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EDITORIAL COMMENTARY

The Governance Journal emerged from a collaboration between the Institute of Certified Secretaries (ICS) and the University of Nairobi. Its primary objectives are to foster intellectual discourse on corporate governance, cultivate a research and learning culture within the corporate governance domain, and facilitate the success of businesses for economic growth.

The journal operates on the premise that a robust private sector is a key driver of economic development. Over the past two decades, Africa has emerged as the world's fastest-growing economic region, attributing this success to the dynamism of its private sector. The contribution of the private sector and state-owned corporations are crucial to governments' development plans, fostering economic growth, wealth creation, job provision, and services. The effective application of corporate governance practices is central to these outcomes, highlighting the significance of corporate governance in driving economic growth, enhancing living standards, and alleviating poverty.

To sustain Africa's economic growth, policymakers, scholars, and practitioners must formulate sound policies and laws conducive to business growth and corporate resilience. The journal aims to feature articles that contribute to creating a competitive and dynamic business framework. This framework should be responsive to the needs of commerce and industry, streamline business setup procedures, reduce regulatory burdens, establish investor-friendly legal frameworks, protect investors' interests, support small businesses, and promote local industries. Additionally, the journal advocates for user-friendly legislation, simplified decision-making processes, well-regulated securities markets, reinforced gatekeeper roles, equitable treatment of shareholders, efficient enforcement of shareholders' rights, enhanced corporate disclosure, improved audit and accounting standards, and strengthened efficiency of state-owned entities.

Enjoying broad readership among policymakers, corporate executives, and scholars, the journal plays a significant role in knowledge creation and policy advisory. It invites article submissions covering various aspects of corporate governance, including the board of directors, transparency, accountability, risk management, ethical leadership, shareholder rights, stakeholder relationships, sustainability, compliance with laws, governance of state-owned entities, regulatory framework reform, corporate governance during crises, comparative corporate governance, and the theoretical foundations of corporate governance.

The journal accepts article submissions on an ongoing basis and subject to peer review. Authors can submit articles to the ICS Research and Business Development Manager at research@ics.ke, referring to the journal's editorial policy at <https://www.ics.ke/downloads-center-2/category/7-governance-journal>.

FCS Kenneth Wyne Mutuma,
PhD Editor-in-Chief

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THE EVOLUTION OF CORPORATE GOVERNANCE: ARE CRISES SYMPTOMS OF SYSTEMIC WEAKNESSES?

BETHUEL KAPERRE

Introduction

The 1990s and 2000s are fondly remembered as decades marked by numerous scandals and crises that shook the corporate world.¹ The early 2000s, in particular, are notable for a major economic meltdown triggered by corporate scandals in the USA and Europe.² These scandals implicated corporations such as Enron, WorldCom, and Parmalat, which collapsed into massive bankruptcies. Kenya also had its share of corporate failures, including the Goldenberg scandal,³ the collapse of Uchumi Supermarkets,⁴ and the downfall of Nakumatt Holdings,⁵ among others. The most significant global crisis during this period was the 2008 financial crisis, which had devastating effects on the world economy.⁶

These scandals and crises were largely attributed to systemic risks, corporate greed, and poor regulation. In response to the financial crisis, there was an increased focus on public discussions about corporate governance principles and best practices. Companies were compelled to adopt robust governance frameworks, which included well-structured boards, independent directors, enhanced disclosures, and improved risk management measures.⁷ Despite these interventions, corporations have continued to grapple with governance challenges, resulting in painful losses for investors and shareholders. Recent scandals bear striking similarities to those of the 1990s and early 2000s in both nature and impact. This article explores the causes of some of these corporate scandals and examines whether systemic weaknesses in corporate governance are to blame for these recurring crises.

1 Dan Byrne, 'What Is the History of Corporate Governance?' (29 July 2022)

<<https://www.thecorporategovernanceinstitute.com/insights/lexicon/why-does-corporate-governance-matter-a-look-back-at-history/>> accessed 9 July 2024.

2 Ibid.

3 Roman Grynberg and Fwasa Singogo, 'An Anatomy of Grand Fraud: The Goldenberg Scandal and the IMF/World Bank' (2020) 10 Public Policy and Administration Research

<https://www.researchgate.net/publication/350194946_An_Anatomy_of_Grand_Fraud_The_Goldenberg_Scandal_and_the_IMFWorld_Bank> accessed 27 August 2024.

4 Victor Amadala, 'The Rise and Fall of Uchumi Supermarket' (4 November 2019) <https://www.thestar.co.ke/business/kenya/2019-11-04-the-rise-and-fall-of-uchumi-supermarket/#google_vignette> accessed 29 August 2024.

5 Tony Watima, 'Why Supermarkets in Kenya Are Collapsing One-By-One like Flies' (Nation10 August 2020) <<https://nation.africa/kenya/life-and-style/smart-company/why-supermarkets-kenya-collapsing--1916696>> accessed 29 August 2024.

6 Byrne (n 1).

7 Brian R Cheffins, 'The History of Corporate Governance' [2011] SSRN Electronic Journal <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975404> accessed 9 July 2024.

Corporate Governance

The most widely recognized definition of corporate governance was formulated by the Cadbury Committee, which was commissioned by the UK government in 1991 to develop a corporate governance code. The committee described corporate governance as “the system by which companies are directed and controlled.”⁸ Altintas offers a broader definition, describing corporate governance as “the management of corporations and the procedures for holding people in charge accountable, while controlling risks and boosting competitiveness at the corporate and national levels, all the while ensuring that executives and boards are answerable to shareholders.”⁹

Over the past three decades, many countries have introduced significant reforms to their corporate governance structures. While these reforms have yielded commendable results, they have not resolved fundamental challenges in practice. It can be argued that corporate governance structures have not only failed to prevent the collapse of corporations and notable scandals in recent times but have also provided opportunities for unscrupulous companies to exploit existing systems.¹⁰ For example, many scandals involved deliberate manipulation of financial records, such as overstating expenses, understating revenues, or misappropriating business funds for personal use.¹¹

When Enron collapsed in 2001, investigations revealed that the company had overstated profits and employed accounting practices that deviated from accepted standards. Internal and external audits failed to uncover the financial misrepresentations that had been concealed for years. The financial crisis of 2008, on the other hand, was attributed to systemic risks, corporate greed, poor regulation, and excessive risk-taking in pursuit of profit.¹² Kirkpatrick observed that the collapse of many corporations during the crisis was due to “failures and weaknesses in corporate governance arrangements.”¹³ It is worth noting that these scandals and crises occurred despite the presence of well-established regulatory frameworks.

The Nexus Between Corporate Governance and Scandals and Crises

There are three perspectives regarding the relationship between corporate governance and corporate scandals or crises. The first argues that corporate governance has no significant relationship, or only a negligible one, with corporate scandals and crises.¹⁴ For example, Cheffins posits that during the financial crisis, most state corporations remained

⁸ ‘Report of The Committee on The Financial Aspects of Corporate Governance’ (1992) <<https://www.ecgi.global/sites/default/files/codes/documents/cadbury.pdf>> accessed 9 July 2024.

⁹ N Altıntaş, ‘Evolution of Corporate Governance in The United States of America’ 153 <<https://dergipark.org.tr/tr/download/article-file/100753>> accessed 9 July 2024.

¹⁰ William Sun, Jim Stewart and David Pollard, ‘A Systemic Failure of Corporate Governance: Lessons from the On Going Financial Crisis’ (12 February 2012) <<https://www.europeanfinancialreview.com/a-systemic-failure-of-corporate-governance-lessons-from-the-on-going-financial-crisis/>> accessed 28 August 2024.

¹¹ Byrne (n 1).

¹² Grant Kirkpatrick, ‘The Corporate Governance Lessons from the Financial Crisis’ (2009) 2009 OECD Journal: Financial Market Trends 61 <https://www.oecd-ilibrary.org/finance-and-investment/the-corporate-governance-lessons-from-the-financial-crisis_fmt-v2009-art3-en> accessed 28 August 2024.

¹³ Ibid.

¹⁴ Supra note 10.

stable because corporate governance frameworks functioned relatively well.¹⁵ Therefore, companies that collapsed did so for reasons unrelated to corporate governance.

The second perspective asserts that corporate scandals and crises are directly linked to the inadequate application of corporate governance guidelines and principles. The Organization for Economic Co-operation and Development (OECD) emphasizes that the issue lies not in the frameworks themselves, which are advanced, but in their poor implementation by companies and policymakers.¹⁶ The third perspective attributes scandals—and particularly the financial crisis of 2008—to systemic weaknesses in corporate governance. This view contends that governance failures are not solely due to poor implementation but also arise from systemic issues embedded in how corporations operate. These include prioritizing shareholders, profit maximization, inefficient incentive structures, agency issues, and mismanagement of risks.¹⁷

Corporate models that emphasize short-term gains over sustainable growth have significantly contributed to recent collapses. Julian Birkinshaw remarked that the financial crash was both a market failure and a failure of corporate management, stating, “The crash is an astounding market failure, but the interesting thing is that the visible hand of management failed, too. Most big companies just failed to do what big companies are supposed to do.”¹⁸ “The management” in this sense refers to the boards and executives of corporations. One could argue that the management created the problem by letting outdated ideology and their self-interests override corporate governance strictures. Sun et al. while quoting Simon Caulkin observe that traditionally,

“The company’s job was to make money for shareholders; the individual’s job was to pursue self-interest, allowing the invisible hand to work its magic; and the job of governance was to align ‘agents’ (managers) with ‘principals’ (shareholders) by incentives and sanctions. The carrot was pay linked to stock price, often in the form of stock options. The stick: high levels of debt and a vigorous market for corporate control, which ensured that underperforming assets could readily pass into the hands of sharper managers at hungrier companies.”

