ISSN:2229- 6247
Phillip C. James | International Journal of Business Management and Economic Research(IJBMER), Vol 15(2),2024, 2372- 2383

Improving Corporate Governance: Internal Mechanisms or External Controls- Which is better? A Review of the Literature

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Abstract

Corporate governance is vital for the protection of shareholders and resolve the agency problems arising from the separation of ownership and control. Researchers have not agreed on a consensus of the best method to achieve effective governance. The prevailing view is that internal control mechanisms should be effective, where the board of directors play the key role in ensuring that the interests of shareholders are aligned with those of management. It is the board that is seen as the main agent with the responsibility and capability of disciplining management and removing rouge CEOs. This paper has presented literature which clearly show that boards of directors are, by nature, not sufficiently equipped to execute their restraining function of management and CEOs. The literature highlighted the many problems of conflict of interests experienced by inside directors who are loyal to management and the need to protect their career, a situation which severely weakens their monitoring function. Independent/outside directors, who are expected to be more effective in monitoring management, have been shown to be ineffective arising from their selection, which is normally done by the CEO. External control mechanisms have been presented as an alternative to the internal control mechanisms.

Keywords: Corporate Governance, Board of Directors, Control Mechanisms, Board Size

JEL Classification: M48, M49, L51

1. Introduction

Corporate governance has received much attention is recent years from both academic researchers and practitioners. Recent corporate failures and accounting scandals, have all place renewed interest in our attempt to gain a better understanding of corporate governance issues. Any attempt to better understand corporate governance, begins with having a working definition of corporate governance, and this is where the problem begins.

There is no single definition of corporate governance, the definition depends on one's perspective of the world. Berle and Means (1932) and Zingales (1998) see corporate governance as the allocation of ownership, capital structure, managerial incentive schemes, board of directors and pressure from institutional investors. Shleifer and Vishny (1997) define corporate governance as the methods used by suppliers of finance to corporations to ensure that they receive a return on their investment. Garvey and Swan (1994) argue that governance determines how the firm's top decision makers administer legally binding contracts. The OECD in 1999 defined corporate governance as "the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, mangers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance." Interestingly, Oman (2001) argued that corporate governance refers to a concept of private and public institutions that include laws, regulations and business practices which govern relationships between stakeholders and corporate managers.

This paper presents a view of corporate governance from two perspectives, the central issues is which control mechanism is better for improve corporate governance. Corporate governance is examined here from both the internal and external control mechanisms, with the aim of using the literature to better understand which governance structure is more effective in terms of management control. Most governance research focus on internal control structures, with very little focus on the external control elements. This review of literature, while highlighting the internal control elements, will put the spotlight on the "under-discussed" external control mechanisms.

2. Internal Control Mechanism Of Corporate Governance

Corporate governance concerns normally arise in organizations whenever there is an agency problem, and related transactions costs related to the agency problem cannot be dealt with by a simple contract. Jensen and Meckling (1976) defined the agency relationship as one where there is a contract between the principal and the agent, where the principal requires the agent to perform services on behalf of the firm. This feature of the typical public company where there are a large number of small owners lends itself to two problems. The first problem is that the owners who are the shareholders are too numerous to exercise any form of control over the day-to-day operation of the company, hence they appoint a board of directors to overs see the operations, but the directors in-turn delegate this responsibility the company's management. This is the type of arrangement that Berle and Means (1932) called separation of ownership and control.

Hart (1995) argues that the second problem is linked to the dispersed shareholders' unwillingness to monitor management, given their lack of incentive. Monitoring is costly, and thus individual shareholder would hope that the other shareholder does the monitoring. The result is that all shareholders think alike, and thus no monitoring takes place, (Hart, 1995).

Hart (1995) makes the point that this separation of ownership and control and the lack of monitoring is fertile ground for managers of public companies to pursue their own goals at the expense of shareholders. The self-interested managers may reward themselves with excessive pay packages, extravagant fringe-benefits and undertake unprofitable investment ventures with the aim of consolidating their power base.

Given that managers have the ability to enrich themselves by pursuing their own agenda, it is necessary that there are oversight structures, called checks and balances, to guide managerial behavior. These monitoring structures are integral to effective corporate governance. I will now discuss the board of directors which is one of the most important internal control mechanisms.

