Understanding Corporate Governance and Board of Directors: A Generic Analysis

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ABSTRACT

This study has taken a simplistic and generic approach towards analyzing the role of board of directors in corporate governance and understanding corporate governance mechanism in this context. The concept of the independency of directors came under discussion in this paper along with the concept of corporate governance which illustrates the concept of independence of board of directors. It has been found that Board of directors play an important role in making smooth functioning and control in organizations. Importance of Board of Directors in Corporate Governance and Responsibilities of Board of Directors also came under discussion in this paper. OECD Principles of Corporate Governance have been included in this paper which is comprehensive in nature. The independence concept of board of directors also came under discussion in this paper and it was argued by Linck, Netter & Yang, (2008) that for internal auditors it is crucial to remain independent for effective results. Determination of the Independence was an important component of this paper which included views and analysis of various researchers for understanding it. The role and significance of Non-Executive Directors was another highlight of this paper. It has been found that the company performance is directly related to the Board Independence and corporate governance should be considered as a system that controls the organizations so that it can provide better and favorable results for organizations. Professionals, individuals and organizations can obtain basic understanding from this paper for modifying and improving their corporate governance system in special consideration of board of directors.

Keywords: Corporate Governance, Shareholders, Board of Director, Responsibilities, Stakeholders, Board Composition, Profits, Non- Executive Directors, Firm Performance, Risk Policies, Acquisition, Board Independence

INTRODUCTION

Corporate Governance is referred as the processes, relations and mechanisms by which the firms and corporation are operated and controlled (Dissanaike and Szilagyi, 2010). Governance structures in any organization is mainly concerned with the rules and regulations, the distribution of rights and responsibilities between different members of the organization including managers, directors, employees, shareholders, auditors and other stakeholders and the procedures and guidelines for making decisions in corporate matters.

The corporate governance illustrates the concept of independence of board of directors. Board of director play an important role in making the strategies and policies of the organization. According to Thomas, (2004) in an effective structure of corporate governance, the ides of an independent director is an important one. As the directors are independent they are more responsible and accountable for their operations.

The concept of the independency of directors is the one that is being delivered in the organizations so that the fundamental objectives of the organizations are fulfilled.

ISSN: 2223-9944, eISSN: 2223-9553

Independent director is one who does not have shares of the company and also not has any material relationship with the company or related persons; the main relationship of an independent director with the company is related to the outstanding fees. In most of the organizations the concept of an independent director and a non-executive director is not the same, as non-executive directors despite of being independent also allowed to own company shares.

All the parties or stakeholders of an organization have a legitimate interest with the company operations either having financial interest or non-financial interests. Directors, management and employees have interests in the company operations as their salaries and wages are highly dependent while the customers and creditors businesses are interrelated with company operations. While government agencies and departments have non-financial interests by identifying the operations are being executed following the corporate social responsibilities. However, the corporate governance concept gives the shareholders a capital gain. According to this, managers and Board of directors are held responsible for the running operations of the company in the best interests of shareholders. Shareholders are the persons who own the company shares and with their investments, company's operations are being executed so an organization having good corporate governance enforces the shareholders' interest to be kept under consideration.

The corporate governance concept is also considered to be competitively new as it sets separate roles for each member of an organization. According to the definitions ofAnil & Zenner (2002), corporate governance is a mechanism, a system, or a definite set of rules and regulations, the companies are controlled and directed by following g such rules and regulations or the mechanism that is set for the company. The concept of corporate governance identify the rights and duties of the members involved in the operations of the company for example, it identify and demonstrate the responsibilities of board of directors, also responsibilities of the top management and distribute the rights of respective shareholders.

The concept also specifies the procedures and rules for the directors for making decisions concerning corporate national and international affairs (Masdoor, 2011). At the same time, corporate governance also incorporates relationships with a wider range of stakeholders. In this regard, Thomas & Jean-Francois, (2009) defined corporate governance as the design of a company that forces or induces the management to manage the operations of the company in the interests of stakeholders. It generates shareholder values by increasing their profits, revenues enhancing corporate growth as well.