Self-interest and concepts of shareholder primacy have contributed to the failures of many companies. The recent scandals and financial crisis portray a similar pattern. The management misjudged risks, distributed resources improperly, and gave people incorrect incentives. They also overlooked the importance of trust. These concepts of incentives and self-interest perpetuate too much corporate greed by placing too much authority on the management to the exclusion of shareholders and stakeholders. The problem extends beyond poor implementation to systemic weaknesses that encourage excessive risk-taking for short-term gains. While strong governance systems promote stability, weak ones create a breeding ground for crises.

15 Brian Cheffins, ‘Did Corporate Governance “Fail” during the 2008 Stock Market Meltdown? The Case of the S&P 500’ (2009) <https://www.ecgi.global/sites/default/files/working_papers/documents/SSRN-id1396126.pdf> accessed 28 August 2024.

16 Supra note 10.

17 Ibid.

18 ‘Corporate Apocalypse’ [2009] Management Today <<https://www.managementtoday.co.uk/corporateapocalypse/article/870435>> accessed 29 August 2024.

Systemic Issues of Corporate Governance

The Merriam-Webster dictionary defines the term “systemic” as “what relates to or affects an entire system.”¹⁹ In the context of corporate governance, an issue is systemic if it impacts the entire governance structure rather than isolated components. The Cadbury Committee described corporate governance as “the system by which companies are directed and controlled.”²⁰ This widely accepted definition, however, often limits its scope to board composition and shareholder rights. Blair offers a more comprehensive perspective, defining corporate governance as “the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.”²¹

Blair’s broader conceptualization identifies four distinct levels of governance: regulatory, market, stakeholder, and internal.²² The regulatory level involves government-imposed rules that guide corporate behavior. The market level focuses on the influence of market forces like supply and demand on corporate decision-making. The stakeholder level addresses the role of stakeholders such as employees, customers, suppliers, and the community in shaping corporate conduct. Finally, the internal level pertains to a company’s internal frameworks, including board composition, executive powers, and shareholder meetings. 2 Failures at one or more of these levels can result in systemic weaknesses, undermining the effectiveness of corporate governance and increasing the likelihood of scandals or crises.

Case Study

The Enron Scandal

Enron Corporation, once a prominent American energy company, is infamous for its catastrophic failure due to poor governance and unethical practices. Its downfall was characterized by what Cuong describes as “poor corporate governance and a dishonest culture that nurtured serious conflicts of interest and unethical behavior.”²³ Enron’s financial manipulations involved overstating profits while concealing substantial losses. Despite ongoing failures, the company maintained an illusion of success, attracting unsuspecting investors. These issues were exacerbated by systemic governance failures involving the board, executives, auditors, and whistleblowers.²⁵

Enron’s board members failed to fulfill their fiduciary duties, allowing an environment where whistleblowing was discouraged and audits were compromised. Executives extracted exorbitant compensation packages at the expense of other stakeholders, while the board neglected its responsibility to question management decisions. The directors on their part were cited for failing to execute their fiduciary duties. They failed to carry

¹⁹ <https://www.merriam-webster.com/dictionary/systemic>.

²⁰ Supra note 8.

²¹ Margaret M Blair, ‘Rethinking Assumptions behind Corporate Governance’ (1995) 38 Challenge 12.

²² Supra note 10.

²³ Nguyen Cuong, ‘Factors Causing Enron’s Collapse: An Investigation into Corporate Governance And Company Culture’ (2024) <<https://virtusinterpress.org/IMG/pdf/10-22495c0cv8i3c6p2.pdf>>. accessed 29th August 2024.

out their mandate in the best interests of the company, the shareholders, and other stakeholders.²⁴ They failed to question the decisions of the board all through as long as their interests were catered for.

Both internal and external auditors failed to identify or disclose Enron's fraudulent practices. Investigations revealed that the external auditor had significant conflicts of interest, having been paid substantial fees for non-audit-related services.²⁷ The auditor was also involved in appointing an inexperienced internal auditor, further compromising oversight. Ultimately, the external auditor's decision to shred key documents reinforced the systemic weaknesses in Enron's governance structure.²⁵

The Fall of Uchumi Supermarket

The weaknesses seen in Enron's collapse were similarly evident in the fall of Uchumi Supermarket, one of Kenya's largest retail chains. After more than 30 years of operation, Uchumi collapsed in 2006, marking what many called Kenya's "greatest corporate disaster."

²⁶ Uchumi's downfall was attributed to an aggressive and poorly planned expansion strategy, lax management, insufficient resource allocation, and inappropriate funding.

²⁷ An investigative task force revealed that Uchumi had pursued high-risk expansion plans that overstretched its finances. During this period, some employees conspired with unscrupulous suppliers and distributors to carry out fraudulent schemes, including fictitious claims, which went undetected by the board, directors, and auditors.³²

Allegations of financial manipulation also emerged, and the undetected fraudulent dealings lent credibility to these claims. Uchumi's governance structures failed to uphold fundamental principles of corporate governance, leaving the company vulnerable to collapse.

The weaknesses that led to Uchumi's fall were mirrored in the subsequent collapses of two other major Kenyan retail chains, Tuskys Supermarket and Nakumatt Holdings. These companies suffered from similar issues, including weak corporate governance structures and excessive risk-taking.²⁸ Management decisions in both companies were largely concentrated within a small group of family members, which created opportunities for unscrupulous employees and suppliers to exploit the businesses through fraudulent

²⁴ Ibid.

²⁷ Ibid.

²⁵ Adam Hayes, 'What Was Enron? What Happened and Who Was Responsible' (1 March 2024)

<<https://www.investopedia.com/terms/e/enron.asp>> accessed 29 August 2024.

²⁶ Victor Amadala, 'The Rise and Fall of Uchumi Supermarket' (4 November 2019) <https://www.thestar.co.ke/business/kenya/2019-11-04-the-rise-and-fall-of-uchumi-supermarket/#google_vignette> accessed 29 August 2024.

²⁷ Business Daily, 'PS Lists Reasons for Uchumi Collapse before Nairobi Court' (16 December 2020) <<https://www.business-dailyafrica.com/bd/corporate/companies/ps-lists-reasons-for-uchumi-collapse-before-nairobicourt-1980400>> accessed 29 August 2024.

²⁸ Carolyne Mbatia and Abraham Wanjiku, 'The Collapse of Supermarket Chains: Evidence and Lessons for Retail Giants' (14 September 2020) <<https://businessday.co.ke/the-collapse-of-supermarket-chains-nakumatt-collapseukwala-supermarkets-nakumatt/>> accessed 29 August 2024.

claims for undelivered goods.²⁹

The Financial Crisis

The global financial crisis of 2007–2009, often referred to as the “Great Recession,” originated from the United States housing bubble and quickly spread to global economies. The crisis was fueled by the reckless issuance of subprime mortgages by American banks, even to borrowers with poor creditworthiness, in pursuit of short-term profits. This behavior created a housing boom as demand for mortgages surged. However, an oversupply of housing eventually caused prices to plummet, leaving many borrowers unable to repay their loans. As defaults increased, banks faced liquidity crises, triggering widespread financial instability that extended across international markets.³⁰ The crisis was attributed to structural risks, corporate greed, and inadequate regulatory oversight. In response, significant reforms were introduced, including the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S. and the Basel III Accord globally. These measures sought to improve financial stability by enhancing bank regulation, supervision, and risk management, particularly through the introduction of minimum liquidity and capital requirements.³¹

Corporate governance failures within the banking industry were also blamed for the crisis. Kirkpatrick noted that existing governance frameworks failed to curb excessive risk-taking, which exposed systemic weaknesses rooted in greed, unethical practices, and managerial shortcomings.³² Kevin Dowd highlighted poor risk management and flawed financial strategies as major contributors to the crisis.³³ He pointed to weak accounting regulations that allowed financial institutions to hide risks using off-balance-sheet entities, reducing transparency and accountability. Additionally, regulators were poorly equipped to monitor and control financial institutions effectively.³⁴ Short-term performance incentives for executives further exacerbated the crisis. These incentives encouraged excessive risk-taking for immediate gains, sacrificing long-term stability for quick profits. This erosion of accountability underscored the systemic governance weaknesses at play.³⁵

Governance Weaknesses in The Scandals and Crises

The above cases of the Enron scandal, Uchumi supermarket fall, the financial crisis, and collapse of Nakumatt holdings all illustrate both the internal and external regulatory weaknesses inherent in many a corporation. These weaknesses range from weak boards to compromised management, and auditors. However, it is instructive to note that while external weaknesses played a huge role in the scandals and crises, the failures were largely a product of weak internal control measures. Some of the weaknesses were deliberate,

29 Mbatia and Wanjiku (n 31).

30 Michael Boyle, ‘The Great Recession: What It Was and What Caused It’ (18 December 2023) <<https://www.investopedia.com/terms/g/great-recession.asp>> accessed 30 August 2024.

31 Sunil K Mohanty and others, ‘The Dodd-Frank Act and Basel III: Market-Based Risk Implications for Global Systemically Important Banks (G-SIBs)’ (2018) 47-48 *Journal of Multinational Financial Management* 91.

32 Kirkpatrick (n 12).

33 Kevin Dowd, ‘Moral Hazard and the Financial Crisis’ (2009) 29 *Cato Journal* <<https://www.cato.org/sites/cato.org/files/serials/files/cato-journal/2009/1/cj29n1-12.pdf>> accessed 30 August 2024.

