# 9 Corporate governance

Some large corporations (particularly PLCs) get up to some very naughty things at times. Why they do this of course we'll never fully know because we're only aware of the ones that get caught. However, it's easy to speculate about what the main reasons are likely to be…

We looked earlier at the most common forms of business organisations and noted that PLCs have shareholders who they have to keep happy. We noted that, in the words of many writers and business leaders themselves, shareholders in general tend to take a much more short-term view about dividend pay-outs than probably the board of directors might like. Directors would often like to retain earnings within the company for reinvestment purposes, but they feel obliged to pay out dividends so as not to annoy existing shareholders and to hopefully attract potential new investors. The decision as to how much to retain as a proportion of earnings of course affects the funds available to allocate to shareholders' dividends. The greater the amount of retained earnings, the less is available for the shareholders.

Things are generally not too bad when times are good for a company, but decisions about how much earnings to retain become more difficult when times get hard. Whatever the trading climate, it's often been said, large companies are pretty much profit-driven. The ever-increasing demand by shareholders for increased dividends, means that ultimately, PLCs are really shareholder driven. Or driven by "shareholder greed" – not my words.

To an extent then, PLCs are in competition with each other, even if they're not in the same industry. Why should this be? Well, shareholders holding shares in a company that isn't for any reason paying out (or increasing) dividends, always have the option of selling their shares and switching to shares in a company which is paying higher dividends. Now, shareholders normally don't want to do this because the act of selling and buying shares isn't free. The costs of trading in shares is normally called 'transactions costs' or trading costs. These fees hit shareholders right in the pocket and they don't like it one little bit. So, shareholders naturally are quite reluctant to sell their shares

unless they feel they have to. Companies know this and to an extent rely upon it. Transactions costs vary as a percentage of the number of shares that you want to trade. As is normal in life, the greater the amount of money you have in shares, the less you'll have to pay in trading costs as a percentage of your shareholding.

Having said that, although shareholders normally are reluctant sell their shares in a particular company, they certainly will do it when they see their dividends falling behind the dividend pay-outs of other companies for too long. So, a PLC isn't just in competition with other companies in the same industry, but is also in a sort of 'dividend war' with other PLCs in virtually every other industry. If you remember what we said in Chapter 6, *Types of business*, we mentioned that being a director of a PLC is not quite as entertaining as us ordinary folk seem to think.

What seems to be an eternal race for profit by large companies can have a very beneficial effect. In theory at least, it should give these firms great encouragement to improve their efficiency in production (a good thing) but it may unfortunately also encourage them to engage in certain other activities designed to increase profit, which may be not quite so moral. I once had a perceptive student who wrote me an essay regarding corporate governance and she said something along the lines of being a bit hesitant to use the words 'moral' and 'large corporations' in the same sentence. She'd obviously grasped the subject area well.

The concept of corporate governance is, to put it crudely, an attempt to encourage corporations to behave themselves. Some systems of corporate governance try to use force to 'tame' such companies, while other systems use a more gentlemanly (courteous and polite) approach. For those students who prefer a more formal definition of corporate governance, the Chartered Governance Institute website (www.cgi.org.uk) says, "Corporate governance is the system of rules, practices and processes by which a company is directed and controlled".

It does sometimes seem that the field of corporate governance is a new one, but it isn't. The concept of corporate accountability dates at least as far back as the emergence of large corporations such as the East India Company in the 1600s. The real position is that corporate governance has become more noticed in recent years because of a whole series of scandals which really shook the financial world. The term 'corporate governance' began to be a trendy term in the 1970s and hasn't as yet gone away.

We have to bear in mind that all incorporated companies under English law are ultimately governed by the 2006 Companies Act. Under this act, directors are given certain rules which they are expected to rigidly stick to. The main rules the act stipulates – from section 170 onwards – are:

- to promote the success of the company;
- to exercise independent judgment;
- to exercise reasonable care, skill and diligence;
- to avoid conflicts of interest; and
- not to accept benefits (which really means bribes) from third parties.

Company law in America has similar provisions as do all legal jurisdictions throughout the world. Whether directors always work within these provisions is what is in question regarding the question of corporate governance.

# Failures of corporate governance

The whole concept is best explained by examples. We'll start with an example of corporate malpractice (misconduct) well known to many students of business studies and/or economics the world over. As many readers will know this was the shocking conduct of an American corporation known as Enron.

## The Enron scandal

Enron was a giant corporation, one of the largest businesses in the United States. It was involved in a variety of business activities including energy and commodity trading, together with some service interests. It was founded in 1985 and bankrupted (or more correctly went into liquidation) in 2001. For years the company had produced reports and accounts which stated that it was in an excellent financial position. Its trading position and profits could hardly have been better, according to the company. At this time the shareholders were blissfully happy.

It was apparently one of the finest companies in the American tradition of hard work and reward. Of course, in reality it was nothing like this at all, otherwise we wouldn't be talking about it. Years of losing vast sums of dollars were hidden by some of the top company directors and accountants. Together these individuals engaged in what must be one of the finest examples of 'creative accounting' the world has ever seen. What we would now call 'toxic' debt of the company's many subsidiary companies were being cleverly hidden.