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Corporate Governance Speaks! – A Responsible Individual becomes Responsible Leader

SAI SREEVATHSAV IMANDI[1]

ABSTRACT

To examine the role of the Board in a company's success, this paper aims to provide a concise overview of relevant corporate scandals and triumphant corporate narratives. A brief inquiry reveals that the deterioration of a company often begins at its core, namely, the Board. While there has long been interest in understanding the connection between Board performance and corporate achievements, this paper advises researchers to learn from past mistakes. These errors include relying solely on assumptions such as ethical erosion within the Board as the cause for corporate failures, as well as using single performance measures to comprehend this relationship. To gain deeper insight into this subject matter, it is suggested that a more purposeful approach be taken. This involves revisiting past corporate scandals and contrasting them with successful stories within corporations. By doing so, we may be able to identify cause-and-effect relationships and shed light on areas that require further focused research. Such endeavours would undoubtedly bring immense value to this crucial field of study. The purpose of this study is to examine the impact of the Board on company performance using real-life examples and information from secondary sources. The prime focus will be on specific corporate scandals and successful corporations that demonstrate good corporate governance practices. A hybrid methodology, combining theoretical and qualitative techniques, will be utilized, relying on information gathered from secondary sources. Upon initial examination, it becomes apparent that it is the Boards themselves that are responsible for failures in adhering to good corporate practices, leading to a decline in overall company performance. Upon closer examination, it becomes evident that there is a deeper layer of complexity to the situation. It appears that external auditors, who are entrusted by the public, have learned from their past errors, and have now made it customary for stakeholders to view their actions of adhering to fines as signs of accountability. Surprisingly, neither regulators nor stakeholders have taken strong action against them in most of the scandals. This study further recommends focussed research on these issues.

Keywords: *Good Corporate Governance, Board Leadership, Responsibility.*

[1] Author is a Law Officer at NLC India Ltd., India.

I. INTRODUCTION

The implementation of corporate governance practices has played a crucial role in enhancing value creation and financial performance, particularly in response to widespread corporate scandals that have rocked the global business landscape (Korac-Kakabadse et al.,2001).[2] Corporate governance is defined as '*the system by which companies are directed and controlled* (Cadbury Report, 1992).[3] The downfall of corporations such as Enron, Parmalat, Adelphia Communications, and Arthur Andersen has demonstrated the crucial role of strong corporate governance in ensuring sustainable competitiveness in today's volatile, uncertain, complex, and ambiguous (VUCA) market. Scholars Berne and Means emphasized the importance of implementing effective mechanisms to address the conflicts of interest that arise between firm owners and managers (Ayuso and Argandona, 2007).[4] In response to the corporate failures, there have been the implementation of laws and guidelines commonly referred to as "code of best practices." These regulations aim to address any shortcomings or deficiencies in protecting shareholders. As corporate governance gained prominence in the management and operation of businesses, various theoretical models emerged (Kirkbride et al, 2004)[5] each offering different perspectives on understanding the intricate nature of concepts such as:

1. The agency theory
2. The stewardship theory
3. The stakeholder theory
4. The resource dependency theory

The concept of agency theory proposes a clear distinction between decision-making and control, as advocated by Fama and Jensen, 1983.[6] It goes on to suggest the inclusion of outside independent non-executive directors, a dual leadership structure, and a larger board size to

[2] Kakabadse, A., Ward, K., Korac-Kakabadse, N., & Bowman, C, Role and contribution of non-executive directors (2001). *Corporate Governance: The International Journal of Business in Society*, 1(1), 4-8< http://dx.doi.org/10.1108/EUM0000000005455> accessed on 11 September 2023.