34 Ibid.

35 Ibid.

others accidental, and some due to ignorance. The internal weaknesses can be narrowed down to the failure of the companies to cultivate a positive corporate culture based on which the external governance measures would flow. For instance, the implementation of regulations, if any, depends on the willingness of the company for effect. Otherwise, a company founded on ill corporate culture will still find a way to get around the existing regulations.

External corporate governance factors depend on formidable internal corporate governance measures. Appropriate internal control measures founded on good corporate culture determine the efficacy of external factors of corporate governance. Concerning the external factors, it is evident that companies exploited the regulatory gaps, misjudged the market dynamics, and underestimated the stakeholder role, a combination of factors that occasioned their downfall. Little wonder, most legal and policy pronouncements were made in reaction to the scandals and crises, albeit to seal the gaps that were exposed. For instance, the Enron scandal culminated in the passage of the Sarbanes-Oxley Act. The Act introduced considerably new obligations on public corporations regarding disclosure and corporate governance. Additionally, it greatly raised the executives' and directors' culpability for public corporations.³⁶

The financial crisis on the other hand birthed the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US and the Basel III Accord, which was introduced globally. The interventions improved the banking system's capacity to withstand financial stress and enhanced bank regulation, supervision, and risk management by introducing minimum liquidity and capital norms.³⁷ All the said regulatory interventions were made in reaction to the aftereffects of the scandals and crisis; a reaction to the weaknesses that were deeply rooted in the entire system.

Therefore, scandals are indeed products of systemic weaknesses to the extent that the extent that systemic weaknesses only contribute a substantial component of what is visible. At least, they can be ascertained, prevented, and redressed empirically and practically. In a free market economy, however, there are other invisible forces including factors of production, competition, and consumption patterns which also determine the success or failures of enterprises.³⁸

Conclusion

Effective corporate governance requires a holistic approach that integrates regulatory, market, stakeholder, and internal governance mechanisms. A proactive regulatory framework and a culture of ethical behavior within corporations are essential for sustainable governance. However, history has shown that human behavior, when left unchecked, often prioritizes greed over long-term stability. Regulations must therefore step in to establish boundaries and enforce accountability. Good corporate governance is fundamental to the success and resilience of corporations. Strong governance structures

³⁶ Sarbanes-Oxley Act.

³⁷ Mohanty and others (n 38).

³⁸ Christina Majaski, 'Dispelling Mysteries about the Invisible Hand' (Investopedia 21 March 2023) <<https://www.investopedia.com/terms/i/invisiblehand.asp>> accessed 5 September 2024.

must address systemic weaknesses by balancing internal control measures with external oversight, ensuring that corporations remain stable, ethical, and sustainable in the face of challenges.

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AGENCY THEORY IN PERSPECTIVE: THE ENRON SCANDAL

MAINA ALLAN

Introduction

At the heart of agency theory is the agency problem.¹ The agency problem is a conundrum that sees a conflict of interest between managers and shareholders.² On the one hand, managers are keen on issues including job security, better salaries and meeting their performance targets while the shareholders tend to be keen on maximising their profit.³ A deconstruction of agency theory pits one group against the other. The first group is the shareholders; these are the principals in the principal-agent relationship.⁴ The second group is the board of directors; these are the agents in the principal-agent relationship.⁵ The idea that one group is the principal and another the agent stems from the complex nature of corporations in the near past.⁶ Initially, entities were established and run by the same people.⁷ However, an increased need for capital injection into the entities saw the development of stock companies where ownership in the company was in the form of stock which was transferable from one person to another.⁸ This saw the separation of ownership and control in the sense that persons who held stock were not necessarily involved in the day-to-day running of the business.⁹ This separation was further entrenched when companies began listing their stock on the stock market.¹⁰ Owing to the decentralised nature of publicly listed stock, there rose the need for further separation between ownership and control.¹¹ Management of the day-to-day affairs of the entities was left to a group of professional managers styled as a board of directors.¹² The directors acted on behalf of the shareholders and as a result, there existed a fiduciary relationship.¹³

1 Kathleen Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 *The Academy of Management Review* 57.

2 Walaa Wahid ElKelish, 'Corporate Governance Risk and the Agency Problem' (2018) 18 *Corporate Governance: The International Journal of Business in Society* 254.

3 John Roberts, 'Agency Theory, Ethics and Corporate Governance', *Corporate governance: Does any size fit?* (Emerald Group Publishing Limited 2005).

4 Eisenhardt (n 1).

5 *ibid.*

6 Thomas Clarke, *Corporate Governance: A Survey* (Cambridge University Press 2020).

7 *ibid.*

8 *ibid.*

9 *ibid.*

10 *ibid.*

11 *ibid.*

12 *ibid.*

13 *ibid.*

The fiduciary relationship between directors and the shareholders is based on the trust which the shareholders place on the directors.¹⁴ The shareholders entrust some of their powers with the directors who are expected to use these powers for their proper purpose.¹⁵ That is to mean, they should use these powers within the boundaries of the principal-agent relationship, at all times being mindful of the interests of the shareholders.¹⁶ English law has developed the proper purpose rule in corporate law to include several core aspects. Firstly, the directors are mandated to act in the best interests of the company.¹⁷ This is illustrated in the case of *Hogg v Cramphorn Ltd*¹⁸ where the court directed that the decision by the directors to issue new shares to prevent a hostile takeover was not in the best interest of the company regardless of whether the directors genuinely believed that they acted in the company's and shareholders' best interests.¹⁹ This case illustrates that the powers exercised by the director shall be in the best interests of the company and within the scope of powers granted to the director, thus being within the intended purpose.

Secondly, directors are mandated to exercise reasonable care, skill and diligence in their operations.²⁰ Thirdly, the directors are mandated to avoid conflicts of interest.²¹ The directors' duty to exercise reasonable care, skill and diligence was addressed in the case of *Dorchester Finance Co Ltd v Stebbing*²² where the court found that the directors had breached their duty to act with the necessary skill and care.²³ This case involved a situation where directors signed blank cheques on behalf of a non-executive director and these cheques were used to commit fraud.²⁴ The court found that the directors were negligent and noted that they ought to have exercised reasonable care, skill and diligence in the process.²⁵ Additionally, the case of *Cook v Deeks*²⁶ spelt out the directors' duty to avoid conflicts of interests.²⁷ In this case, three directors also being the majority shareholders of the company diverted a corporate opportunity from the company to themselves by way of a ratification of their actions as directors.²⁸ However, a fourth director, being a minority shareholder, was aggrieved by this action and brought an action citing ethical concerns of the actions of the three directors.²⁹ The court noted that the actions by the three directors were marred by dishonesty and a lack of transparency thus declaring the purported ratification invalid.³⁰ The court held that in consequence, the three directors would be

14 Eisenhardt (n 1).

15 *ibid.*

16 *ibid.*

17 Jonathan Munnery, 'Understanding a Company Director's Fiduciary Duties and Consequences of Failing These Duties' (Begbies Traynor Group, 22 May 2024), 9, 6], "issued": {"date-parts": [{"2024", "5", "22"}]}, "schema": "https://github.com/citation-style-language/schema/raw/master/csl-citation.json"}]

18 [1967] Ch 254

19 *Hogg v Cramphorn Ltd* [1967] Ch 254.

20 Munnery (n 17), 9, 6], "issued": {"date-parts": [{"2024", "5", "22"}]}, "schema": "https://github.com/citation-style-language/schema/raw/master/csl-citation.json"}]

21 *ibid.* 9, 6], "issued": {"date-parts": [{"2024", "5", "22"}]}, "schema": "https://github.com/citation-style-language/schema/raw/master/csl-citation.json"}]

22 [1989] BCLC 498 (Ch)

23 *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498.

24 *ibid.*

25 *ibid.*

26 [1916] 1 AC 554

27 *Cook v Deeks* [1916] 1 AC 554.

28 *ibid.*

29 *ibid.*

30 *ibid.*

bound to account to the company for their secret profit following the transaction.³¹The principal-agent relationship albeit based on an underlying set of fiduciary duties which directors owe the shareholders, is prone to breach. One such instance is in the much-a-publicised Enron scandal which culminated in the company filing for bankruptcy on December 2, 2001. The section below further discusses the Enron scandal.

The rise of Enron: 1985-2001

Enron was founded in 1985 by Kenneth Lay who served as the founder, chief executive officer and chairman.³² On August 1, 1990, Jeffrey Skilling took on the role of chief executive officer and chairman of Enron Finance, the finance arm of the Enron enterprise.³³ On December 3, 1990, Andrew Fastow joined Enron Finance.³⁴ The firm adopted mark-to-market accounting following an approval by the United States Securities and Exchange Commission.³⁵ The adoption of this accounting method allowed the Enron senior management to manipulate their financial records.³⁶ This saw the company include future value yet to be realised in their current income statements which presented an image of good financial health.³⁷In addition to the fraudulent adjustments using the mark-to-market accounting technique adopted by senior management, Andrew Fastow- the Chief Financial Officer- established two limited liability partnerships through which he engaged in sham transactions defrauding the Enron shareholders and enriching himself.³⁸

The United States Securities Exchange Commission described two of such transactions as secret asset-parking arrangements.³⁹ These transactions involved the sale of power plants in Nigeria and in Cuiaba, Brazil.⁴⁰In July 2000, Enron subsequently entered into a twenty-year contract with Blockbuster for the provision of on-demand video services.⁴¹ This was through its subsidiary company, Enron Broadband Services.⁴² Even though the transaction fell through after one year, Enron would claim that it made 110 million U.S Dollars from the partnership with Blockbuster.⁴³Following the string of transactions and accounting tactics adopted by senior management from 1990 to 2000, Enron saw a steady rise in the value of its stock with its peak on August 23, 2000 when the value stood at 90 U.S Dollars per share.⁴⁴ However, cracks began appearing in the Enron success story and this came to a head in 2001 when journalist Bethany McLean published the infamous 'Is Enron

31 *ibid.*

32 Douglas Linder, 'The Enron Trial: A Chronology' (UMKC School of Law: Famous Trials, 2024) <<https://www.famous-trials.com/enron/1789-chronology>> accessed 6 September 2024.

