WHY THE ACCEPTANCE OF VOLUNTARY CODES ON CORPORATE GOVERNANCE BY LISTED FIRMS IS SO RAPID?: A THEORETICAL EXPLANATION

Walter Gunathilake, Anil Chandrakumara***

Abstract

Implementation of principles of the Codes on Corporate Governance (CCG) is aimed at minimizing agency conflicts and corporate governance problems in the listed firms. It is, however, observed that such conflicts and problems occur frequently despite the rapid implementation of the CCG by listed firms. We developed a theoretical framework to understand why do firms accept and implement the voluntary CCG principles and what type of behaviours could be expected from top management. We argue that ccorporations implement the principles and provisions of the voluntary CCG due to (a) their compliance with societal norms and ethics,(b)coercive isomorphic behavior of managers, (c) the need for basic integration and adaptive and mimetic behavior of managers, (d) specific needs of corporations, and (e).strategic vs. self- focused behavior of CEOs and non-executive directors (NEDs).

Keywords: Corporate Governance, Voluntary Codes, Agency Conflicts, Ethical Behabiour

* *University of Greenwich, UK*
** *Corresponding Author, Sydney Business School, University of Wollongong, NSW 2522, Australia,*
Tel.: +61-02-42214034
Email: anilc@uoe.edu.au

Introduction

Due to the adaptability to suit the needs of listed firms, Codes on Corporate Governance(CCG) have become popular in listed companies across many market economies (Gregory & Simmelkjaer, 2002) and in many big and small emerging economies such as China (Tam, 2000), Taiwan (Luan and Tang, 2007) and Sri Lanka (Gunetilleke, 2009). The rapid implementation of the CCG has caused strengthening the board and the role of Non-Executive Directors (NEDs) to avoid agency conflicts and many other corporate governance problems (Fama & Jensen, 1983; Shleifer & Vishny, 1997; Pass, 2004, Cromme, 2005). However, empirical studies find that the agency conflicts and corporate governance problems emerge repeatedly (Fleming & Zyglidopoulos, 2006; Luo, 2006). The editorial of the Wall Street Journal (2008) points out that even the mandatory regulation of Sarbanes – Oxley Act 2002 has not succeeded entirely to prevent frauds in the context of US. Luo (2006) shows a variety of managerial opportunisms such as behaviour performed by one party to seek unilateral gains at the expense of another party or parties by breaching explicit or implicit agreements, exercising private control, withholding or distorting information, withdrawing commitments or promises, shirking obligations, or grafting joint earnings. As such, what we observe in reality is a 'paradoxical compliance' (e.g. MacDonald, Nail & Levy, 2004:78), that is the acceptance of CCG on the one hands and the emergence of corporate governance problems on the other. Therefore, we have an 'intellectual puzzle' (e.g. Mason, 1986:15) as to why do the listed firms voluntarily accept the principles of CCG? and why the acceptance of them is so rapid across firms?

The aim of this paper is to answer this intellectual puzzle by paying particular attention to type of behaviours among CEOs and NEDs through a theoretical analysis and subsequent formulation of propositions, which is structured as follows. First, we highlight the significance of addressing in the context of listed firms and their CSR. Then, we explain the ideas of voluntary CCG and provide evidence to justify the paradoxical issue. The final section of the article presents the literature and arguments that support the formulation of propositions.

The intended theoretical analysis is important for number of reasons. First, the implementation of the principles of codes by a firm costs to stakeholders. The cost may include quantifiable items such as payment for the NEDs to attend the meetings, travelling expenses, remuneration of Chair and so on and non-quantifiable expenses such as allocation of the time of executives to prepare various reports for the NEDs and Chair (Vafeas, 2003). According to the Financial Reporting Council in the UK (FRC, 2006), various elements of costs to be borne by the listed companies include, fees for the new NEDs, costs for tailored induction for new directors, cost of training and development of NEDs, performance evaluation of boards, and additional company secretarial resources and insurance cover. These expenses are to be borne by none other than the shareholders. In the case of mandatory regulations, a part of cost is born by taxpayers and regulatory bodies such as the Registrar of Companies and the Independent Oversight Bodies appointed under the direction of the Sarbanes - Oxley Act, 2002 in the US (Anand, 2005). In the case of voluntary compliance and less mandatory regulations, investors have to bear the cost of monitoring. Therefore, better corporate governance is required to reduce these costs.