2.1 Board of directors

John and Senbet (1998) argue that board of directors is a central component of corporate governance, they see the board of directors as the main way in which shareholders can exercise control over top management. Gillan (2006) states that board of directors is the lynchpin of corporate governance, owing to their fiduciary responsibility to shareholders, and the duty of providing strategic direction to and the monitoring of management.

A significant portion of the literature see a board as being effective when the interest of the board is aligned with the interests of the shareholders, this allows the board to achieve its monitoring function (Warther, 1998; Hirshleifer and Thakor, 1994). Achieving the alignment between both directors and shareholders interests requires that directors are compensated relative to firm value (John and Senbet, 1998). Another means of achieving the alignment is to link directors' performance to their reputation going forward. Noe and Rebello (1996) discount the attempt to use reputation as a means of achieving alignment, saying it is a weak position to adopt. Rather they see the compensation of board members as a more effective means of achieving the desired outcome.

Several questions have been asked about what makes a board effective. One view is that, the size of the board and its independence from management are central elements of an effective board (Rosenstein and Wyatt, 1990; Yermack, 1996), others advance the view that board activity (Vafeas, 1999) and the structure and functioning of board subcommittees are important (Klein, 2000; Deli and Gillan, 2000).

According to Johnson et al., (1996) the board of directors has three major responsibilities to accomplish namely: monitoring management actions, advising the CEO, and getting external resources that are vital to build corporate capabilities. An effective board is therefore vital to ensure that agents/CEOs do not enrich themselves at the expense of the shareholders. The effectiveness of the board is dependent on its structure. However, managerial power theory contends that board structure arrangements are important boundary conditions for board monitoring and for aligning CEO pay to firm performance. Boards dominated by executive insiders, are assumed to be problematic monitors and compromised compensation decision-makers, given that the CEO can influence fellow executive rewards and career advancement (Beatty and Zajac, 1994). In addition, managerial power theory proposes that CEOs who are also board chairpersons have the power to influence board decisions in general, but especially in the setting of CEO pay (Boyd, 1994). Combining the role of board chairperson and CEO is said to render directors beholden to the CEO and hence, to create the conditions for board complicity or board capture (Bebchuk and Fried, 2004; Cadbury, 2002; Gumbel, 2006; Huse, 2007).

There is considerable debate in corporate governance literature on the role of board in disciplining the firm management (Rashid, et al. 2012). The board's ability to exercise the governance function depends on a number of board attributes, such as the distribution of power between the board Chair and the Chief Executive Officer (CEO) (Pearce and Zahra 1991; Finkelstein and Hambrick 1996; Kakabdse et al. 2006); board size (Hermalin and Weisbach 2003; Zahra and Pearce 1989); boards of directors' ability to choose CEO with standard managerial competencies who may demonstrate integrity, provide meanings, generate trust, and communicate values (Bennis and O'Toole 2000); board independence (Rosenstein and Wyatt 1990; Gopinath et al. 1994; Maassen 2002; Raheja 2005), and the extent of influence of external environment (Pfeffer and Salancik 1978).

The board's ability to monitor management attracted attention following the collapse of Maxwell Publishing Group, BCCI, and Poly Peck in the United Kingdom (Rashid, 2013). The Cadbury Code developed and published in response to these collapses (Jonsson, 2005), made recommendations for board reforms, including the structural independence of the board (Rashid, 2013).

Similarly, the board's ability to monitor management also attracted attention following the wave of mega corporate collapses in the early 2000s, such as the collapse of Enron, WorldCom and HIH insurance (Brick et al. 2006; Braun and Sharma, 2007). It is alleged that, board's inability to monitor management within these corporations was due to insufficient monitoring as the management had a consolidation of power (Rose, 2005). The Sarbanes-Oxley Act in 2002, following the corporate scandals in the United States (such as Enron and WorldCom), recommends several additional checks and balance be put in place to monitor the CEOs (Dey et al. 2009)

The corporate governance mechanisms provide shareholders some assurance that managers will strive to achieve outcomes that are in the shareholders' interests (Shleifer and Vishny, 1997). Shareholders have available both internal and external governance mechanisms to help bring the interests of managers in line with their own (Walsh and Seward, 1990). Internal mechanisms include an effectively structured board, compensation contract developed by a compensation or remuneration committee that encourage a shareholder orientation, and concentrated ownership holdings that lead to active monitoring of executives. It is the view of John and Senbet (1998) that outside directors, also called independent directors, should lead to improved firm performance due to their ability to better discipline management and exercise robust monitoring. They make the point that firms with outside directors show better levels of sales, and higher profitability ratios than firms whose management is not well disciplined.