Importance of Board of Directors in Corporate Governance

This section provides the explanation of the importance of board of directors in any organization and whether good governance illustrates its importance. As corporate governance focus on the independence of board of directors from shareholders, therefore the importance is highly connected with the good performance of any organization (Bob, 2009). Moreover, they are considered to be the representatives of the shareholders, the main purpose of their existence in the company is to oversee the functions of the company and monitoring whether the operations are being performed in the best interests of the company and are according the identified rules and regulations fulfilling the general objectives. Their importance is associated with the effective responsibilities that they deliver to the organisation.

ISSN: 2223-9944, eISSN: 2223-9553
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Responsibilities of Board of Directors

1. According to the OECD Principles of Corporate Governance (2004), the main responsibilities of board of directors are as follows:
2. All board members of directors must be informed of the issues of the organization and must ethically and in good faith, with care and due diligence, must manage the operations in the best interest of the company and the shareholders.
3. All board members are responsible for reviewing and guiding corporate strategy, setting obvious objectives, major plans, their executions, making of risk policies and their execution and preparing annual budgets for the organizations buy keeping in view the financial positions.
4. All members are responsible to oversee and have monitor for major acquisitions and divestitures.
5. All board members are responsible for selecting, compensating, monitoring and replacing important executives and moreover they are also responsible to monitor succession planning.
6. All board members are responsible for aligning the important executives on their operations and for setting board remunerations after keeping in view of the wider interest of eth shareholders and the company as well.
7. The board of members is responsible to ensure that a formal and transparent board member nomination and election process is being executed in the organization.
8. They must ensure that the integrity of the organizations accounting and financial reporting systems, including their independent audit are withheld in eth organization.
9. The board of directors must ensure that the company is following appropriate internal control systems and that the operations are being executed in the company under these internal control systems.
10. Moreover, all members of the board of directors must oversee the procedures of communication and disclosures, must ensure that the established committees, their composition, and procedures are well defined and disclosed to the stakeholders (Bob, 2009).

However, Brick, Palmon & Wald (2006) and Brown (2007) studies reveal that despite of above mentioned responsibilities, the board of directors also provide the services of counselling and advising in some circumstances. For example, if the CEO of an organization needs to replace, board members provide advices of better members of also council to the potential person suited for the place of CEO. However, according to Bloch, (2005), the responsibility for board of members does not include counselling, they are not responsible for counselling or if they provide advices, the nature of such advices is unclear. Different surveys were conducted by different researchers in order to examine the role of responsibilities that the board of directors are performing.

In some oragnziation, the duties and responsibilies of board members are more diversified, and act beyong the set responsibilities. They are much more empowered than the imaginations, and such cases mostly lie in the family owned businesses, where family intersts dominate the owership and structure of the oragnziations and the board of directors are directed the authority to deal in all types of strategic decisions.

ISSN: 2223-9944, eISSN: 2223-9553
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THE INDEPENDENCE CONCEPT OF BOARD OF DIRECTORS

In different range of corporate governance aspects the significance of board independence concept is very clear. In the context of corporate control the standing of board independence is of crucial importance and considered as basic ingredient (Gregory, 2009). It has also been stated by Solomon, (2007) that for the effectiveness of internal and external auditors the requirement of board independence becomes vital. This indicates that in diverse business and governance contexts the independence factor is valuable one. Moreover in this similar context it was argued by Linck, Netter & Yang, (2008) that for internal auditors it is crucial to remain independent of their peers and contemporaries and this holds true for external auditors as well regarding their customers. This is where the debate of defining independence arises in the context of corporate governance.