Second, corporate governance in listed companies is important due to the creation of employment opportunities, contribution to the economy of a country and cross border capital flows (McKinsey Global Institute, 2008). As such, failure in corporate governance results in a huge social cost to the society especially to taxpayers as evidenced by the historical case of the South Sea Bubble (Chapman, 1986) and many other collapses in 1990s such as the Bearing Bank, and Enron and World Com, and bankruptcies such as the Northern Rock bank in the UK and Lehman Brothers in USA (Šević, 2005). Third, researchers have studied various factors which influence the listed companies in their choice of internal corporate governance mechanisms (Fama & Jensen, 1983; Bathala & Rao, 1995). However, there is a gap in the literature to understand the factors, which could influence the listed companies to comply with the voluntary codes on corporate governance. Therefore, our analysis could be a significant contribution to corporate governance literature and organisational practices.

Voluntary Codes of Corporate Governance

Security Exchange Commissions or the regulators of the public limited liability companies (PLCs) in many countries have introduced non-regulatory codes or voluntary codes on corporate governance. Code of Best Practices, popularly known as the Cadbury guidelines (Cadbury, 1992) and the subsequent introduction of many other codes provide guidelines for the PLCs to improve corporate governance practice. The present Combined Code on Corporate Governance (FRC, 2008) has incorporated many of these guidelines as main principles and provisions which consist of: (1) separation of the role of the Chair and the CEO, (2) appointment of majority of NEDs, (3) appointment of number of sub committees of the board of directors comprising only the NEDs (audit, remuneration and nomination), and (4) appointment of a senior independent director to liaise between the institutional investors and the board as well as the NEDs and the Chair.

These principles and provisions have been incorporated as listing rules in the London Stock Exchange (LSE). PLCs in the main market of the LSE are required to either comply with or explain the reasons for not complying with the Combined Code (FRC, 2008). A large number of companies in the Alternative Investment Market (AIM) in the LSE also implement some of the principles of the above code when they are only encouraged to think of getting the benefit of accepting the guidelines of the Combined Code (Gunetilleke, 2009). The principle of 'Comply or explain' (FRC, 2008:1) suggests that listed companies to choose the best practices to suit the size of the firm, future needs and potential agency conflicts rather than pushing firms on to a mandatory compliance or to a model of 'one-size fit-all' (Filatotchev, 2005:26) such as the Sarbanes - Oxley Act 2002. Studies of Piotroski & Srinivasan (2007) point out that some of the firms de-listed from the New York Stock Exchange (NYSE) have listed in the AIM in the LSE in order to avoid mandatory regulations of the Sarbanes - Oxley Act 2002 and some Initial Public Offers (IPOs) have opted to go to the AIM instead of listing in the NYSE.

Corporations as Social Units

Understanding the reasons for the emergence of mandatory company regulations such as the Companies Acts and non-mandatory regulations such as the CCG is required in the context of the broader social framework. Social contract theory argues that the citizens of a country and the government enter into a contract and that government has to take necessary actions to meet the expectations of the society. Accordingly, we argue that the listed firms are social units with a specific role to play in the economy and the society (Aguilera & Jackson, 2003). Firms are situated within a given society and political tradition, which will influence the decisions of individuals within the firm (Aguilera et al., 2006). Of course, corporations are an essential integral in the organizational society (Morgan, 1997) and therefore whether they be large or small, companies are social units as they are created to fulfill the expectations of the society (Ducker, 1974). When there is a threat for the normal situation, a government comes under pressure from the society to take corrective action (McCormick, 1976). Corporate failures in the capital markets have been such a trigger to disrupt the *status quo* in the society as evidenced by the corporate collapses in the recent past.