33 *ibid.*

34 *ibid.*

35 David Gwilliam and Richard HG Jackson, 'Fair Value in Financial Reporting: Problems and Pitfalls in Practice: A Case Study Analysis of the Use of Fair Valuation at Enron', *Accounting Forum* (Elsevier 2008).

36 *ibid.*

37 *ibid.*

38 U.S. SEC, 'Fastow to Disgorge More Than \$23 Million; Agrees To Cooperate in Ongoing Investigation' (U.S. Securities and Exchange Commission, 2024) <<https://www.sec.gov/enforcement-litigation/litigation-releases/lr-18543>> accessed 8 September 2024.

39 *ibid.*

40 Forbes, 'Enron's Nigeria Barge: The Real Deal' (Forbes, 20 September 2004) <https://www.forbes.com/2004/09/20/cx_da_0920topnews.html> accessed 8 September 2024.

41 Anne Marie Squeo and Bruce Orwall, 'Enron and Blockbuster Terminate Partnership for Video-on-Demand' (The Wall Street Journal, 12 March 2001) <<https://www.wsj.com/articles/SB98418137490463655>> accessed 8 September 2024.

42 *ibid.*

43 *ibid.*

44 Linder (n 29).

Overpriced?’ article in the Fortune magazine.⁴⁵ In the article, McLean brought to focus, the complex businesses in which Enron was engaged, the purported impenetrability of their financial records and called into question the scale at which the Enron stock traded at the bourse.⁴⁶

The Agency Problem as illustrated in Enron

Upon investigation into the Enron story, one notices three major issues which may be associated with the agency problem. Firstly, the misreporting by Enron was abetted by their accountants- Arthur Andersen.⁴⁷ Secondly, Enron had close links to the political class, which saw the firm contribute generously to the George W. Bush gubernatorial and presidential campaigns.⁴⁸ Thirdly, the individual interests of senior management overrode those of the shareholders.⁴⁹ Firstly, the proximity of senior management to the auditors entrenched the conflict of interest between the shareholders and management.⁵⁰ The role of the auditor has generally been to conduct an analysis of the status of the books of the entity, ensuring that the financial records reflect the state of affairs as is.⁵¹ The auditor is expected to be a disinterested party and as such, to provide an objective assessment of the firm.⁵² However, one notes that in the Enron situation, Andersen could not provide objective auditing services to Enron owing to the fact that they offered consulting services to the firm in addition to auditing services.⁵³ In this sense, there was evident conflict of interest and thus, the auditors could not adequately serve their purpose. This further entrenches the conflict of interest which saw the senior management leverage the information asymmetry to their own advantage.

Secondly, the proximity of Enron to the political class hindered effective corporate governance in Enron and effective government involvement to ensure that the interests of the shareholders were upheld. In their paper, Corporate Governance and Disappointment, Erturk et al discuss the intersection between corporate governance and the political economy.⁵⁴ They demonstrate that in larger to midsize economies, the political economy is determined by either of two things- the socio-political status quo or the reliance of corporate funding in politics.⁵⁵ Erturk et al discuss the socio-political status quo by presenting the case of the United Kingdom.⁵⁶ They note that in the U.K., politics is informed by club membership typically associated with the older, wealthier political elite or by a strict adherence to the law, which is an approach typically associated with Margaret Thatcher and the political outfits which followed.⁵⁷ They note that these forms of political

45 Bethany McLean, ‘Is Enron Overpriced?’ (2001) 143 Fortune 122.

46 *ibid.*

47 Yuhao Li, ‘The Case Analysis of the Scandal of Enron’ (2010) 5 International Journal of business and management 37.

48 ABC News, ‘Enron’s Close Ties to Bush’ (ABC News, 10 December 2001) <<https://abcnews.go.com/Politics/story?id=121269&page=1>> accessed 6 September 2024.

49 Li (n 44).

50 William W Bratton, ‘Shareholder Value and Auditor Independence’ (2003) 53 Duke LJ 439.

51 J Alabede, ‘The Role, Compromise and Problems of the External Auditor in Corporate Governance’ (2012) 3 Research Journal of Finance and Accounting.

52 David Lavin, ‘Perceptions of the Independence of the Auditor’ (1976) 51 The Accounting Review 41.

53 Li (n 44).

54 Ismail Erturk and others, ‘Corporate Governance and Disappointment’ (2004) 11 Review of International Political Economy 677.

55 *ibid.*

56 *ibid.*

57 *ibid.*

organising influence corporate governance since the adherents of the club membership political economy typically make a case for lenient rules around appointment of directors and the interaction between directors and various other stakeholders of the firm.⁵⁸ The appointment of directors on this form of political organising is largely based on one's networks and as such, entry into the echelons of firm directorships becomes a strictly members-only affair.⁵⁹

The authors note that this tends to disenfranchise efforts towards stricter conflict of interest laws especially on the part of the directors as this may see the CEO directly involved in the appointment of the board of directors, determination of the directors' remuneration among others.⁶⁰ Erturk et al further discuss the American form of interconnection between corporate governance and the political economy, finding that owing to the size of the country, the members-only approach to appointment of directors and management of firms is not feasible and instead, big corporates leverage their financial muscle to influence political outcomes.⁶¹ The authors note that corporates tend to contribute to political campaigns and often this tends to influence the politician's approach to policies around the corporate sponsor's industry.⁶² This may take the form of introduction of liberalisation of certain markets to the advantage of the corporate sponsor.⁶³

In the case of Enron, owing to the firm's proximity to the government, this allowed for more opaque dealings by senior management. The government may create an enabling environment which would occasion opportunities for senior management to bypass the corporate governance requirements and further their own self-enrichment schemes. The authors note that this may be exacerbated in a neoliberal capitalist economy largely driven by market forces.⁶⁴ The analysis of a potential for increased conflict of interest between the shareholders' needs and the desires of the directors may be underscored where one notes that a neoliberal market is based on the principles of a free market which sees minimal government involvement.⁶⁵ A neoliberal market is based on the forces of demand and supply where it is understood that the market shall remedy any inconsistencies by way of market forces.⁶⁶ A neoliberal economy calls for minimal government involvement and believes in the 'invisible hand' which will remedy any market inconsistencies.⁶⁷

However, the law and economics movement has argued that the market is inherently flawed and it calls for government regulation to address the inadequacies of the market forces.⁶⁸ These inadequacies include information asymmetry, the problem of common goods, negative externalities and the principal-agent problem.⁶⁹ In the case of the management of a firm, the directors are likely to have better information on the goings-

58 *ibid.*

59 *ibid.*

60 *ibid.*

61 *ibid.*

62 *ibid.*

63 *ibid.*

64 *ibid.*

65 Robert Cooter and Thomas Ulen, *Law and Economics* (6th edn, Addison-Wesley).

66 Raewyn Connell, 'Understanding Neoliberalism' (2010) 23 *Neoliberalism and everyday life*.

67 Bruna Ingraio and Giorgio Israel, 'The Invisible Hand'.

68 Cooter and Ulen (n 62).

69 *ibid.*

on of the firm including the firm's financial performance than the shareholders would. An agent may take advantage of this information asymmetry and use it to further his/her own interests thus disenfranchising the shareholder. This is an element of what happened in the Enron scandal. Owing to the senior management's proximity to the government, they were able to operate on relatively friendly terms with the regulator and thus, were able to leverage the information asymmetry to their advantage. This exposed the shareholders to fraud and saw their senior management enrich themselves in an unethical manner.

Elsewhere, the Enron scandal highlighted the impact of the agent's interests overriding those of the principal. This may be best analysed through the lens of the firm as a 'nexus of contracts'.⁷⁰ The nexus of contracts theory seeks to address the simplistic approach of the agency theory by providing that the firm is in fact more than the principal-agent relationship.⁷¹ The nexus of contracts theory suggests that the corporate entity is made up of a web of express and implied contracts which allow for the optimum performance of the firm within the economy.⁷² Easterbrook and Fischel state that the corporation is made up of contracts through which various actors seek out their self-interested ends.⁷³ The authors provide that the corporation is made up of various stakeholders such as the founders, the shareholders, the managers, the employees and creditors.⁷⁴ They state that the mechanics of the operation of the firm are best left to the firm itself, that is, the network of contracts between the self-interested persons involved with the firm.⁷⁵ At the outset, the founders of the firm have a contract that stipulates the objectives of the firm and the way in which it shall be ran.⁷⁶ The shareholders also have a contract which entitles them to returns from the business.⁷⁷ The managers, employees and creditors alike have contracts with the firm which provide for the rights and responsibilities of the parties and what they stand to derive from this contractual relationship.⁷⁸ Easterbrook and Fischel state that corporate law and as such, the rules on corporate governance, merely provide a background term to all these contracts which shall prevail unless trumped by the terms of the contracts themselves.⁷⁹ They note that these express or implied contracts therefore inform the relationship between the board and the shareholders and in a sense, they allow the parties to act within the scope of the contracts and in particular, they serve to prevent the parties from introducing 'surprise terms' to the contractual relationship.⁸⁰