Interestingly, a study by Fosberg (1989) did not support the view that outside directors lead to improve firm performance. Fosberg (1989) found no relationship between the presence of independent/outside directors and the variables used to measure firm performance. The author presented an interesting set of explanations to this unexpected finding. They argue that management normally has the ability in get outside directors on the board who are less willing or in capable of disciplining management. Another explanation was that the presence of external control mechanisms (such as the market) may have effectively motivated and disciplined management, thereby rendering the role of outside directors useless.

Hart (1995) presents a series of suggestions as to why boards of directors may not be effective monitors of management. Hart (1995) states that board comprise of executive directors, who are employees of the management, and non-executive directors, who are outside directors. No one should expect executive directors to monitor themselves, similarly, non-executive directors may be ineffective for several reasons. One view presented is that these outside directors may not have a material financial interest in the company, hence there is no personal financial benefit accruing to them from improved firm performance. Another reason is that non-executive directors tend to be very busy with their personal jobs, and may be CEOs for another companies, hence, they are unable to devote sufficient time and energy needed to effectively discharge their duties. Finally, outside directors are normally recommended by management, hence, they may have a sense of loyalty to management and would want to remain collecting their fees and to be in a good relationship with the executive management especially the CEO.

John and Senbet (1998) argue that the standard view is that the degree of board independence is closely related to its composition, thus boards are seen to be more independent as the number of outside directors increase in relation to executive directors. Bhagat and Black (1997) stated that half of the 100 largest American public companies examined in 1996 had only one or two inside directors. Rosenstein and Wyatt (1990) investigated whether the announcement of new outside directors impact shareholders' wealth. The authors used financial data and the announcement of outside directors' board appointment for the period 1980-1985. The results showed significant positive excess returns related to the days of the board

announcement. The conclusion was that the announcement of the inclusion on new outside directors on the board is associated with increase in shareholders' wealth.

Another interesting study by Brickley, Coles, and Terry (1994) examined whether outside directors promote shareholders' interests, by looking at companies which adopted poison pills. The general view is that poison pills can benefit or be disadvantageous for shareholders because shareholders vote is not required. John and Senbet (1998) make the point that if outside directors embrace shareholders interest, then the possibility of using poison pills to harm shareholders should decrease with the proportion of outside directors on the board. The underlying assumption is that the market can observe the structure of the board, hence the effect of adopting a poison pill should be reflected in the stock price. John and Senbet (1998) further argue that if outside directors embrace management interests, the possibility of using poison pills to harm shareholders would not vary with the number of outside directors on the board.

The results of Brickley et al. (1994) showed a statistically significant positive relation between the stock market response to the adoption of poison pills and the proportion of outside directors. This result supports the underlying theoretical statement that outside directors embrace shareholders' interests. The literature is not settled on the question of whether board composition has a positive impact on firm performance. Hermalin and Weisbach (1991) study showed that the issue is inconclusive when they examined the effects of board composition and firm performance, in their attempt to measure the variation in firm performance caused by board composition and ownership structure. Their results showed that there was no relation between board composition and firm performance, however, there was a strong relationship between ownership structure and firm performance.

Given that the board is the primary internal control mechanism of corporate governance, recent studies have looked at the evolution of the board structure over time in the post Sarbanes-Oxley (SOX) era. Chhaochharia and Grinstein (2005) examined recent changes in board structure and found that board size and independence have increased in post SOX. Coles, Daniel, and Naveen (2005) and Linck, Netter, and Yang (2005) investigated board changes over time and the accompanying costs associated with new regulations. Other studies examined board characteristics. For example, Ferris, Jagannathan, and Pritchard (2003) showed that busy boards are not harmful to shareholders' wealth, while Conyon and Muldoon (2004) focused on interlocking boards and found that "cozy" board relationships limit effective monitoring.

The board's role as an effective agent of internal corporate governance cannot be overstated, hence much attention has been placed on the board's actions and the level of expertise that resides on the board. Agrawal and Chadha (2006) found that financial expertise on board serves as a deterrent to accounting fraud and restatements. Anderson, Deli, and Gillan (2005) showed that the market places more credibility to earnings announcements when audit committees and boards are both active and independent. In a subsequent study Guner, Malmendier, and Tate (2005) reported that the size of loans is directly related to the presence of commercial bankers on the board, while the presence of investment bankers on boards in linked to more frequent outside financings and larger public debt issues. Interestingly, the researchers found that the presence of board members with financial expertise did not necessarily improve shareholder value.