Influence of Social Forces on Managerial Behaviour

Organisational man is a social and political animal and the behaviour is conditioned by the social norms and values in the organisation Gibson (1966). As noted in the Social identification theory (Obst & White, 2005), the members of a society, whether known or unknown to each other, build up a 'psychological sense of community, in which the foundation is the acceptance of the social norms and values. In such a community, a little request to comply for something could lead to a large compliance (Scott, 1977) and structures and processes are created to accommodate and pull individuals into the line of beliefs and practices of the society. If there is a deviant behaviour, punishments are inevitable and the rewards are offered for the obedient members across all the structured organisations such as the armed forces, educational institutions, religious places and in business organisations (Sonnenfeld, 1985). As such, the nature of such social units is to associate with the likely minds and to follow the social norms established in order to maintain the coherent values and the program of actions (Kadushin, 2002). In order to ensure that the members follow the structured norms and values, Bowles & Gintis (2002) argue that informal build up of social norms stand up to avoid any threats for the stability and the orderly conduct of the norms and values. Bothner (2003) argues that when a social actor's rivals have adopted an advantageous trait, that actor is then likely to adopt it in order to avert the probable social and economic costs of falling behind. Feldman (1984) also points out that 'Informal rules adopt to regularize group members' behaviour. As such, PLCs operate to achieve not only the individual corporate objectives but also to protect common interests of them, especially when there are threats to change the existing structures such as statutory and non-statutory rules and regulations (Ornstein, 1984). Accordingly, O*rganisational men* (Gibson, 1966), such as the board of directors, CEOs, the *elites* in top management (Pettigrew, 1992) are influential in maintaining a certain framework of social norms in the business society (Mizruchi, 1983). In order to stand for the common needs of a larger society and to maintain social legitimacy, companies are keen to maintain public relations (Belkaoui & Karpik, 1989). Public relations through social interactions help companies to fall in line with the societal values (Monks & Minow, 2004). When a company does business respecting the societal and ethical values of a society apart from the legal compliance (Goodpaster, 1991), it gains social legitimacy (Suchman, 1995). In line with these realities and arguments, we derive our first proposition.

Proposition 1: *Corporations implement the principles and provisions of the voluntary Codes on Corporate Governance due the acceptance of and compliance with social norms and values.*

Interlocking Directorships and Coercive Isomorphism

Managers and leaders with social contact networks tend to monitor information more effectively (Burt, 1997). Network structures are a key decisive force on the speed of spreading the governance practices and expose a firm to a particular role model (Davis & Greve, 1997). Thus, managers have a collective informal behaviour due to the influence of the interlock directorates (Davis, 1991). Therefore, corporate actions are not determined solely by the characteristics of their own but also by the actions and characteristics of other organizations in its environment (Davis, 1991).

Ornstein (1984), by investigating the interlocking directorships of more than 5,000 interlocks among the largest Canadian companies during the period of 1946 to 1977, argues that interlocking directorates serve to coordinate the political and ideological orientation of the capitalist society. Accordingly, boards are viewed as vehicles that corporations use to control other corporations, to co-opt threats in their environment from competitors, suppliers, customers, and regulatory agencies. Similarly, D'Aveni & Kesner (1993) argue that cooperation and resistance may be a function of the social networks and power relationships that exists between and within firms. Thus, social influences lead to 'Coercive isomorphism' or the acceptance of a certain pattern of behaviour under influence (Ashforth & Gibbs (1990:178). In such situations, the CEOs as well as the NEDs could become the targets to overt conformity (Quiamzade et al., 2003). Stiles & Taylor (2001) argue that executives would follow the plans of chief executives, but may not agree with the plans in private but approve as they depend on the CEO for their own ambition of reaching to the top position of the firm. As such, an individual has to subdue self-conscientiousness of the need to resist for external influences and therefore PLCs may comply with certain way of doing business collectively in order to avoid any damage on business (Bothner, 2003). Reflecting this reality, Neilson & Rao (1987) argue that people do not speak openly about information and ideas if it might harm their chances at achieving their objectives or if it validates their standards of personal development. These arguments and realities led us to develop our second preposition as follows.

Proposition 2: *Corporations implement the principles and provisions of the voluntary Codes on Corporate Governance due to coercive isomorphic behavior of managers and leaders.*

Need for basic Integration and Adaptive and Mimetic Behaviour

According to Soeters (1986), the model of *excellent companies* (Peter & Waterman, 1982) highlights behaviours similar to the norms and values of cults in the US that existed during 1980s. In cults, there is a certain belief about the world and life with a strong leadership and devoted set of followers who do not question the beliefs and the values other than sharing them with the fellow members (Stark & Bainbridge, 1980). The values and the beliefs bind them all together. Similarly, in the *excellent companies*, the employees were groomed to believe of certain values in business and each individual shared the same values irrespective of the position of the firm. The tendency to maintain and build relationships is high in the right context. Grossetti (2005) argues that the social relations are created among people when they have close interests and are aroused out of certain contexts but rarely on chance meetings. The argument behind shared values and principles of culture of an organisation also justify this view point. As human beings are frequently motivated to create and maintain social relationships with others (Cialdini & Goldstein, 2004), it is important to note that mutual gains solidify those relationships (Jensen & Greve, 2002), which may lead to create strong social processes (Ryan, 1999) and internal integration within organizations (Schein, 1992). According to Schein, culture is 'a pattern of shared of basic assumptions that a group learned as it solved its problems of basic adaptation and integration that has worked well enough to be considered valid and therefore to be taught to new members as the best way to perceive, think, and feel in relation to these problems'(Schein, 1992, p.12). Taking another perspective, Hampden-Turner (1990) argues that culture is the outcome of the process of strategic decision-making in organizations. Falling in line with these arguments of cultural influences and interactions, Menon & Williams (1994) argue that the formation of sub committees of the board is an attempt to show good governance to make the shareholders pleased.