Therefore, the nexus of contracts theory explains that the relationship between the board and the shareholders is part of a network of contracts between the firm and other stakeholders all of whom have competing interests.⁸¹ Thus, in the Enron scandal, it may be apparent that the contract between the firm and the senior management exerted more pressure than the contracts between the firm and other stakeholders. This led to the

70 Frank H Easterbrook and Daniel R Fischel, 'Corporate Contract, The' (1989) 89 Colum. L. Rev. 1416.

71 William W Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (1988) 74 Cornell L. Rev. 407.

72 Easterbrook and Fischel (n 67).

73 *ibid.*

74 *ibid.*

75 *ibid.*

76 *ibid.*

77 *ibid.*

78 *ibid.*

79 *ibid.*

80 *ibid.*

81 Bratton (n 68).

interests of persons such as Lay, Skilling and Fastow overriding those of the shareholders. Thus, the former took advantage of any potential vulnerabilities in the network of contracts and used these to their own advantage. For instance, Fastow took advantage of the directors' power to grant an exemption from conflict of interest rules which thus allowed him to run the limited liability partnerships through which he misappropriated funds from the company.⁸²

The Sarbanes-Oxley Act

The Enron scandal sent shockwaves throughout the U.S. economy and in response, the federal government passed the Sarbanes-Oxley Act to navigate the murky waters of financial impropriety by firms which occasioned harm to investors.⁸³ However, the Sarbanes-Oxley Act has been cited as being inadequate since it largely addresses one issue out of a whole host of issues which form the agency problem.⁸⁴ In particular, the Sarbanes-Oxley Act introduced stricter compliance rules for firms with regard to their financial reporting.⁸⁵ Its sections affect the corporate governance, risk management, auditing and financial reporting of public companies.⁸⁶ The Act establishes the Public Company Accounting Oversight Board which is tasked with the registration and inspection of accounting firms which offer audit services to public companies in the U.S. securities markets.⁸⁷ The Board is also tasked with establishing auditing, quality control and ethics standards for the registered accounting firms along with the duty to investigate and discipline any accounting firm which is in violation of the law or of professional standards.⁸⁸ Additionally, the Act mandates that the auditor shall be independent and further, it provides for corporate responsibility.⁸⁹

It does the latter by providing requirements for public disclosures of the responsibility of management in the establishment and maintenance of adequate internal control structures.⁹⁰ It also provides that the external auditors of these public firms must report on whether they agree with the assessments by management on the company's internal controls.⁹¹ Erturk et al⁹² state that, though welcome, the Sarbanes-Oxley Act only addresses the role of the auditor and the financial responsibilities of management.⁹³ They note that though Title II of the Act provides for the periodic rotation of the audit partners managing the audit of a public company, it would be prudent to call for the rotation of the entire audit firm so as to entrench the independence of the auditor and to protect the interest of the shareholders.⁹⁴ Additionally, they state that the Act would be more adequate

⁸² Linder (n 29).

⁸³ Tim Vipond, 'Sarbanes Oxley Act' (CFI, 2024) <<https://corporatefinanceinstitute.com/resources/economics/sarbanes-oxley-act/>> accessed 8 September 2024.

⁸⁴ Erturk, Ismail, Julie Froud, Sukhdev Johal, and Karel Williams. "Corporate governance and disappointment." *Review of International Political Economy* 11, no. 4 (2004): 677-713.

⁸⁵ Vipond (n 80).

⁸⁶ *ibid.*

⁸⁷ Sarbanes-Oxley Act.

⁸⁸ *ibid.*

⁸⁹ *ibid.*

⁹⁰ *ibid.*

⁹¹ *ibid.*

⁹² Erturk, Ismail, Julie Froud, Sukhdev Johal, and Karel Williams. "Corporate governance and disappointment." *Review of International Political Economy* 11, no. 4 (2004): 677-713.

⁹³ *Ibid.*

⁹⁴ *ibid.*

if it limited or ultimately put a stop to the contributions by firms, to political aspirants' campaigns.⁹⁵

Conclusion

In conclusion, the Enron scandal serves as an example of the agency problem, where the interests of the agents (executives and employees) were prioritized over the interests of the principals (shareholders and stakeholders). This led to unethical practices, financial misrepresentation, and ultimately, the collapse of the firm. The scandal underscores the critical importance of addressing corporate governance issues—specifically, determining how the principal-agent relationship is structured, by whom decisions are made, and for whose benefit they are made. It is evident that without appropriate checks and balances, the agency problem can have devastating consequences for both the firm and its principals. The Enron case highlights the necessity for rigorous oversight, transparency, and alignment of interests to protect stakeholders in the future.

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⁹⁵ *ibid.*

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AN ANALYSIS OF THE EXTENT TO WHICH THE ENACTMENT OF THE COMPANIES ACT 2015 HAS ENHANCED THE STANDARDS OF SKILL AND CARE EXPECTED FROM DIRECTORS.

ONESMUS NZUKI

Introduction

In the context of corporate governance, board accountability is pivotal to maintaining the integrity, transparency, and sustainability of organizations. The board of directors, which represents the interests of shareholders, is responsible for overseeing corporate activities and ensuring compliance with financial reporting standards. Among its key duties are the creation of committees, such as the Audit and Risk Management Committee, that serve to monitor financial practices and risk management, ensuring transparency and accountability to both internal and external stakeholders. This section discusses the essential role of board accountability in fostering trust, sustaining investor confidence, and ensuring organizational longevity, with real-world examples to illustrate its impact on corporate governance.

The Role of the Board in Corporate Governance

The board of directors plays a critical role in steering the organization and ensuring that it adheres to financial, legal, and ethical standards. It is responsible for setting the organization's strategic direction, approving financial statements, and ensuring compliance with regulatory standards. According to Aguilera (2005)¹, board accountability can be understood through a comparative perspective of institutional frameworks, where variations in governance structures across countries influence the effectiveness of accountability measures. The board's primary responsibility is to act in the best interests of shareholders, while also considering the broader impact on stakeholders such as employees, customers, and the community.

To ensure proper governance, boards often establish specialized committees, such as the Audit Committee and the Risk Management Committee, to oversee specific aspects of the company's operations. These committees are instrumental in reviewing financial reports, assessing risks, and ensuring that the company complies with regulatory standards, such as those imposed by the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP). The existence of such committees enhances board accountability, as it ensures that the organization's financial practices are

¹ R V Aguilera, 'Corporate Governance and Director Accountability: An Institutional Comparative Perspective' (2005) 16(S1) British Journal of Management S39

subjected to rigorous scrutiny and are reported in a transparent and timely manner.²

The Audit and Risk Management Committees are vital to upholding board accountability in relation to financial reporting and risk management. The Audit Committee is responsible for overseeing the financial reporting process, ensuring the integrity of financial statements, and maintaining compliance with legal and regulatory requirements. It plays a key role in liaising with external auditors to provide an independent assessment of the organization's financial health. Coffee (2006) discusses the role of external auditors as "gatekeepers" in corporate governance, ensuring that financial disclosures are accurate and reflect the company's true financial position. The Audit Committee, therefore, serves as a bridge between the board, management, and external auditors, ensuring transparency in financial reporting.³

The Risk Management Committee, on the other hand, is responsible for identifying, assessing, and mitigating potential risks that could impact the organization's financial performance or reputation. This committee oversees the company's risk management framework and ensures that the organization has internal controls in place to manage operational, financial, and reputational risks. According to Ribstein (2006)⁴, internal controls are essential for maintaining accountability within the organization, as they provide a system of checks and balances to prevent fraud and mismanagement. By ensuring that risks are adequately identified and managed, the Risk Management Committee contributes to the long-term sustainability of the organization and enhances investor confidence.⁵

Case Study: The Enron Collapse and Lack of Board Accountability

One of the most prominent examples of the failure of board accountability and governance is the Enron scandal. Enron Corporation, once a leading energy company, collapsed in 2001 after it was revealed that the company had engaged in fraudulent accounting practices to hide its financial losses. The company's board of directors, and specifically its Audit Committee, failed to exercise adequate oversight over financial reporting, allowing Enron's management to manipulate financial statements and deceive investors.⁶ This lack of accountability and transparency led to the company's downfall, resulting in massive losses for shareholders and eroding public trust in corporate governance.

Enron's collapse was primarily caused by the failure of its governance structures, particularly the lack of effective oversight by the board and its committees. The company's Audit Committee did not properly scrutinize the financial statements or question the complex accounting practices used by management to conceal the company's debt. As a result, the company's financial health was grossly misrepresented, leading to its eventual bankruptcy. Chaney and Philipich (2002) highlight the impact of audit failures on corporate reputation, noting that the collapse of Enron was a direct consequence of the

2 D Branson, 'Enron: When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform' (2003) 48(4) Villanova Law Review 989.

3 J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

4 L Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) Notre Dame Law Review 1431.

5 Ibid

6 Ibid n2

failure of its auditors, Arthur Andersen, to perform their role as gatekeepers of financial transparency. This case underscores the critical importance of board accountability and the need for independent, rigorous audits to maintain the integrity of financial reporting.⁷

Case Study: The Role of Board Accountability in the Lehman Brothers Bankruptcy

The collapse of Lehman Brothers in 2008 further illustrates the consequences of inadequate board accountability and risk management. Lehman Brothers, a global financial services firm, declared bankruptcy in the midst of the financial crisis, largely due to its excessive exposure to subprime mortgage-backed securities and its failure to manage risk effectively⁸. The board of directors, including the Risk Management Committee, did not adequately assess or mitigate the risks associated with the company's investment strategy, leading to massive losses and the eventual failure of the firm.⁹

Lehman Brothers' failure can be attributed to a lack of board oversight and poor risk management practices. The board did not have a comprehensive understanding of the risks associated with the company's investments, nor did it implement adequate internal controls to prevent excessive risk-taking. As a result, the company's financial position deteriorated rapidly, leading to a loss of investor confidence and the collapse of the firm. The Lehman Brothers case highlights the importance of effective board accountability and risk management in ensuring the long-term sustainability of the organization and protecting the interests of shareholders and stakeholders.