Shareholders' interest is served when CEO compensation is not excessive. The board is the monitoring internal mechanism to prevent CEO overpayment. Brick, Palmon, and Wald (2006) studied board characteristics and CEO compensation. The focus of the research was to analyze the link between CEO compensation and the board. The findings showed that excess compensation paid to directors was associated with excess CEO compensation. The explanation presented by Brick et al. (2006) is that the findings indicated a form of "cronyism" or a mutual back-scratching relationship, which shows that the excess compensation paid to the directors affected their independence which ultimately led to overpayment of CEOs.

It is the responsibility of the board to ensure that managers pursue the interests of the shareholders, this should be achieved by structuring the compensation package appropriately. Holmstrom and Tirole (1993) and Diamond and Verrecchia (1982) have models where the interaction of the capital market contingent compensation package achieves the alignment of managers' interests with that of shareholders. The underlying argument is that given that investors have a desire to obtain information and stock price, incentives can be so structured to make executive compensation a function of the company's stock price. Allen and Gale (1998) argue that if share prices contain sufficient information about expected future profitability of the company, an effective automatic incentive scheme can be designed to ensure that managers maximize shareholders' wealth. Other accounting measures could also be used by directors to

align managers' interests with shareholders; however, stock price has the advantage in that, it is not easily manipulated by management as are the other accounting data.

2.2 CEO removal

An important function of the board is to evaluate the performance of the CEO and where necessary, recommend his/her removal. CEO removal for underperformance, represents effective internal control mechanism within the corporate governance framework. Hence, the board monitoring effectiveness will be seen in its managerial hiring and firing decisions (John and Senbet, 1998). Weisbach (1988) examined the behavior of both inside and outside directors when it comes to the decision of removing a CEO. John and Senbet (1998) argue that both groups of directors have different incentives regarding firing a CEO. The executive/inside directors, they argue, are reluctant to remove a CEO because their careers are normally linked to the CEO, while the outside/independent directors are more willing to remove a CEO to protect their reputation.

Weisbach's (1988) study examined companies from 1974 – 1983. The board was classified as outsider-dominated if it had more than 60% of outside directors, and inside dominated if outside directors were less than 40% of the board. The findings showed that performance measures played a major role in the firing decisions of CEOs, if the board is outsider dominated. Interestingly, no such results were observed for insider-dominated boards.

John and Senbet (1998) in analyzing the findings stated that: "these results show significant differences in the pattern of monitoring management between inside and outside director dominated boards. To the extent that independent directors are more vigilant in replacing poorly performing management, there should be value creation for shareholders. The observed shareholder wealth effect of CEO turnover is consistent with more efficient monitoring by independent directors."

2.3 Board size

The effectiveness of the board as an internal control mechanism, may be a function of its size. Lipton and Lorsch (1992) and Jensen (1993) argued that the board's monitoring capacity normally increases as the number of directors increase, however, the downside to the increase in the number is the increase cost of poor communication and decision- making typical of larger groups. Yermack (1996) investigated if limiting the size of the board would improve efficiency. The author (Yermack) examined board size of 792 companies over an eight-year period and found that there was an inverse relationship between companies' market valuation and the size of the board.

Yermack (1996) findings also showed that investors' valuation of companies tends to decline steadily as board size moves from 4 to 10 directors, however, for greater than 10, there appears to be no relationship between board size and market valuation. The findings further revealed that the threat of CEO dismissal and CEO incentives from compensation are more pronounced with smaller boards. Interestingly, the results showed that where non-executive chairmen and non-CEO presidents were present, company valuation improved, this result supports the view that CEO duality can be harmful to companies and should be avoided. The final and probably most stunning finding from the study was that the presence of outside directors did not improve firm valuation. This, therefore, hits at the core of corporate governance where it is the view that outside/independent directors improve corporate governance.

2.4 Can boards be truly effective monitors?

Given that the board of directors is the main internal corporate governance mechanism, this section on internal control mechanism of corporate governance ends by answering the question as to whether boards can be expected to be effective monitors of management. John and Senbet (1998) reported that board composition is endogenized by the interaction of board members and management. They argued that directors tend to have a utility function that depend on their desire to remain on the board and the firm value. Therefore, any unsuccessful vote to dismiss the CEO could lead to them losing their position on the board, it is this possibility of losing their board seat why board members may be reluctant to fire non-performing managers. This shows that the board does not always act in the best interest of the shareholder.