Another aspect of cultures in organizations is the creation of social context that influence on the individual's role in corporations, *organisational men* (Gibson, 1966), compare and contrast their practices with the others in similar level or above their levels of operations and follow the same pattern (Suls, Martin & Wheeler, 2002; Shackleton, 2005). In social context, Hong, Kubik & Stein (2004) observed that the transactions of stocks in the stock exchange by shareholders are influenced by the decisions of peer groups. Thus, the mimetic behaviour is a natural phenomenon both in organizational and social context. As such, managers are required to make strategic decisions with regard to adaptation of their organisations to external changes and internal integration on the one hand and to follow the steps of their superiors and leaders on the other hand. This argument led us to develop our third proposition as follows.

Proposition 3: *Corporations implement the principles and provisions of the voluntary Codes on Corporate Governance due to need for basic integration and adaptive and mimetic behavior of managers.*

Specific Needs of Corporations

If the acceptance of corporate governance codes were purely in view of the needs of the investors other than the influence of the social forces, investors would be lucky to get 'informed decisions' (Monks and Minow, 2004:83). Private firms may find it difficult to attract investors by IPOs due to lack of trust by investors (Pagano, Panetta & Zingales, 1998). In general, information plays the key role in making informed decision by market participants and therefore the availability of information in the corporate sector suggests a good state of financial and governance transparency (Bushman, Piotroski & Smith, 2004). As Fama & Jensen (1983) argue shareholders are risk experts in diversifying the portfolio of investments but face the problem of information asymmetry as the managers withhold some information. With regard to the link between information and corporate governance mechanism, a number of authors find that corporate governance mechanisms such as the appointment of NEDs and the separation of chair and the CEO would result in increased disclosures and strong incentives for the shareholders to remain loyal with their investments (Chen & Jaggi, 2000; Bushman, Piotroski & Smith, 2004; Barako, Hancock & Izan, 2006).

According to some scholars (Schmidt & Spindler, 2002); Zahra & Filatotchev 2004), specific corporate governance mechanisms of a firm would be decided by path dependence, level of knowledge acquisition and contingencies and life cycle stage of a firm. As such, Filatotchev (2005) argues that the development of 'one size fits all' corporate governance codes may be highly problematic for firms at different thresholds in their life cycle. Similarly, Pye & Camm (2003) also questioned about the rationality of a particular model for all the companies. For example, Finkelstein & D'Aveni (1994) point out that the holding of both the role of Chair and CEO by a single hand (duality) is required when a firm needs to map out strong strategies and to implement and monitor the performance of executives at crises. They suggest that when a firm has continuous success in the market, it is required to separate the office of Chair and CEO. Unless the separation of office of Chair and CEO is done, CEO becomes powerful with the good results and gets entrenched.

Some other firms resort to the minimum legal requirements to practice corporate governance codes due to switching costs (Hart, 1995, Vafeas, 1999). In a study of the implications of de-regulations in the US on the airline industry, Kole & Lehn (1997) found that the corporate governance structures evolve to suit the competition and the inability to make the changes in a firm lead to disappearance of the same from the market place. According to them, firms that survive in competitive markets are presumed to have optimal governance structures. In addition, Li (1994) found that the ownership structure, the degree of leverage, size of the firm, level of performance in the market and strategy of the firm decide the structural composition of the board. Williams, Fadil & Artmstrong (2005) also argue that moderate size of a board has the ability of minimising illegal activities in organisations when they have complex structures and scattered markets. Accordingly, we developed our fourth proposition as follows.