The Importance of Transparency in Financial Reporting

Transparency in financial reporting is essential for maintaining investor confidence and ensuring the sustainability of an organization. Investors rely on accurate and timely financial information to make informed decisions about the company's financial health and future prospects. When transparency is compromised, as seen in the cases of Enron and Lehman Brothers, it can lead to a loss of investor confidence and significant financial losses.

The Sarbanes-Oxley Act of 2002¹⁰, which was introduced in response to the Enron and WorldCom scandals, emphasizes the importance of transparency in financial reporting and enhances the accountability of boards and auditors. The Act requires companies to implement stronger internal controls and mandates that executives certify the accuracy of financial statements. This legislation has been instrumental in improving the transparency and integrity of financial reporting, thereby restoring investor confidence in the wake of corporate scandals.¹¹

Board accountability is a fundamental component of corporate governance, ensuring that

7 PK Chaney and KL Philipich, 'Shredded Reputation: The Cost of Audit Failure' (2002) 40(4) *Journal of Accounting Research* 1221.

8 Ibid n3

9 Ibid n3

10 I Dewing and P Russell, 'Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Developments Before and After Enron' (2004) 42(2) *Journal of Common Market Studies* 289.

11 Ibid

organizations adhere to financial reporting standards and maintain transparency in their operations. The creation of specialized committees, such as the Audit and Risk Management Committees, enhances board accountability by overseeing financial reporting and risk management processes. Case studies such as Enron and Lehman Brothers demonstrate the devastating consequences of a lack of board oversight and transparency, highlighting the importance of rigorous governance practices in sustaining organizational sustainability and investor confidence. To ensure the long-term viability of organizations, boards must remain vigilant in their oversight responsibilities, implementing robust internal controls and fostering a culture of transparency. By doing so, they can safeguard the interests of shareholders and stakeholders while promoting trust and confidence in the financial markets.

Risk Management and Internal Control: Analyzing Their Role in Preventing Financial Crises and Enhancing Organizational Decision-Making

Risk management and internal controls are essential elements of corporate governance, critical to the long-term sustainability and operational success of organizations. Effective risk management frameworks help companies identify, assess, and mitigate risks that could threaten their financial health, reputation, and strategic objectives. Internal controls, on the other hand, provide the checks and balances that ensure financial integrity, regulatory compliance, and operational efficiency. Together, risk management and internal controls safeguard organizations against financial crises, enhance decision-making processes, and promote transparency. This discourse explores the importance of these mechanisms in corporate governance, with real-world examples and case studies to illustrate their significance in maintaining organizational sustainability and investor confidence.

The Role of Risk Management in Corporate Governance

Risk management is a proactive process that involves identifying, assessing, and prioritizing risks, followed by the implementation of strategies to mitigate or manage those risks. These risks can range from financial and operational risks to legal, reputational, and strategic risks. As part of corporate governance, risk management ensures that organizations are prepared to handle uncertainties that could negatively impact their performance or ability to meet objectives. Effective risk management frameworks enable companies to anticipate and address potential challenges before they escalate into crises. According to Ribstein (2006)¹², risk management is not just about mitigating known risks but also about creating a culture of awareness and preparedness within the organization. This requires the involvement of the board of directors, senior management, and specialized committees, such as the Risk Management Committee, to oversee the risk management process and ensure that appropriate controls are in place.¹³

The importance of risk management became especially evident during the global financial crisis of 2008, when many organizations collapsed due to inadequate risk management practices. Lehman Brothers, for example, suffered from excessive risk-taking in the form of overexposure to subprime mortgage-backed securities, leading to its bankruptcy.¹⁴ The failure of Lehman Brothers serves as a stark reminder of the consequences of neglecting risk

¹² L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) Notre Dame Law Review 1431

¹³ Ibid

¹⁴ Ibid n3

management, particularly in the financial services industry. Had Lehman implemented a more robust risk management framework, it could have identified and mitigated the risks associated with its investment strategy, potentially avoiding its catastrophic collapse.

Internal Controls: Safeguarding Financial Integrity and Enhancing Decision-Making

Internal controls refer to the policies, procedures, and processes implemented by an organization to ensure the accuracy and reliability of financial reporting, compliance with laws and regulations, and the efficient use of resources. Internal controls play a crucial role in safeguarding an organization's assets and preventing fraud, errors, and mismanagement. These controls are typically categorized into three types: preventive, detective, and corrective controls. Preventive controls are designed to prevent errors and fraud before they occur, while detective controls identify issues after they have occurred, and corrective controls address the issues to prevent their recurrence.

One of the most significant aspects of internal controls is their ability to enhance decision-making by providing accurate and timely financial information. Boards and senior management rely on this information to make informed decisions regarding the organization's strategic direction, financial investments, and operational activities. According to Dewing and Russell (2004)¹⁵, internal controls ensure that financial reports accurately reflect the organization's financial position, enabling stakeholders to assess the company's performance and risks. This level of transparency is crucial for maintaining investor confidence and ensuring the long-term sustainability of the organization.¹⁶

A well-known example of the failure of internal controls is the case of WorldCom, which collapsed in 2002 after it was revealed that the company had engaged in accounting fraud to inflate its earnings¹⁷. WorldCom's internal controls were insufficient to detect the manipulation of financial statements, allowing the company's executives to engage in fraudulent practices for several years without detection. The company's failure to implement strong internal controls led to one of the largest bankruptcies in U.S. history, resulting in significant losses for investors and the public.¹⁸ The WorldCom case underscores the importance of robust internal controls in preventing financial crises and ensuring the integrity of financial reporting.

Case Study: The Collapse of Barings Bank

The collapse of Barings Bank in 1995 is another notable example of the consequences of weak internal controls and inadequate risk management. Barings Bank, one of the oldest and most prestigious financial institutions in the United Kingdom, collapsed due to unauthorized trading activities conducted by a single employee, Nick Leeson. Leeson, a derivatives trader, engaged in speculative trading on the Singapore International Monetary Exchange, accumulating losses of over \$1.3 billion, which ultimately led to the

¹⁵ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

¹⁶ Ibid

¹⁷ Ibid n2

¹⁸ Ibid n2

bank's insolvency.¹⁹

The Barings Bank case highlighted significant weaknesses in the bank's internal controls and risk management framework. Despite the size and scope of Leeson's trading activities, the bank's internal controls failed to detect or prevent his unauthorized actions. Leeson was able to circumvent the bank's control systems, exploiting gaps in oversight and risk management. The collapse of Barings Bank serves as a powerful reminder of the need for strong internal controls, particularly in high-risk environments such as financial trading, where the potential for catastrophic losses is high. In response to the Barings collapse, many financial institutions reevaluated their internal controls and risk management frameworks, implementing stricter oversight procedures and introducing new technologies to monitor trading activities in real time. The case also prompted regulatory changes, with authorities placing greater emphasis on the importance of internal controls in maintaining financial stability and protecting the interests of investors and the public.

Case Study: JP Morgan's "London Whale" Trading Losses

The JP Morgan "London Whale" incident in 2012 provides another example of how inadequate risk management and internal controls can result in significant financial losses²⁰. JP Morgan Chase, one of the largest banks in the world, incurred trading losses of over \$6.2 billion due to the actions of a trader nicknamed the "London Whale".²¹ The trader, Bruno Iksil, engaged in highly speculative trades involving credit derivatives, which went unnoticed by the bank's risk management team until the losses became too large to conceal. The incident revealed significant shortcomings in JP Morgan's internal controls and risk management framework. Despite the size and complexity of the trades, the bank's risk management system failed to identify and mitigate the risks associated with the trading activities. In particular, the bank's Value at Risk (VaR) model, which is used to measure the potential losses on investments, was flawed and underestimated the risks involved in Iksil's trades.²²

Additionally, there were gaps in communication between the bank's risk management team and senior management, preventing timely action to address the growing losses. In the aftermath of the "London Whale" incident, JP Morgan took significant steps to strengthen its risk management framework and internal controls²³. The bank revamped its risk oversight structure, improved its VaR model, and implemented new processes to enhance communication between risk managers and senior leadership. The case serves as a cautionary tale for organizations about the importance of continuously evaluating and improving their risk management practices to prevent financial crises and protect the interests of shareholders.

¹⁹ Ibid n2

²⁰ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

²¹ Ibid

²² Ibid n9

²³ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

Preventing Financial Crises through Effective Risk Management and Internal Controls

The aforementioned case studies illustrate the devastating consequences of inadequate risk management and internal controls. However, they also highlight the potential for organizations to learn from these failures and implement stronger governance practices to prevent future crises. Effective risk management frameworks and internal controls can help organizations identify and mitigate risks before they escalate, ensuring that potential issues are addressed in a timely manner and preventing financial crises.

