Why does Corporate Governance Become So Important? An Attempt to Identify the Major Causes for Calls to Improve Corporate Governance

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Abstract
This paper is an attempt to identify the major causes for calls to improve corporate governance whether at the firm level or at the country level. The last three decades has witnessed exponential increase in corporate governance awareness, corporate governance regulations and a drive for improved corporate governance. Based on the review of the relevant literature five reasons has been identified as the major causes for calls to improve corporate governance. These causes are a) increase in firm size and complexity, b) separation of ownership and management, c) exponential growth of capital markets, d) increase in fraud cases and financial crises and, e) increased awareness of corporate governance impact on firm financial performance.
Keywords: Corporate Governance, firm size, market growth, fraud, separation of ownership

1. Introduction

Corporate governance has come to the forefront of knowledge as a distinct and expanding field of study (Parker, 2014) and gained momentum as a result of the infamous corporate fraud cases that occurred during the last three decades, such as the case of Enron and World Com in the USA. In addition, the recent financial crises in 2008 have further emphasized the impact of poor corporate governance on firms' performance and the repercussion of that on countries' economic growth as well. The last three decades has witnessed exponential increase in corporate governance awareness, corporate governance regulation and a drive for improved corporate governance. Five reasons have been identified as the major causes for calls to improve corporate governance. This paper is organized in four sections, following this introduction, is section two which reviews and evaluates critically the debate on the definition for corporate governance, followed by section three which identifies and discusses the major causes for calls for improved corporate governance and the final section is section four which concludes summarizes and gives recommendations for future research.

2. Definition of Corporate Governance

The extant literature revealed that there is no agreement among researchers and organizations on a single definition for Corporate Governance, definitions differ based on the perspectives and the varying outlooks and exposure of researchers Armstrong and Sweeney (2002). Some definitions have been criticized as being too narrow while others have been criticized as broad (Ntim, 2009). A definition is classified as broad if it focuses on all stakeholders' protection without defining who these stake holders are, and it is classified as narrow if it focuses on shareholders' interest maximization while disregarding or ignoring other stakeholders' interests.

The most widely used definition is the Cadbury Report definition, where it defines corporate governance as how companies are managed and controlled(Arifin *et al.*, 2014; Cadbury *et al.*, 1992). This definition highlights the need for good management and good control without getting into the dilemma of being pro maximization of shareholders' interests or pro protection of stakeholders.

In (2001) The Organization for Economic Cooperation and Development (OECD) defined corporate governance as a system governing the relationship between executive management and shareholders. This definition seems very broad. In 2010 the Organization OECD offered a more comprehensive definition that defines Corporate Governance "as a set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled". Both OECD definitions focus on managing and controlling the relationship between corporate managers and equity owners in order to mitigate the negative impact of the agency conflict.

According to (Velnampy, 2013) corporate governance is concerned with ways in which all stakeholders implement mechanisms to protect their interests. Velnampy definition is considered too broad because of the infinite number of stakeholders involved. According to (Rezaee, 2008) corporate governance can be defined as "a process through which shareholders induce management to act in their interest, providing a degree of confidence that is necessary for capital markets to function effectively". Rezaee (2008) definition heavily draws from agency theory and emphasizes on the need to induce management, probably to arrive at some goal congruence where executive management's interests are aligned to the interests of shareholders.

In March 2003 the Australian Stock Exchange (ASX) Corporate Governance Council published corporate governance guidance for Australia where Corporate Governance is defined as "the system by which

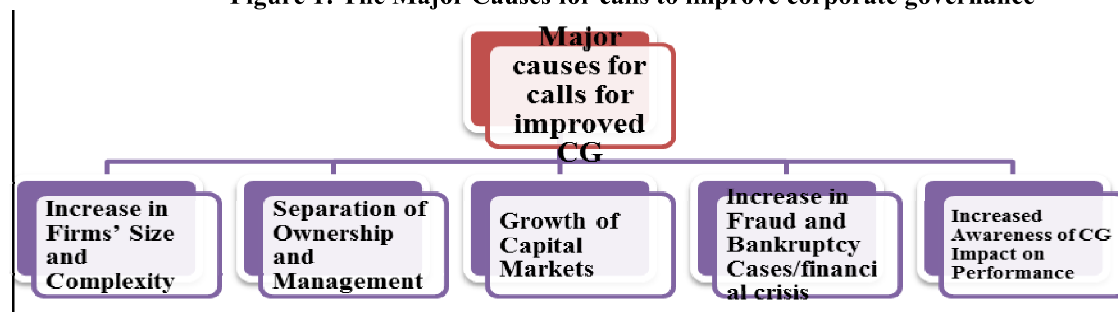
companies are directed and managed and the risk is controlled". This definition is most comprehensive since it includes the risk involved as part of the definition of corporate governance.