Boards may also be poor monitors if they are dominated by outside directors. Noel and Rebello (1996) research were influenced by the view that outside directors normally have little financial commitments to the company and insufficient information regarding the operations of the company. The authors focused on a governance structure that include both outside and inside directors. Their results showed that the reputational concern of outside directors may not be a significant enough factor to align the interest of outside directors with the interests of shareholders.

The reason why the board may not be an effective internal corporate governance control mechanism could be because we have overlooked a few important questions. Questions which Hermalin and Weisbach (1997) attempted to answer. They asked two questions. First, what determines who gets on or taken off the board and how boards become the way they are? Hermalin and Weisbach (1997) found that companies tend to recruit inside directors as the CEO approached retirement, a move that negatively impacts effective monitoring, they found that inside directors tend to leave and are replaced by outside directors when the company performs poorly.

As the main internal control mechanism of corporate governance, the board of directors may have failed to align its interest with those of the shareholders. The answer why the board may have failed this very important function is complex and as we have seen from the literature, numerous factors are involved. Factors ranging from directors' loyalty to CEOs, directors more concern with their retention on the board than losing board seats and fees, CEO dominating the board, CEOs who are also CEO and chairman, directors with little or no financial interest in the company, and finally directors who have outside engagements hence, they don't have the time, nor the information required for effective review of the company's performance.

It Is therefore appropriate that the discussion now shifts to an examination of the external control mechanisms of corporate governance. The aim is to try and understand which control mechanism is more effective and serves the interests of the shareholders better.

3. External Control Mechanisms

The literature has shown that the board of directors which is the key internal control mechanism of corporate governance may not be as effective and efficient as one would think. We have so far identified plausible reasons why boards may become ineffective and fail to protect the interests of shareholders. It is now timely for a shift in focus from the board, as a means of disciplining management, to external control mechanisms which may prove more effective than boards of directors.

3.1The market for corporate control

Gillan (2006) views the market as the ultimate corporate governance mechanism, because as mangers compete in the market, resources go to highest value entity and inefficient managers are disciplined. Manne (1965) sees an active capital market for corporate control as essential for an efficient capitalist economy. The author argues that it allows management to access large amount of resources, the effects of which is that inefficient managers are replaced with those who are more competent. Allen and Gale (1998) argue that the market as a means of corporate control also provides a means of disciplining managers, in that, if the company is engaged in policies that fail to maximize shareholders' wealth, it can be taken over and the managers replaced. An alternate view of the market was presented by Bittlingmayer (2000) who argued that the market as a means of corporate control could be a double edge where is allows inefficient managers to undertake empire building through ill-advised acquisitions.

Allen and Gale (1998) stated that proxy contests and hostile takeovers are two ways by which the market for corporate control can function. The basic premise of a proxy contest is that a group of shareholders, or an individual engage to persuade the other shareholders to act in unison with him/them and unseat the current board of directors. Normally, the set of disgruntled shareholders who would like a change in the direction of the company, would request proxies form other shareholders, which allow them to vote on their shares at the annual shareholders' meeting.

Hart (1995) argues that despite the potential effectiveness of proxy fights, most proxy fights may not achieve the result of disciplining directors. The author states that the disgruntled shareholder incurs the initial costs of obtaining the information to determine that the company is underperforming, and then to initiate the proxy fight, also contacting existing shareholders. Hart (1995) further states that, given that the benefit of improved management accrue to all shareholders in the form of higher stock prices, then some shareholders may be reluctant to participate. Another problem identified with proxy fights by Hart (1995) is that, even if the proxy fight is initiated, some shareholders may have no incentive to vote or even think about who to vote for believing that their vote will not make a difference. Hence, they may end up voting for the incumbent management rather than persons unknown to them.

Hostile takeovers have proven to be another way in which the market as a means of control can operate. Allen and Gale (1998) argue that hostile takeovers occur for several reasons including; where differences exist between acquirors and acquirees, the policy direction on the entity and other possible problems. The hostile tender offer allows the acquirors to by-pass the company's management and appeal directly to the shareholders. Hart (1995) made the point that a hostile takeover is a much more powerful mechanism than

proxy fight for disciplining management, because it allows the person who identified the underperforming company to obtain a substantial reward.