One of the key elements of effective risk management is the establishment of a risk-aware culture within the organization. This involves not only the implementation of risk management frameworks and internal controls but also fostering a culture of accountability and transparency, where employees are encouraged to report risks and potential issues without fear of retaliation. According to Ribstein (2006)²⁴, organizations with a strong risk-aware culture are better equipped to anticipate and address risks, reducing the likelihood of financial crises and enhancing decision-making processes. In addition to fostering a risk-aware culture, organizations must also continuously evaluate and improve their internal controls to ensure they remain effective in an ever-changing business environment. This requires regular audits, both internal and external, to assess the effectiveness of existing controls and identify areas for improvement. By maintaining strong internal controls, organizations can prevent fraud, errors, and mismanagement, ensuring the integrity of financial reporting and enhancing the decision-making process.²⁵ Risk management and internal controls are critical components of corporate governance, essential for preventing financial crises and enhancing organizational decision-making. As demonstrated by the cases of Enron, WorldCom, Barings Bank, and JP Morgan, the failure to implement effective risk management frameworks and internal controls can result in significant financial losses and damage to an organization's reputation. Conversely, organizations that prioritize risk management and internal controls are better positioned to navigate uncertainties, protect their assets, and maintain investor confidence. By fostering a risk-aware culture, continuously evaluating internal controls, and ensuring that risk management practices are integrated into decision-making processes, organizations can enhance their resilience and ensure long-term sustainability. In today's increasingly complex business environment, the ability to effectively manage risks and maintain strong internal controls is more important than ever for the success and sustainability of organizations.

Transparency and Disclosure

Transparency and disclosure are essential pillars of corporate governance, critical to fostering stakeholder confidence and ensuring organizational sustainability. These concepts refer to the openness and clarity with which organizations communicate information to their stakeholders, including investors, employees, and the public. Transparent communication and comprehensive disclosure reduce information asymmetry, a situation in which one party has more or better information than the other,

²⁴ L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) *Notre Dame Law Review* 1431.

²⁵ *Ibid* n9

which can result in mistrust and poor decision-making²⁶. By providing accurate and timely information through mechanisms like the Board Charter, Annual Report, and Audit Report, organizations not only comply with regulatory standards but also enhance their reputation and reliability²⁷. This discussion explores the role of transparency and disclosure in corporate governance, emphasizing how they help reduce information asymmetry and build stakeholder confidence. Case studies will illustrate the importance of these mechanisms in sustaining trust and ensuring organizational success.

The Importance of Transparency in Corporate Governance

Transparency in corporate governance refers to the clear, honest, and accessible communication of an organization's operations, financial performance, risks, and strategic direction. This level of openness is crucial in maintaining trust between the company and its stakeholders, particularly investors who rely on accurate information to make informed decisions. According to Ribstein (2006)²⁸, transparency acts as a safeguard against corporate mismanagement and fraud by holding organizations accountable for their actions. This accountability ensures that stakeholders, especially shareholders, have the necessary information to evaluate the company's governance and financial health.²⁹ Disclosure of relevant information through documents such as the Annual Report and Audit Report allows organizations to present a comprehensive overview of their financial activities, operational risks, and future plans. The Board Charter, another key document, outlines the responsibilities of the board of directors and sets the standards for governance practices. Together, these documents provide stakeholders with a clear understanding of the organization's financial standing and governance framework, helping to bridge any information gaps between the company and its stakeholders.

Reducing Information Asymmetry through Disclosure

One of the primary purposes of disclosure is to reduce information asymmetry, which occurs when one party in a transaction or relationship has access to more or better information than the other. In corporate settings, information asymmetry can create a power imbalance between management and stakeholders, particularly investors. When investors lack critical information about a company's financial health or operations, they may make poor investment decisions or lose confidence in the organization. Transparency, through timely and accurate disclosure, mitigates this risk by ensuring that all relevant information is shared with stakeholders.

Chaney and Philipich (2002) highlight that transparency and comprehensive disclosure prevent the manipulation of information by management, reducing the potential for corporate scandals. In cases where companies fail to provide accurate and timely information, stakeholders may be left in the dark about potential risks or financial weaknesses, leading to misinformed decisions and a loss of trust. Transparent

26 Fung, Benjamin. "The demand and need for transparency and disclosure in corporate governance." *Universal Journal of Management* 2, no. 2 (2014): 72-80.

27 Ibid

28 L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) *Notre Dame Law Review* 1431.

29 Ibid n9

communication helps to establish a level playing field for all stakeholders, ensuring that they have the same access to critical information about the company's performance and prospects.³⁰

A notable example of the impact of information asymmetry is the collapse of Enron in 2001. Enron engaged in complex accounting practices that obscured the company's true financial condition, misleading investors and analysts about the company's profitability.³¹ By withholding key information and failing to provide transparent financial reports, Enron created a significant information asymmetry between the company's management and its stakeholders, which ultimately led to the company's downfall. The Enron scandal underscored the importance of transparent financial reporting and the need for rigorous disclosure standards to protect stakeholders from corporate malfeasance.

The Role of the Board Charter in Enhancing Transparency

The Board Charter is a governance document that outlines the roles, responsibilities, and decision-making processes of the board of directors. It serves as a guide for the board's operations and establishes the standards of governance that the company adheres to. By clearly defining the duties and expectations of the board, the Board Charter promotes transparency in governance practices and ensures that the board is accountable to its stakeholders. The Board Charter also contributes to reducing information asymmetry by providing stakeholders with a clear understanding of how decisions are made within the organization. This transparency in governance fosters trust among investors and other stakeholders, as it assures them that the company is being run in a responsible and ethical manner. According to Aguilera (2005)³², the Board Charter plays a key role in shaping stakeholder perceptions of the company's governance practices, particularly in environments where there is a lack of regulatory oversight or weak enforcement of corporate governance standards.³³

Annual Reports and Audit Reports: Tools for Financial Transparency

The Annual Report is one of the most important tools for financial transparency, providing a comprehensive overview of the company's financial performance, operations, risks, and future strategies. It is a key communication document that allows stakeholders to assess the company's health and make informed decisions about their investments. A well-prepared Annual Report includes financial statements, management's discussion and analysis, and an overview of the company's corporate governance practices, providing stakeholders with the information they need to evaluate the company's prospects.

Audit Reports, on the other hand, provide an independent assessment of the company's financial statements, ensuring that they are accurate and free from material misstatements. The Audit Committee, a subcommittee of the board of directors, works with external

30 PK Chaney and KL Philipich, 'Shredded Reputation: The Cost of Audit Failure' (2002) 40(4) *Journal of Accounting Research* 1221.

31 Ibid n2

32 D Branson, 'Enron: When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform' (2003) 48(4) *Villanova Law Review* 989.

33 D Branson, 'Enron: When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform' (2003) 48(4) *Villanova Law Review* 989.

auditors to ensure that the financial reports are prepared in accordance with established accounting standards and that they present a true and fair view of the company's financial position. The role of the Audit Committee in overseeing financial reporting is crucial for maintaining stakeholder confidence, as it provides an additional layer of oversight and accountability.³⁴

The failure to provide transparent and accurate financial reports can have severe consequences for an organization, as demonstrated by the WorldCom scandal in 2002. WorldCom, a major telecommunications company, engaged in accounting fraud by misrepresenting its financial statements, inflating its assets by billions of dollars³⁵. The company's failure to provide transparent financial reports led to one of the largest bankruptcies in U.S. history, eroding investor confidence and leading to widespread financial losses.³⁶ The WorldCom case highlights the critical role of Annual Reports and Audit Reports in maintaining transparency and preventing corporate fraud.

Case Study: The Role of Transparency in the Volkswagen Emissions Scandal

The Volkswagen (VW) emissions scandal, also known as "Dieselgate," is a prime example of how a lack of transparency can severely damage a company's reputation and erode stakeholder confidence. In 2015, it was revealed that Volkswagen had installed software in its diesel vehicles to cheat emissions tests, making the cars appear more environmentally friendly than they actually were. For years, Volkswagen misled regulators, customers, and investors by failing to disclose the true environmental impact of its vehicles.³⁷

The lack of transparency in Volkswagen's communication and reporting led to a significant loss of trust among stakeholders. Investors suffered financial losses as the company's stock price plummeted, and the company faced billions of dollars in fines and legal settlements. Moreover, the scandal tarnished Volkswagen's brand reputation, leading to a decline in customer loyalty. The Volkswagen case underscores the importance of transparent communication and comprehensive disclosure in maintaining stakeholder confidence and protecting a company's reputation.

Transparency and disclosure are foundational to effective corporate governance, fostering stakeholder confidence and reducing information asymmetry. Through clear communication and comprehensive reporting mechanisms like the Board Charter, Annual Report, and Audit Report, organizations can ensure that stakeholders have access to accurate and timely information about the company's operations, financial performance, and governance practices. Case studies such as Enron, WorldCom, and Volkswagen illustrate the devastating consequences of failing to provide transparent and accurate information, highlighting the importance of transparency in maintaining organizational sustainability and investor trust. By embracing transparency and rigorous disclosure practices, companies can reduce the risk of corporate scandals, enhance decision-making processes, and build long-term relationships with stakeholders. In

³⁴ Ibid n3

³⁵ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

³⁶ Ibid n2

³⁷ Ibid n1

today's complex business environment, the ability to provide transparent and accurate information is more important than ever in fostering trust and ensuring the long-term success of organizations.

Continuous Improvement and Sustainability

The principles of accountability, transparency, and risk management are not only essential for maintaining investor confidence but also for fostering continuous improvement and organizational sustainability. These governance structures—comprising practices like transparent financial reporting, robust internal controls, and a well-functioning board—allow organizations to adapt to evolving risks, regulatory changes, and market demands. By embedding continuous improvement into their operations, organizations can enhance their long-term sustainability, ensuring they remain competitive and resilient in an ever-changing environment.