In light of the above it can be concluded that there is significant disagreement among researchers and institutions concerning the definition of corporate governance; such diversity is caused by the ever expanding scope of the subject of Corporate Governance itself and on whether executive management is responsible to maximizing owners' equity or to also protect and maximize the interest of other stakeholders', including employees, community, banks, etc., Sundaram and Inkpen (2004) argue that companies' objective is maximization of owners' wealth whereas Donaldson et al. (1983) and Freeman and McVea (2001) argue that firms are responsible to all stakeholders not only to their shareholders. Mc Vea's argument highlights the need to realign companies' objectives to those of shareholders in order to strike a balance between shareholders' wealth maximization and their responsibility to other stakeholders. Accordingly to this argument the definition for corporate governance should incorporate both shareholders' wealth maximization and the firm responsibility to other stakeholders. However for the researchers view corporate governance as a set of mechanisms imposed by regulators, companies' boards and shareholders so that the negative impact of agency conflict can be mitigated.

3. The Causes for calls for Improved Corporate Governance

The first two decades of the third millennia are witnessing exponential increase in corporate governance awareness, corporate governance regulations and a drive for improved corporate governance(Black *et al.*, 2014; Fox, 2014). Five reasons can be identified as the major causes for calls to improve corporate governance. Figure 1 provides a summary of the major causes for calls for improved governance.

Figure 1: The Major Causes for calls to improve corporate governance



3.1 Increase in firm size and complexity

Business entities are becoming more global and more complex due to the increase of the size and number of multinational firms. Firms become more complex (Poschke, 2014) because they work in different cultures, exposed to more risks and operated by professional management teams who are not owners. These changing and evolving conditions have created the need for improved corporate governance in order to protect firm owners and other stakeholders from abuse by professional management. Increase in firm complexity due to extensive spatial and or line of business diversification limits transparency hence it increases the demand for corporate governance (Bushman et al., 2004).

3.2 Separation of ownership and management

Separation of ownership and management is considered a major driver for improving corporate governance due to the impact of principal agency conflict. According to (Berle and Means, 1932) separating ownership from control creates incongruence between the goals of managers and that of owners, therefore sometimes managers do divert from corporate goals in order to achieve their own personal goals.

3.3 Growth of capital markets

The unparalleled growth of capital markets in developed, developing and emerging markets is also another driver for improved corporate governance regulations. Capital market growth need to be coupled by stringent, governance framework that guarantee competency of boards and boards accountability in order to mitigate the impact of agency theory and to avoid capital market collapse. Capital markets crashes that happened in 2008 due to corporate governance failure caused the whole world economy to collapse and lead to worldwide economic crises. The financial crisis that hit the South East Asian countries economies in 1997 was partially due to inefficient governance systems, including poor reporting practice (Becht et al., 2003, 2011; Furman et al., 1998)

3.4 Increase fraud and bankruptcy cases

Fraud and loose governance is considered number cause for financial (Jelal and Mbohwa, 2014). Regulations such as Sarbanes Oxley (2002) in the USA and the recommendations of the Cadbury committee in the United

Kingdom (UK) which both call for more stringent corporate governance regulations are the direct result of reactions to corporate fraud cases.

3.5 Increase awareness of corporate governance impact on firms' performance

The increase in awareness of corporate governance impact on firms' performance is also considered one of the major Drivers for improved corporate governance. O'Regan and Oster (2005) argue that poor corporate performance and stakeholders' dissatisfaction are direct result of poor corporate governance. "Good governance is now accepted as vital to achieving the United Nations Millennium Development Goals and as a pre-requisite for sustainable economic growth"(Oman and Blume, 2005)

4. Conclusion and recommendation for further research

Awareness campaigns lead by the Organization for Economic Development OECD, other regulatory bodies and governments in 1990s have resulted in the introduction and adoption of the OECD principles(Governance, 2004) for corporate governance by both developed, developing and emerging markets and the introduction of corporate governance codes.

This paper based on the review of the extant literature has identified five major reasons the researchers believe to be the major causes for the increased attention given to improved corporate governance, by international organizations, by governments, by financial institutions and by academic researchers.

The researchers recommend that future research examine the impact of these causes on corporate governance development at both firm level and country level.

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