[3] Report of the Committee on the Financial Aspects of Corporate Governance, (1992), < chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf> accessed on 13 September 2023

[4] Ayuso, S., & Argandoña, A, Responsible Corporate Governance: Towards a Stakeholder Board of Directors? (2007) (*IESE Business School Working Paper* No. 701) http://www.iese.edu/research/pdfs/DI-0701-E.pdf accessed on 14 September 2023

[5] Kirkbride, J., Sun, X., & Letza, S., Shareholding versus stakeholding: a critical review of corporate Governance (2004). *Corporate Governance: An International Review*, 12(3), 242-262 http://dx.doi.org/10.1111/j.1467-8683.2004.00367.x accessed on 14 September 2023

[6] Fama, E.F., & Jensen, M.C, 'Separation of ownership and control. *Journal of Law and Economics' (1983),* 26,301-325 http://dx.doi.org/10.1086/467037 accessed on 15 September 2023

combat potential conflicts of interest and prevent manipulation by management, as mentioned in Petrovic's research (2008).[7] On the other hand, the Stewardship theory advocates for the consolidation of the CEO and board chair roles to minimize agency costs and promote a unified command approach. Additionally, it proposes greater involvement of executive directors and a smaller board size to foster group cohesiveness and enhance overall performance, as highlighted in Yermack's study (1996)[8]. These theories offer different perspectives on how organizations can effectively address governance issues and optimize their operations. The responsibility of the board is primarily focused on strategic formulation rather than monitoring and control. According to stakeholder theory, a company does not operate in isolation but within an environment that consists of various interest groups. Therefore, when making corporate decisions, it is important for the company to consider the interests of these different constituent groups (Asher et al.,2005).[9] Stakeholder theory also suggests that the purpose of a firm should shift from solely pursuing shareholder interests to meeting the expectations of stakeholders (Kirkbride et al.,2004).[10]Additionally, stakeholder theory advocates for larger and more diverse corporate boards that can accommodate and promote the alignment of interests among all constituents, particularly those that contribute value to the firm (Zingales and Rajan, 1998).[11] Finally, the Resource Dependency Theory proposes that the Board of Directors plays the role of "Boundary-spanners" under the resource dependency model. They utilize their personal external network to attract various essential resources that the company needs to remain competitive and achieve superior performance. This approach also helps to reduce the transaction costs associated with interacting in the external environment. According to the Resource Dependency theory, having a well-diversified board with appropriate representation of outside independent members can lead to enhanced corporate performance, particularly in a VUCA world where firm dependency increases (Siciliano, 1996).[12] All these theories converge on the belief that the Board is at the heart of the corporate governance mechanism, ultimately determining the fate of the organization. In addition, there has been a significant emphasis on

[7] Petrovic, J., ‘Unlocking the role of a board director: a review of the literature (2008), *Management Decision*, 46(9),1373-1392 < http://dx.doi.org/10.1108/00251740810911993> accessed on 15 September 2023

[8] Yermack, D., Higher market valuation of companies with a small board of directors (1996), *Journal of Financial Economics*, 40, 185-211 http://dx.doi.org/10.1016/0304-405X(95)00844-5 accessed on 15 September 2023

[9] Asher, C.C., Mahoney, J.M., & Mahoney, J.T. Towards a property rights foundation for a stakeholder theory of the firm (2005), *Journal of Management and Governance*, 9(1), 5-32. http://dx.doi.org/10.1007/s10997-005-1570-2 accessed on 15 September 2023

[10] Kirkbride, J., Sun, X., & Letza, S., Shareholding versus stakeholding: a critical review of corporate governance. *Corporate Governance: An International Review*, 12(3), 242-262 http://dx.doi.org/10.1111/j.1467-8683.2004.00367.x accessed on 14 September 2023

[11] Zingales, L., & Rajan, R.G., Power in a theory of the firm (1998), *The Quarterly Journal of Economics*, 113(2), 387-432. http://dx.doi.org/10.1162/003355398555630 accessed on 15 September 2023

[12] Siciliano, J.I., The relationship of board member diversity to organizational performance (1996), *Journal of Business Ethics*, 14, 1313-1320. http://dx.doi.org/10.1007/BF00411816 accessed on 15 September 2023

