are occurred from one of the shareholders in the company (Bradley and others, 1999, p.57). However, the main bank also plays a key role in the corporate governance system as an outside manager of the company (Bradley and others, 1999). It not only provides loans for the company, but also monitors and elects a director to the supervisory board (Fernando, 2006).

The main bank also can have up to 5 per cent company shares in the company (Muir and Saba, 1995). The supervisory board confirms the president decision (Muir and Saba, 1995) and meets with investors in the company in order to exchange ideas (Bradley and others, 1999). The president is one of the members of the firm, who consults to the management board and evaluates the activities of the company, and the management board directs the company (Bradley and others, 1999).

The main system of this model can be seen in the following figure below



**Figure III: Japanese Model**

(This figure was prepared by evaluating the following book: Fernando, 2006, p.54)

#### **4. Fundamental Problems of Corporate Governance and Some Theoretical Approaches**

As it can be seen from the abovementioned information, there are some different corporate governance systems. Therefore, it is not possible to define 'one size fits all' corporate governance system in the financial markets. However, due to these differences between the corporate governance systems, there are some different problems in corporate governance structures.

Separation of ownership and control, conflict of interest between shareholders and stakeholders, director's remunerations, risk management or honesty of directors for example, has caused some problems during the past decades in companies (Coyle, 2005). In this part, as the fundamental problems of corporate governance, the agency theory and the stakeholder theory will be analysed and potential solutions will be evaluated.

#### 4.1. Separation of Ownership-Control and Agency Theory

Separation of ownership and control can be accepted as the main problem in corporate governance structures. This system can be usually seen in the Anglo American model and German (European) model. As mentioned before, shareholders may not have enough ability to run company in a professional manner. Therefore, they may need an external agent for the daily running of company's issues. However, this divorce can be accepted as the main reason of the conflict of interest between the shareholders and the external agents. Theoretically, this problem is defined as 'the principal-agent problem or agency problem' in the literature. In the following, this problem will be analysed and evaluated. Shareholders, as an owner of the company, want to increase their value maximisation in the company. In this respect, they generally expect long-term returns. However, external agents may prefer to focus on short-term profits, because their payments are generally determined pursuant to the short-term performance of corporations (Solomon and A. Solomon, 2004). Therefore, external agents can work for their own interest instead of increasing the value maximisation of shareholders in the company. This is because, external agents, as the professional managers, are better informed than shareholders; hence, shareholders may not realise that whether agents are indeed working pursuant to company's determined policies (Kraakman and et all, 2009). Therefore, in order to reduce the main concerns about the external agents, shareholders want to sign a contract with the agents, which identify the principal-agent relationship in the company (Wearing, 2005). However, such a pressure on the external agents may lead to some problems in the company.

Firstly, shareholders may prefer to monitor the external agents in the company. However, monitoring the external agents may increase the costs in the company. This cost is known as 'the agency cost' in the literature and Wearing identifies this cost as *'monitoring cost incurred by the principles (shareholders) and bonding cost incurred by the agents (managers)'* (Wearing, 2005, p.7).

Secondly, it may not be easy to allocate residual control rights efficiently between the managers and the financiers in the company (Shleifer and Vishny, 1997). As it was mentioned before, the external agents are better informed than the shareholders. Hence, the external agents have advantages in using the control rights in the company. Thirdly, if the shareholders manage to improve their control rights over the external agents with a complete contract, it may reduce the management discretion on the unexpected issues in the company (Shleifer and Vishny, 1997). In other words, if something goes wrong in the company, the professional external agents may easily take the essential precautions on time. Therefore, there should be a balance on the residual control rights between the shareholders and the external agents. In the past decades, the financial markets have witnessed how the principal-agent relations led to a destructive impact on the largest companies. The Enron case, for instance, can be highlighted as one of the biggest corporate scandals for the agency problem in the financial markets. Briefly in the Enron case, the better informed external agent have worked for his own pocket by committing some white collar crimes, such as fraud and misreporting, and the owners and the auditors of the company could not have realised it. Hence, one of the largest corporations in the US has gone bankrupt and shareholders lost around \$74 billion (Clarke and Roma, 2008; Roe, 2005; Nelson, Price and Rountree, 2008).