For continuing this discussion it can be stated here that Laux, (2008) gave useful definition of independence i.e. it is an attribute that people hold and which is an imperative element towards professionalism and ethical behaviour. Moreover, Klausner, Black and Cheffins, (2005) in their study found that independence is kind of prevarication regarding behaving too biased because of personal or broader benefits. Moreover, this concept of independence in corporate governance was elaborated as something which is set free from all sorts of bounding and which can also restrain the needed follow up actions required for correcting the situation or problem. This reflects that the extent to which board in an organization stays away from being manipulated tends to refer the independence of board as this leads towards undertaking accurate and transparent decisions when encountered with organizational issues and problems i.e. social and friendly relations between the auditor and the employee or individual being audited (Egwuonwu, 2010).

Determination of the Independence

In different situations that an organization may face, there is a general issue that they usually encounter i.e. "ensuring the independence" when a challenge is already injected for that organization which makes it vital to be considered for organizations so that smooth process of CG can be achieved.

In the context of board independence and its different levels Bebchuk & Cohen, (2005) carried out a comprehensive study for determining it. They recognized in their study that a significant factor was the utilization of continua in illustrating independence variables. However, there can be more than one level of indepednece in relation to the contimuum i.e. zero and total independence. The included parties in case of total independence contain no connection with each other inspite of being in the relationship. It has been stated by Agrawal and Chadha, (2005) that the awareness of this issue can be lacked within the invovled parties. Therefore, a justification for acting dependently is not facilitated to the parties. On the other hand, there also exists the zero level of independence and in this particular aspect the parties included appear to behave flexibly.

The Non-Executive Directors

It has been discussed previously in this report that the non- executive director or an independent director's legal dependability is owed to the organization's shareholders. In this context Song & Thakor, (2006) undertook a detailed study and reflected that it is preferred by various shareholders of the organization to include new directors (non- executive) specifically belonging to some other industry for the purpose of enhancing the non- executive directors' independence. This has been an interesting development in the field of corporate governance.

However, there is a strong argument regarding the benefits and limitations of selecting directors (non- executives) that needs to be undertaken by organizations (Slyke, 2006), i.e. in the context of executives having good experience from the same industry or from different industry and at the same time having less experience from the same or different industries. These scenarios can present are powerful implications for organizations.

The company's article of association define that the board of directors must be comprised of a definite number of executive and non-executive directors that they deem to function appropriately and that their presence must provide benefits to the organization (Cadbury, 2002). The nomination committee in an organization and the structure of Corporate Governance reviews the composition of the full Board in keeping view the qualifications and area of expertise of respective directors that are required to further enhance the profitability of the organization.

The composition of the Board including non-executive directors are always found to be advantageous for the company as they provide best recommendations to the Board concerning the critical issues with the use of diversified expertise that they own and also provide assistance to executive directors and to the top management (Klein, Shapiro and Young, 2005).

The Board is comprised of a substantial majority of independent, non-employee directors and the Board considers this to be the appropriate structure. The Board establishes principles and procedures to determine whether or not any particular director is independent in accordance with applicable regulations and the requirements of the relevant stock exchanges.

According to the studies of Brown (2007), the board of directors are the persons of the organization that have the rights and complete legal authority to hire the management, fire the employees, compensate the top managers and to safeguard the invested capital. As non-executive directors are associated with more than one company, therefore can provide more expertise, as they are more experienced and are aware of the multicultural differences of the organization. Moreover, the regular meeting of the executive as well as non-executive directors could prove many benefits to the organization and can identify, discuss and avoid the potential problems facing by the organization. On the other hand, non-executive directors are considered to be the more independent in terms of the provision of effective corporate governance guidelines to the organization management and may prove to provide more efficient performance in terms of increasing revenues and profits.

Studies by Bebchuk and Chohan, (2005) revealed that different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a purpose of its access to information. Executive directors are referred as they possess better knowledge for making decisions regarding critical issues of the company and therefore assess top management on the basis of the quality of its decisions that lead to financial performance outcomes. It could be argued, therefore, that executive directors look beyond the financial criteria.