Interestingly, Grossman and Hart (1980) made the point that hostile take overs may not be a very effective corporate control mechanism in disciplining management. They argue that many existing shareholders may be more inclined to free ride on raiders who aim to increase the value of the company. This will occur, as stated by Grossman and Hart (1980), if a price offered by the raider is less than the price the new policies will justify, and shareholders are of the view that the offer will be successful, they will hold their shares, refusing to sell, and the takeover/offer will fail. Raiders may not be able to significantly increase their offer price, because when all the costs are considered, the result may be a loss, hence there would be no incentive to pursue the takeover.

To overcome the problem of the free-rider, Grossman and Hart (1980) suggested that companies charter should permit raiders to dilute minority shareholders' interests after the takeover. This would allow raiders to offer a price below the post-take over vale of the company and the bid would still be successful. The authors argue that with this arrangement, existing shareholders would be aware that if they hold on to their shares, the raider will dilute their interests. A solution to the raider's problem of the likelihood of incurring a loss, was presented by Shleifer and Vishny (1986), they pointed that if the raider was able to obtain several shares, e.g., a block, prior to the takeover attempt at a low takeover price, there would be a profit on these shares, even if the remaining shares are acquired at full price.

Research evidence show that despite the problems, hostile takeovers have been common in the USA and U.K. Prowse (1995) study indicated that almost 10% of companies in the Fortune 500 in 1980 in the United States were acquired in transactions that were deemed hostile. The U.K. also experienced hostile takeover, Franks and Mayer (1992) reported that there were 35 successful bids during over 2 years in the 1980s. Therefore, the likelihood of an impending hostile takeover bid can be an effective mechanism for disciplining an underperforming management team.

3.2 Labor markets

There is a body of literature which focus on the role of labor markets in determining how successful managers become in their career. Fama and Jensen (1983) joined by Jensen and Meckling (1976) stated that labor market and management concerns regarding reputation have a disciplining effect on senior managers including board members. The underlying view is that excellent managerial performance by board members and CEOs creates the possibilities or openings for better offers in the future. Gillan (2006) argues that top performing CEOs may be presented with job offers at larger more prestigious companies or be invited to sit on other boards. Similarly, the author states that poor performing CEOs may be fired and hence encounter difficulties in securing another job as an executive or a board member.

Studies by Murphy (1999) and Coughlan and Schmidt (1985) provide evidence of an association between firm performance and the labor market for CEOs. Their results showed that good performance was positively associated with CEO compensation, whereas poor performance increases the likelihood of CEO termination. A study by Gayal and Park (2002), which supports the position that CEO duality should be avoided, found that the sensitivity of CEO dismissal to firm performance, is significantly reduced when the CEO is also the chair of the board. Based on these findings, Gillan (2006) stated "these papers suggest that governance and organizational structure are associated with the employment relationship and the labor market for executive."

Another perspective of the effect of the labor market on CEOs was presented by Agrawal et al. (2006) who argued that outsiders are normally chosen for CEO openings only if they are perceived to be better than the current insider CEO, that is, a ranking system like a handicapping is used. Chan (1996) states that reason for the handicapping is to provide the incentive for insiders to work hard to be successful.

Other studies also showed the effect of the labor market on directors. Brickley et al. (1999) reported that the chances of an out-going CEO serving on his board or other boards after his leaving the CEO position, is positively related to his performance while as CEO. Srinivasan (2005) found that outside directors of companies that restate their financial statements, experienced higher turnover and served on fewer boards after the restatement. Interestingly, Harford (2003) reported that companies that are taken over, the directors of the target companies are rarely retained and eventually serving on fewer board in the future, when compared to the control group. Additional evidence was provided by Yermack (2004), who found that external directors receive positive performance incentives in the form of compensation and opportunities to join new boards. A concluding note was provided by Gillan (2006) by saying, "a common theme in all of these studies is that reputation is important in the labor market for directors."

3.3 Corporate debt

The use of debt as a corporate governance mechanism for disciplining management has now emerged as a significant component in the corporate governance framework. The pioneering work by Grossman and Hart (1982) reported that managers can commit themselves to working hard by using debt and not equity. The free cash flow theory advanced by Jensen (1986) stated that debt could be used to prevent management from wasting resources. Interestingly, Jensen and Meckling (1976) argued that managers may be inclined to take on risks and thus, pursue risky projects that reduced value, if a large amount of debt is used. The negative effect of the debt burden was stated by Myers (1997), who reported that companies may refuse good projects if they have a large amount of debt outstanding because, a large porting of the returns for profitable investments go to bondholders if the companies are experiencing financial distress.