#### 4.1.1. Possible Suggestions and Solutions

As it can be seen from the abovementioned information, the separation of ownership and control may lead to three fundamental problems in a company; 'agency cost, the problem of allocating the residual control rights between the shareholders and external agents and a reduction in the management discretion while controlling the company'. In this respect, in order to solve or at least to reduce the negative impacts of these problems, some precautions can be taken in the company. For example, a high level of transparency can be suggested as an appropriate solution for the agency cost in the company. Transparency, as one of the principles of corporate governance, can be defined as a right to access all kind of recorded information with regard to company at a low cost and in a timely manner (Smith, 2004). The main advantage of a high level of transparency is; it creates a top-down communication between the corporate bodies in a corporate governance structure, which helps to create a well-organised corporation.

Hence, shareholders may have an idea about what is going on in the company and they can easily understand whether the external agents work for the benefits of the company. In addition, a high level of transparency also prevents misbehaviours of the external agents. Therefore, it will prevent or at least help to reduce corporate scandals (white-collar crimes) in the financial markets (Sonmez, 2014). Taken together, it can be claimed that transparency may have a positive impact on the agency cost in the corporate governance structure. Apart from a high level of transparency, better independent auditors can be regulated in the corporate governance structures. Hence, it improves the monitoring system in the company and prevents illegal activities of the external agents by providing secured and reliable information on financial tables of the company. In addition, there should be some dissuasive sanctions in the legislative frameworks. In order to prevent misbehaviours or illegal activities of the external agents, legal systems should be strengthened with dissuasive sanctions. Hence, the external agents may not dare to commit any kind of white-collar crimes in corporations. In general, therefore, it can be assumed that a high level of transparency, better independent audit systems and dissuasive sanctions may have a positive impact on the agency problem of corporate governance.

#### 4.2. The Stakeholder Theory

The stakeholder theory deals with the situation of stakeholders of the company. Fundamentally, it is based on the conflict of interests between shareholders and stakeholders in the company (Clarke, 2004). As mentioned before, in the agency theory, the value maximisation of shareholders is the main objective of the company. However, the stakeholder theory not only focuses on the values maximisation of shareholders, but also it aims to increase the interest of stakeholders (Solomon and A. Solomon, 2004). Therefore, this theory also pays attention to the interest of stakeholders as much as shareholders in the company. In fact, it can be useful to highlight that shareholder primacy is a controversial issue in the literature, because some scholars, such as Siems, Lele or Mukwiri, claim that the aim of improving the interest of shareholders is not only objective of the corporate governance systems; with the new reforms, most of developed countries have also realised the importance of stakeholders for corporations (Lele and Siems, 2007; Mukwiri, 2013). Perhaps, the question that needs to be asked is why the interest of shareholders is also important in a company. Stakeholders may play a key role in the corporate governance structure, in particular for industrial corporations, because they are the main players for the production of industrial companies.

Therefore, they may have a very important impact on the efficiency of the performance of corporations. In this respect, as long as they have a smooth working area; in other words, as long as they feel themselves as a part of a family in corporations, they may work more efficiently and focus on the success of corporations. Hence, their success will convert into the success of the corporation. In addition, in doing so, corporations will act in a socially responsible manner by considering the interest of stakeholders, which will increase the attractiveness of corporations for the long-terms investors (Solomon and A. Solomon, 2004; Sonmez, 2014).