the role of the board in addressing corporate governance concerns and implementing necessary reforms following recent corporate scandals (Van den Berghe and Levrau, 2004).[13] The literature has extensively discussed the importance of factors such as board size, composition, leadership structure, and adherence to codes and guidelines in ensuring the effectiveness of the board of directors and ultimately improving company performance. The prevailing assumption is that the effective utilization of the board as an internal governance mechanism is vital for enhancing firm performance and profitability (Bhagat and Black, 1999).[14] However, the research conducted over the past two decades has yet to fully substantiate this assumption. In terms of board composition, a board is considered independent if it consists of a greater number of non-executive directors who have no significant connections or interlocked directorships with the management (Ayuso and Argandona, 2007).[15] The inclusion of independent non-executive directors brings much-needed impartiality and objectivity to board discussions. It is worth mentioning, though, that there are differences between Western and Asian countries in this regard. In the United States, a study found no clear evidence of improved company performance due to independent non-executive directors (Bhagat and Black, 2000)[16] whereas in India, it has been reported that firm performance improves when these directors effectively carry out specific tasks such as replacing underperforming CEOs (Weisbach, 1988)[17], establishing external connections (Mizruchi and Stearns, 1994)[18] and driving strategy initiatives (Johnson et al., 1993)[19]. When it comes to the size of a board, there have been various studies that have shown both positive and negative outcomes. On one hand, a small board size is believed to encourage critical thinking, genuine discussions, and active participation among members. This can potentially lead to effective decision-making, monitoring, and improved overall performance for the company (Donaldson and Muth, 1998).[20] On the other hand, a large

[13] Van den Berghe, L.A.A., & Levrau, A., Evaluating boards of directors: What constitutes a good corporate board? (2004) *Corporate Governance- An International Review*, 12(4), 461-478 <https://doi.org/10.1111/j.1467-8683.2004.00387.x> accessed on 16 September 2023

[14] Bhagat, S., & Black, B. The uncertain relationship between board composition and firm performance (1999)., *Business Lawyer*, 54(3), 921-963 https://www.jstor.org/stable/40687871 accessed on 16 September 2023

[15] Ayuso, S., & Argandoña, A, Responsible Corporate Governance: Towards a Stakeholder Board of Directors? (2007) (*IESE Business School Working Paper* No. 701) 14 May, 2010 http://www.iese.edu/research/pdfs/DI-0701-E.pdf accessed on 16 September 2023

[16] Bhagat, S., & Black, B. *Board independence and long term firm performance (2000)*. (CLES Working Paper No.143 http://leeds-faculty.colorado.edu/bhagat/bb-031700.doc accessed on 16 September 2023

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[19] Johnson, R.A., Hoskisson, R.E., & Hitt, M.A. Board of director involvement in restructuring: the effects ofboard versus managerial controls and characteristics (1993). *Strategic Management Journal*, 14,33-50. http://dx.doi.org/10.1002/smj.4250140905 accessed on 16 September 2023

[20] Donaldson, L., & Muth, M.M. Stewardship theory and board structure: A contingency approach (1998). *Corporate Governance- An International Review*, 6(1), 5-28. <https://doi.org/10.1111/1467-8683.00076>

board size promotes diversity, which can give the firm a competitive advantage in multiple areas such as expertise, experience, skills, resource pooling, corporate strategy, innovation, creativity, and the provision of comprehensive services (Dalton and Dalton, 2005).[21] A meta-analysis of 29 previous empirical studies has revealed that board size plays a crucial role in determining firm performance, regardless of the specific board configuration (Wagner et al., 1998).[22] Based on the research conducted, it can be inferred that the effectiveness of corporate discussions and decision-making is determined by the quality of the board rather than the quantity. Another factor that influences the effectiveness of the board and the performance of the company is CEO Duality, which is still supported by the Agency theory. While there are some studies that contradict the position of the Agency theory on this matter, recent corporate scandals and recommendations for corporate governance guidelines emphasize the need for separating the roles of CEO and Chair. Holding both positions can create an imbalance in the distribution of corporate power, jeopardizing the effectiveness of the board and ultimately impacting the company's performance in the long term (Weir and Laing, 2001).[23] The last factor that is believed to have an impact on the effectiveness of the board and the performance of the company is Board diversity. Corporate Board diversity encompasses both demographic and cognitive aspects, including industry experience, professional qualifications, and educational background (Kang et al., 2007).[24] Establishing a cognitive board that is diverse in its composition can foster a sense of self-reliance within an organization. This can be achieved through various means, including enhanced monitoring, resource co-optation, and making quality decisions that promote fairness in corporate practices. However, a meta-analysis of 85 previous empirical studies conducted by Dalton et al. (1998)[25] found no significant correlation between board diversity and either board effectiveness or company performance. It is important to note that these studies predominantly focused on a singular perspective when examining this

accessed on 17 September 2008

[21] Dalton. C.M., & Dalton, D.R. Boards of directors: Utilizing empirical evidence in developing practical prescriptions (2005). *British Journal of Management*, 16, S91-S97. http://dx.doi.org/10.1111/j.1467-8551.2005.00450.x accessed on 17 September 2023

[22] Wagner, J.A., Stimpert, J.L., & Fubara, E.I. Board composition and organizational performance: Two studies of insider/outsider effects (1998). *Journal of Management Studies*, 35,655-677. http://dx.doi.org/10.1111/1467-6486.00114 accessed on 17 September 2023.