Proposition 4: *Corporations which comply with selected principles and provisions of the Codes on Corporate Governance do so due to their own specific needs.*

Strategic Behaviour of CEOs and NEDs and CCG

When there are more NEDs than the insider directors or the executive directors in the board, the ability of the CEO to enjoy privileges such as the appointment of the desired personnel rather than the best, give them promotions and maintaining perquisites such as luxurious offices (Berle & Means, 1933) and higher compensation for self and favoured executives could be limited (Bebchuk & Grinstein, 2005). Therefore, the excessive monitoring by NEDs would lead the CEO to find ways of reaching the NEDs and enhancing his or her power base through impression management (Gardner & Martinko, 1988; Westphal, 1998). The tenure of a CEO is a decisive factor to influence the NEDs as more the tenure of work experience of a CEO more the knowledge and ability to influence the NEDs to approve business plans (Hill & Phan, 1991). CEO has the authority of the information system in the firm and the willingness to provide information required by the NEDs seems to rest upon the CEO. Impression management tactics of the CEO towards the NEDs would result in recognition of the abilities of the CEO by the NEDs and in securing approval for his plans of diversification decisions (Walsh & Seward, 1990). According to Amihud & Lev (1981), CEOs are keen to diversify through mergers and takeovers because they have no any other way of diversifying their own risk of job survival. In their study on the relationship between CEO and the board, Zajac & Westphal (1996) also agree with the above view as they suggest that by diversifying into unrelated businesses, managers can stabilize their investment portfolios and reduce their employment risk.

With regard to relationship between executive directors and CEOs, Katz & Kahn (1978) argue that a relationship built among colleagues centred on the CEO during a long-term period tend to bind them all strong as a group. The charisma of a CEO results in creating favourable attribution among the followers because a successful CEO creates a sense of mission and an inspirational vision (Waldman et al., 2004). The relationships built on these practices would lead to a high level of cohesiveness and therefore tend to take action jointly. Hambrick & Mason (1984) also agree with the above contention that CEOs tend to share tasks and power to some extent with other team members. All these arguments are in line with Drucker's (1974) assertion that large organisations face unstructured, complex and uncertain decision environments and therefore, it is difficult for a single person to take managerial responsibilities.

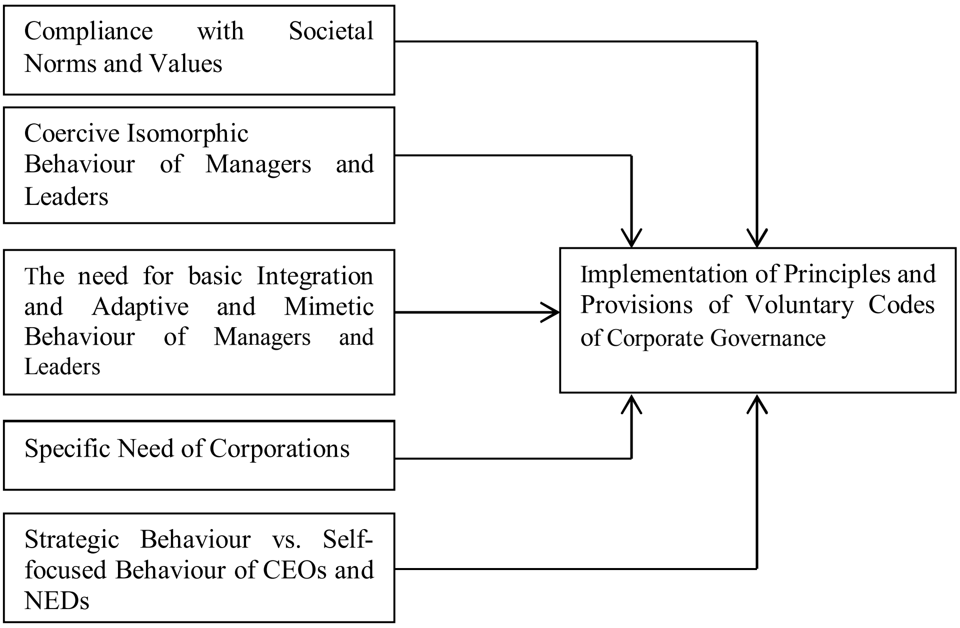
Exploring another aspect of these relationships, Borokhovich, Parrino & Trapani (1996) note that executive directors depend on the CEO for their promotions and future career expectations. Offer of outsider executive directorships to insider executives is mainly decided by the relational power of the executives to the CEO (Richardson, 1987). Executive directors get their power through their position and relationships with the CEO (Minszberg, 1983). Thus, the protection of the CEO from an emerging power will be considered as important by the executive directors. Unless it is done, all the privileges enjoyed by the long stay of executives in the company will be lost. In this context, it could be expected that a CEO be supported by the subordinates to face any threats in the environment including the regulatory bodies. Katz & Kahn (1978) of course argue that a relationship built among colleagues centred on the CEO during a long-term period tend to bind them all strong as a group. Therefore, the NEDs could be considered by them as a threat for their usual way of making decisions in strategy formulation and day-to-day operations. As such, Walsh & Seward (1990), argue that Managerial or CEO's behaviour could cripple the corporate governance mechanisms. In the long run, in the context of polarisation of relations between the NEDs and the executive directors due to the widened information asymmetry, lack of strategic thinking and faulty attributions for success and failure by both the board and the management could occur (Sundaramurthy & Lewis, 2003). As a result, a corporation would not be competitive in the market and eventually would collapse (Thusman & Oreilly, 1996). If the working relationship of the management and the board were good, it would create a situation to get the best possible corporate governance mechanisms (Westphall, 1999). Stewardship theory of corporate governance also believes that the managers are conscious to protect the assets of the shareholders (Davis, Schoorman & Donaldson, 1997) and therefore they must be encouraged. As such, the board tends to be in more supportive mood that in control mood.