#### 4.2.1. Possible Solutions and Suggestions

As it was explained above, stakeholders may also have some positive effects in corporations. In this respect, it may be useful improving the interest of stakeholders in the corporate governance systems Briefly, the stakeholder approach can be defined as creating a well-organised working environment and a better network of relations between all participants in a company (Sonmez, 2014). Therefore, besides shareholders, considering the interest of stakeholders may increase the performance of corporations and also has a positive impact on the attractiveness of corporations. The German model aims to solve this problem by appointing a stakeholder representative in the supervisory board. In this model, stakeholders can easily articulate their main concerns to the top management via their representative in the supervisory board. Hence, thanks to this top-down communication system, stakeholders may feel themselves as a part of the family and reflect this relation to the performance of corporations. It seems to be essential to improve stakeholders' rights in corporations. In this respect, stakeholders' skills and satisfaction can be improved and their interaction around the firm can be provided. As in the German Model, they may have a representative in the management structure of corporations and they can vote for the issues that are directly link to their works. In addition, corporations can increase the number of the corporate social responsibility projects in order to improve the interaction of stakeholders in a firm. However, there are some debates with regard to the stakeholder theory in the literature. For instance, according to Fernando, the main problem is, it is difficult to define who the stakeholders are in the company (Fernando, 2006). Fundamentally, he claims that managers may illustrate child, homeless, prisoners or even dogs as a stakeholder.

Hence, they can lead to a chaos in corporations and easily commit some white-collar crimes, such as fraud. In order to solve this problem, a high level of transparency and a better audit mechanism seem to play a preventative role again in corporations.

## 5. Conclusion

In this paper, the aim was to clarify exactly what is meant by the term corporate governance and to understand its fundamental problems in the financial markets. In this respect, the main definitions of well-known scholars were examined, the fundamental problems corporate governance were analysed, and the potential solutions were evaluated. This paper has argued that the term of corporate governance is complicated and there are still some problems in general understanding. This is because, due to rapidly changing global financial markets, it needs to be updated and to consider common values of all players in the financial markets. In this respect, the findings of this study show that one size fits all corporate governance may not be possible due to historic, cultural and financial differences. In general, therefore, in order to make a unique definition, corporate governance can be evaluated from legal and economic perspectives and its universal values, such as transparency, accountability, reliability and responsibility can be highlighted. This research has also shown that a well-organised corporate governance structure can be accepted as one of the elements to the success of corporations. In the financial markets, three types of corporate governance models can be considered, 'the Anglo-American Model, the German Model and the Japanese Model'. However, due to these differences, the fundamental problems of corporate governance can be varying in the financial markets. For example, the divorce between the ownership and control (the agency problem) requires a perfect monitoring and auditing system in order to prevent corruption and fraud in the company.

As in the Enron scandal, since the owners of the company have failed to monitor the external agent, they could not realise illegal activities in the company, and so, the company went bankrupt. Hence, the findings of this paper suggest that a high level of transparency, better independent audit systems and dissuasive sanctions may play a key role in preventing the agency problem of corporate governance. In addition to the agency problem, the situation of stakeholders (the stakeholder problem) in the company can be accepted as another fundamental problem of corporate governance.

The stakeholder approach requires the value maximisation of stakeholders as well as shareholders in the company. This study has found that stakeholders may also have a positive impact on the performance of corporations, in particular for the industrial firms. Therefore, their concerns should be considered in the corporate governance structure. This paper suggests that in order to improve the stakeholder approach, it seems to be essential to have a stakeholders' representative in the management of the company. They should be able to vote for the issues that are directly link to their works and corporations should increase the number of corporate social responsibility projects in their agenda. In addition, in order to solve the invisibility problem of stakeholders, the level of transparency and the audit system of corporations should be improved. Taken together, it can be claimed that corporate governance can play a very important role for the success of corporations and financial markets. However, it is not easy to have a well-organised and unique corporate governance system due to historic, cultural and financial differences. Therefore, in creating a better corporate governance system, it seems to be essential to focus on the potential solutions for the fundamental problems of corporate governance and to keep pace with the recent innovations in the financial markets by considering the common values of corporate governance. The result of this investigation also suggests that sectorial differences between corporations should be considered in terms of the corporate governance models. From this point of view, an implication of this is the possibility that the German Model and the Japanese Model can be more appropriate for industrial corporations and the Anglo-American Model can be more suitable for stock equity corporations.

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