The Company Performance Is Directly Related To the Board Independence

This section describe the importance of board independence with relevant to eth company performance. With the studies revealed by the researchers, the section demonstrates how much the company performance is directly related to eth existence of an independent board of directors in a company. The studies revealed by Zattoni and Cuomo, (2010) recommend a high level of board independency and that this governance practice must be installed in the codes of corporate governance. This recommendation was provided on the base of the results that the studies revealed that higher level of board independency cause superior performance of the company resulting better outcomes and enhancing companies' profits.

Another study was conducted by the Agrawal and Knoeber (2001) which also indicates that there exist a positive relationship of a corporate performance and the independency for board of directors. As independent directors are allowed to make decisions independently without the inside or outside pressures and that they are supposed to make decisions in the best interest of the company.

Some other studies also reveal an indication that companies which are made of more non-executive members as compared of executive members perform not according to the set objectives. Therefore, the composition of the board of directors including executive and non-executive directors must be one that includes one third of non-executive and two third of executive directors.

The role of the board of directors' particularly non-executive directors is especially important (Donaldson, 2012) in such situations where the operations of the company are highly dependent on the expertise that they deliver to the company such the establishment of the strategies for newly acquired companies, or the execution of the operations for newly launched products and many others.

The non-executive members of the Board of directors can play an important role in limiting the power of shareholders controlling the operations of the company in order to expropriate wealth by ratifying and monitoring important decisions. At the same time, the composition of the board comprised of executive and non-executive directors is likely to be prejudiced by controlling shareholders (Agrawal & Chadha, 2005).

Based on literature review n corporate governance and the principles of good corporate governance, it is revealed that there is a positive correlation between the independency of directors and corporate performance. The research finds an inconsistent correlation between companies' hiring of independent directors, keeping in view of their independency while operating businesses and shareholders profits and corporate performance. From an academic viewpoint, a correlation is found to be existed between company's hiring of independent directors and shareholders profit and corporate performance. However, results of empirical studies have failed to demonstrate a significant relationship between these factors. Nevertheless, other scholars have found a positive correlation. The empirical data regarding the ratio of dependent and independent directors, the company size, board size and the shareholding ratio of the board of directors vary between studies.

The common hypotheses relating to eth composition of the board is that the larger the scales of board of directors are irrespective of the ratio of executive and non-executive directors, the more talented people with professions would be included in the company that provide their services for the best interest of the shareholders and the company as well. These professionals could provide professional knowledge in finance or non-finance aspect. For example, the more directors and independent who own financial and legal professions, the more professional opinions could be proposed while the decision-making of the company, which could help to improve the performance of the company (Bhagat, Sanjay, and Bernard Black, 2002). Therefore, it is revealed from the above mentioned example is that the larger scale the board of directors is, the effects on the company's operating performance and the revenues of the shareholders would be larger.

ISSN: 2223-9944, eISSN: 2223-9553

CONCLUSIONS AND RECOMMENDATIONS

It is concluded from the study that corporate governance is considered to be a system that control the organizations. It includes the processes through which objectives of the organization are set and are pursued in the context of regulatory, social and marketing environment. The common phenomenon of good corporate governance is that the management and board of directors run the businesses in the special interest of shareholders. The responsibilities of members of board are defined; moreover, the composition is also based on the executive and non-executive director that lead the organisation to better performance in order to gain a competitive advantage in the market. The main principles of good corporate governance include the rights and equitable treatment of shareholders, interests of other stakeholders, integrity of ethical behaviour, role and responsibilities of board of directors and disclosure and transparency.

The above mentioned study was a discussion of one of the principles related to the board of directors of the company, its composition, advantages and disadvantages of its composition and the impact of its composition on businesses performance.

It is recommended through the study that the companies must consider for the appropriate composition of its board of directors, must have experienced non-executive directors and they must be independent so that they can provide their expertise in the best interest of the company. Moreover, the performance of the executive directors must be monitored by the non-executive directors as they are considered to be independent of the benefits associated with the operations of the companies. Further, it is recommended that the critic policies are also monitored accurately.

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ISSN: 2223-9944, eISSN: 2223-9553
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ISSN: 2223-9944, eISSN: 2223-9553