According to Mizruchi, board of directors represents 'a self-perpetuating oligarchy accountable to themselves' (1983:427). The NEDs too are a part of the board. NEDs are professional referees (Fama & Jensen, 1983) and their future prospects of getting NED posts elsewhere depend on how they perform in the present corporation. Maintenance of reputation of the NEDs as expert decision makers enables them to get more directorships (Ferris, Jagannathan & Pritchard, 2003), more earnings (Yermack, 2004), and higher positions in the future career (Fich & Shivdasani, 2006). However, such developments of a NED could not always be considered as useful because Baumeister & Exline (1999:1173) argue that prideful people may be so self-focused that they are less prone to contribute to the group's welfare or to be willing to make sacrifices for others. Many researchers argue that the NEDs could behave opportunistically to protect their reputation (e.g. Byrd & Hickman, 1992; Helland & Sykuta, 2005; Miwa & Ramseyer, 2005). Therefore, there could be a tendency to emphasize more on corporate governance than the prime role of the director that is directing the corporations to achieve the business objectives of the shareholders (Jensen & Fuller, 2002). If the NEDs were opportunistic to serve their own interest as argued above, they would be more interested in outcome behavior rather than the strategic behavior (Hillman & Dalziel, 2003). In such situations, the NEDs would behave opportunistically to claim the good performance of the corporation as their own effort and in the case of poor performance; they would say that the CEO has chosen wrong strategies (Walsh & Seward, 1990). Based on the above arguments on the behavior of the NEDs to protect their self-interest, we develop the following proposition.

Proposition 5: *Strategic behavior of CEOs and Non Executive Directors would insist more on the implementation of the codes on corporate governance than it does by their self-focused behavior.*

Based on the above prepositions, we developed the following conceptual model of implementation of CCG principles by listed companies.

Figure 1. A Conceptual Model of Implementation of Principles of CCG



Conclusions and Implications for Research

Codes on corporate governance and their implementation have become very popular across many countries. However, empirical studies revealed number of issues associated with the acceptance of principles of CCG and the behaviors of CEOs and NEDs. In this paper we attempted to answer the intellectual puzzle of why do listed firms voluntarily accept the principles of CCG? In addition, what are the types of behaviors among CEOs and NEDs in the relevant context?

Through a theoretical analysis and accompanying propositions, it was revealed that it is important to understand whether the firms accept corporate governance in order to improve their own governance by complying with social norms and values or whether to follow the others (mimetic behavior) or whether the firms are coerced to follow (isomorphic behavior) or whether the NEDs themselves are keen to protect their goodwill and thus are strict in corporate governance or else whether the opportunistic CEOs accept them and make an impression to the market on their firms. This is really a difficult issue to answer properly. The propositions built on above themes are useful to think in real terms whether the acceptance of the codes on corporate governance shows best practices in corporate governance. Authors have documented evidence to support that the type of internal corporate governance mechanisms are a result of adaptive and evolutionary processes as well as addressing particular needs of the firms. However, when there are a significant number of companies accept and implement the non-regulatory codes on corporate governance, we must question why and how as well as the implications of such a change. The pattern of change will follow a particular direction or route and largely all societies will eventually go down the same road (Warren, 2003). So what are the specific countries and companies who follow the same root? Are there different roots to follow when facing changing circumstances under new global issues and realities of corporate world? Answers lie with further exploration and empirical investigation of the implementation of CCGs.

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