There is a widely held view that debt can be used to shape corporate governance, by using the debt contract as a means of solving agency problems. Townsend (1979) and Gale and Hellwig (1985) claim that borrowers could disappear with the companies' cashflow and profits, where as a failure to repay the debt would initiate a series of events resulting in the transfer of control/ownership of assets from borrowers to lenders. Hart and Moore (1989) supported the use of debt contracts with their model which provide lenders with right of seizing the collateral if the borrower defaults. John and Senbet (1998) explained that the advantage of the debt contract is that it outlines the rights of the lenders very clearly and hence, violations of those rights are easily enforced in the courts.

There is always the concern in the literature regarding what can lenders do to ensure that borrowers repay the debt. The answer that has been provided has to do with reputation. Studies by Diamond (1989), Eaton and Gersovitz (1981) and Allen (1983) have all developed models which showed that managerial reputation is a major factor in ensuring the repayment of debt.

3.4 The legal environment

There has always been the question of "who monitors the monitor"? The role of the laws and regulations in shaping corporate governance may now be clearer, given the recent corporate failures and accounting frauds. The association between law and governance has been extensively studied, for example, Coles and Hoi (2004), and Szewczyk and Tsetsekos (1992) have investigated the effects of changes in state laws on shareholders' wealth and the labor market for directors. The concerns of the likelihood of takeover after the state and firm adopting antitakeover provisions was examined by Comment and Schwert (1995). Other studies have looked at the effects of governance and shareholders' wealth arising from the Sarbanes-Oxley Act (SOX) and recent SEC listing requirements. Chhaochharia and Grinstein (2005) examined wealth effects, whereas Leuz et al. (2005) investigated companies that voluntarily deregister with the SEC before and after SOX Act. Recent accounting/financial frauds have led to studies on the legal consequences of corporate crime. Karpoff et al. (2005) reported that contrary to the popular view that corporate crime is not sufficiently punished, companies and executives have received significant fines, lengthy prison sentences and permanent reputational damage.

The argument could be made that the legal environment, the laws/regulations, provide a basis for the protection of shareholders and creditors. However, not everyone shares this position. Hart (1995) presents a very interesting conclusion to his study on governance, in which the following closing statement was made…

"the case for the government to impose statutory rules on companies on the grounds that the world has changed is not strong. Probably the most the government should do is to follow Cadbury in trying to educate and persuade companies to implement changes but leave the final decisions up to them. In addition, it is important that existing corporate governance mechanisms should be allowed to operate freely…. it is undesirable to interfere with these mechanisms, for example, making hostile takeover harder. Takeovers are potentially one of the most powerful forces for bringing about improvements in corporate governance… any attempt to weaken this mechanism is likely to make corporate governance more rigid, and to worsen company performance in the long run."

4.Closing Comments

Effective corporate governance is vital for the protection of shareholders and to resolve the agency problems arising from the separation of ownership and control. The method to achieve effective governance is not a settled one. The widely held view is that internal control mechanisms should be effective, where the

board of directors plays the vital role in ensuring that the interests of shareholders are aligned with those of management. It is the board that is seen as the main agent with the responsibility and capability of disciplining management and removing rouge CEOs. This paper has presented literature which clearly show that boards of directors are, by nature, not sufficiently equipped to execute their restraining function on management and CEOs. The literature has highlighted the many problems of conflict of interests experienced by inside directors who are loyal to management and the need to protect their career, a situation which severely weakens their monitoring function. Independent/outside directors, who are expected to be more effective in monitoring management, have been shown to be ineffective arising from their selection, which is normally done by the CEO, and their desire to remain on the board and receive fees.

It is therefore clear, that the much-touted internal control mechanism of corporate governance, the board, has failed to perform its role, or at best continues to perform a pseudo role. Arising from this failure, external control mechanisms of corporate governance have received much attention as a more effective method of discipling management and aligning the interests of shareholders with that of management. The external mechanisms of control as presented in this paper have been shown to be more effective in ensuring that shareholders' wealth is preserved and improved. Corporate governance will continue to be discussed; however, we have arrived at a stage where the discussion of how to achieve effective corporate governance must now be centered on external control mechanisms, considering the overwhelming body of evidence supporting the failure of the board of directors as the main internal control mechanism.

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