[23] Weir, C., & Laing, D. Governance structures, director independence and corporate performance in the UK (2001), *European Business Review*, 13(2), 86-94. http://dx.doi.org/10.1108/09555340110385254 accessed on 17 September 2023

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[25] Dalton, D.R., Daily, C.M., Ellstrand, A.E., & Johnson, J.L. Meta-analytic reviews of board composition,leadership structure and financial performance (1998). *Strategic Management Journal*, 19, 269-290. <http://dx.doi.org/10.1002/(SICI)1097-0266(199803)19:3<269::AID-SMJ950>3.0.CO;2-K> accessed on 18 September 2023

relationship. Corporate governance researchers often limited their investigations to board dynamics, which encompassed factors such as board size, composition, CEO duality, and board diversity. However, they failed to incorporate a crucial element of human influence - the individual character and ethical quotient of board members. Without considering these human aspects, any research on board dynamics would be incomplete. The researchers relied on an "express relationship" approach rather than utilizing a "mediation approach," which would have provided a more comprehensive understanding of the subject (Heracleous, 2001).[26] Most studies have utilized a relationship-based approach and employed statistical tools to assess the correlation between the board and company performance. The performance measures employed in these studies have yielded inconsistent results due to the omission of crucial human factors. Typically, researchers have relied on market-based or accounting performance metrics, with more recent studies incorporating the Economic Value-Added Model to gauge the impact of the board on company performance. However, these studies have produced either similar or contradictory findings, primarily because most of the existing research relies on public information sources that fail to disclose pertinent details or attributes of the Board of Directors that may be relevant to investigators. By considering human behavioral aspects such as character and ethical quotient of individual board members, a more accurate representation of the board's ability and the subsequent impact on corporate performance can be obtained. In recent years, there has been a growing focus on the individual roles of board members, highlighting the "human side of corporate governance" (Huse, 2005)[27] This approach emphasizes both the expected board roles and their actual performance in fulfilling these roles. Extensive research has been conducted to delineate the responsibilities carried out by board members (Korac- Kakabadse et al., 2001, Huse, 2005)[28] However, this research has primarily focused on the dynamics within the board itself, rather than examining the inherent character and behavioural patterns of individual members and their impact on board synergy, control, and dialogue. As we enter the millennial generation, stakeholders and shareholders have shifted their attention towards the personal qualities, abilities, and leadership skills of individual board members, in addition to their actual performance and value contribution to the organization.

[26]Heracleous, L. What is the impact of corporate governance on organizational performance? (2001) *Corporate Governance: An International Review, 9(3),*165-173. http://dx.doi.org/10.1111/1467-8683.00244 accessed on 19 September 2023

[27] Huse, M. (2005). Accountability and creating accountability: a framework for exploring behavioural perspectives of corporate governance. *British Journal of Management*, 16(1), 65-79. http://dx.doi.org/10.1111/j.1467-8551.2005.00448.x accessed on 19 September 2023

[28] Kakabadse, A., Ward, K., Korac-Kakabadse, N., & Bowman, C, Role and contribution of non-executive directors (2001). *Corporate Governance: The International Journal of Business in Society*, 1(1), 4-8< http://dx.doi.org/10.1108/EUM0000000005455> accessed on 11 September 2023.

The global discourse in recent times has been focused on the leadership qualities and ethical perspectives of board members in the wake of corporate scandals, with the rallying cry being #responsible leadership leads to enhanced corporate governance practices. Now, this study focusses on the foundational aspects of responsible leadership, that is, #responsible individual becomes responsible leader and what it means to be a responsible individual in Boardroom context and at an organizational context.

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