Governance Structures Driving Continuous Improvement

Governance frameworks such as the Board Charter, risk management policies, and audit mechanisms are integral to fostering a culture of continuous improvement. The Board Charter clearly outlines the roles and responsibilities of the board, which includes overseeing strategic initiatives and ensuring that the organization adheres to legal and regulatory requirements. A strong governance framework allows for continuous reassessment of business processes, encouraging leaders to refine their strategies and operations based on emerging risks and opportunities.³⁸

Audit committees, as part of governance, play a crucial role in ensuring that internal controls are effective and adaptable. By conducting regular audits and reviewing financial practices, these committees help organizations identify inefficiencies, operational risks, and potential compliance issues. This feedback loop is essential for making incremental improvements and fostering a culture of accountability. Moreover, transparency in financial reporting and regular audits builds investor confidence, as stakeholders can see that the organization is committed to continuous enhancement of its internal processes.³⁹

Enhancing Organizational Adaptability

Risk management is another core element of governance that contributes to an organization's adaptability. A robust risk management framework enables businesses to anticipate and mitigate potential threats, whether they arise from market fluctuations, regulatory changes, or operational failures. Organizations that are proactive in identifying risks and implementing mitigation strategies are better positioned to navigate uncertainties and ensure long-term sustainability.⁴⁰

Furthermore, transparency and accountability in risk management practices allow for better decision-making. When an organization's leadership is aware of evolving risks and

³⁸ Ibid n1

³⁹ Ibid n3

⁴⁰ L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) *Notre Dame Law Review* 1431.

the necessary steps to manage them, they are more likely to adapt their business models, operational strategies, and governance practices accordingly. This adaptability is crucial in today's dynamic business environment, where regulatory frameworks and market conditions are constantly shifting.

Case Study: Johnson & Johnson's Continuous Improvement Approach

A notable example of continuous improvement through governance practices is Johnson & Johnson (J&J), which has embedded sustainability and risk management into its corporate governance framework. The company's Credo, a guiding governance document, outlines its commitment to accountability, transparency, and ethical business practices. In the wake of various challenges, including product recalls and legal disputes, J&J implemented stronger risk management and internal controls systems, continuously refining its operations and governance practices to mitigate future risks.⁴¹ J&J also emphasizes sustainability in its long-term strategic planning, regularly updating its governance policies to reflect evolving environmental and regulatory demands. By aligning its governance framework with its corporate sustainability goals, J&J has demonstrated how organizations can adapt to changing risks while ensuring continuous improvement and investor confidence.

Sustainability is a key outcome of effective governance structures. Companies that prioritize continuous improvement through rigorous internal controls and risk management frameworks are more likely to endure over the long term. According to Dewing and Russell (2004), integrating sustainability into governance practices—such as through transparent reporting and risk assessments—enables businesses to meet stakeholder expectations while navigating the challenges of regulatory changes and market dynamics.⁴²

Conclusion

In conclusion, governance structures that emphasize transparency, risk management, and accountability facilitate continuous improvement in business operations. These frameworks allow organizations to be adaptable and resilient, enhancing their ability to sustain growth and remain competitive. By regularly refining their practices to address emerging risks and regulatory demands, organizations can ensure long-term success and maintain stakeholder trust.

⁴¹ Ibid n2

⁴² Ibid n8

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THE ROLE OF ACCOUNTABILITY, TRANSPARENCY AND RISK MANAGEMENT IN ENSURING ORGANIZATIONAL SUSTAINABILITY AND INVESTOR CONFIDENCE

ZAINAB ALI

Introduction

In the context of corporate governance, board accountability is pivotal to maintaining the integrity, transparency, and sustainability of organizations. The board of directors, which represents the interests of shareholders, is responsible for overseeing corporate activities and ensuring compliance with financial reporting standards. Among its key duties are the creation of committees, such as the Audit and Risk Management Committee, that serve to monitor financial practices and risk management, ensuring transparency and accountability to both internal and external stakeholders. This section discusses the essential role of board accountability in fostering trust, sustaining investor confidence, and ensuring organizational longevity, with real-world examples to illustrate its impact on corporate governance.

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subjected to rigorous scrutiny and are reported in a transparent and timely manner.²

The Audit and Risk Management Committees are vital to upholding board accountability in relation to financial reporting and risk management. The Audit Committee is responsible for overseeing the financial reporting process, ensuring the integrity of financial statements, and maintaining compliance with legal and regulatory requirements. It plays a key role in liaising with external auditors to provide an independent assessment of the organization's financial health. Coffee (2006) discusses the role of external auditors as "gatekeepers" in corporate governance, ensuring that financial disclosures are accurate and reflect the company's true financial position. The Audit Committee, therefore, serves as a bridge between the board, management, and external auditors, ensuring transparency in financial reporting.³

The Risk Management Committee, on the other hand, is responsible for identifying, assessing, and mitigating potential risks that could impact the organization's financial performance or reputation. This committee oversees the company's risk management framework and ensures that the organization has internal controls in place to manage operational, financial, and reputational risks. According to Ribstein (2006)⁴, internal controls are essential for maintaining accountability within the organization, as they provide a system of checks and balances to prevent fraud and mismanagement. By ensuring that risks are adequately identified and managed, the Risk Management Committee contributes to the long-term sustainability of the organization and enhances investor confidence.⁵

Case Study: The Enron Collapse and Lack of Board Accountability

One of the most prominent examples of the failure of board accountability and governance is the Enron scandal. Enron Corporation, once a leading energy company, collapsed in 2001 after it was revealed that the company had engaged in fraudulent accounting practices to hide its financial losses. The company's board of directors, and specifically its Audit Committee, failed to exercise adequate oversight over financial reporting, allowing Enron's management to manipulate financial statements and deceive investors.⁶ This lack of accountability and transparency led to the company's downfall, resulting in massive losses for shareholders and eroding public trust in corporate governance.

Enron's collapse was primarily caused by the failure of its governance structures, particularly the lack of effective oversight by the board and its committees. The company's Audit Committee did not properly scrutinize the financial statements or question the complex accounting practices used by management to conceal the company's debt. As a result, the company's financial health was grossly misrepresented, leading to its eventual bankruptcy. Chaney and Philipich (2002) highlight the impact of audit failures on corporate reputation, noting that the collapse of Enron was a direct consequence of the

2 D Branson, 'Enron: When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform' (2003) 48(4) Villanova Law Review 989.

3 J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

4 L Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) Notre Dame Law Review 1431.

5 Ibid

6 Ibid n2

failure of its auditors, Arthur Andersen, to perform their role as gatekeepers of financial transparency. This case underscores the critical importance of board accountability and the need for independent, rigorous audits to maintain the integrity of financial reporting.⁷

Case Study: The Role of Board Accountability in the Lehman Brothers Bankruptcy

The collapse of Lehman Brothers in 2008 further illustrates the consequences of inadequate board accountability and risk management. Lehman Brothers, a global financial services firm, declared bankruptcy in the midst of the financial crisis, largely due to its excessive exposure to subprime mortgage-backed securities and its failure to manage risk effectively⁸. The board of directors, including the Risk Management Committee, did not adequately assess or mitigate the risks associated with the company's investment strategy, leading to massive losses and the eventual failure of the firm.⁹

Lehman Brothers' failure can be attributed to a lack of board oversight and poor risk management practices. The board did not have a comprehensive understanding of the risks associated with the company's investments, nor did it implement adequate internal controls to prevent excessive risk-taking. As a result, the company's financial position deteriorated rapidly, leading to a loss of investor confidence and the collapse of the firm. The Lehman Brothers case highlights the importance of effective board accountability and risk management in ensuring the long-term sustainability of the organization and protecting the interests of shareholders and stakeholders.

The Importance of Transparency in Financial Reporting

Transparency in financial reporting is essential for maintaining investor confidence and ensuring the sustainability of an organization. Investors rely on accurate and timely financial information to make informed decisions about the company's financial health and future prospects. When transparency is compromised, as seen in the cases of Enron and Lehman Brothers, it can lead to a loss of investor confidence and significant financial losses.

The Sarbanes-Oxley Act of 2002¹⁰, which was introduced in response to the Enron and WorldCom scandals, emphasizes the importance of transparency in financial reporting and enhances the accountability of boards and auditors. The Act requires companies to implement stronger internal controls and mandates that executives certify the accuracy of financial statements. This legislation has been instrumental in improving the transparency and integrity of financial reporting, thereby restoring investor confidence in the wake of corporate scandals.¹¹

7 PK Chaney and KL Philipich, 'Shredded Reputation: The Cost of Audit Failure' (2002) 40(4) *Journal of Accounting Research* 1221.

8 Ibid n3

9 Ibid n3

10 I Dewing and P Russell, 'Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Developments Before and After Enron' (2004) 42(2) *Journal of Common Market Studies* 289.

11 Ibid

Board accountability is a fundamental component of corporate governance, ensuring that organizations adhere to financial reporting standards and maintain transparency in their operations. The creation of specialized committees, such as the Audit and Risk Management Committees, enhances board accountability by overseeing financial reporting and risk management processes. Case studies such as Enron and Lehman Brothers demonstrate the devastating consequences of a lack of board oversight and transparency, highlighting the importance of rigorous governance practices in sustaining organizational sustainability and investor confidence. To ensure the long-term viability of organizations, boards must remain vigilant in their oversight responsibilities, implementing robust internal controls and fostering a culture of transparency. By doing so, they can safeguard the interests of shareholders and stakeholders while promoting trust and confidence in the financial markets.

Risk Management and Internal Control: Analyzing Their Role in Preventing Financial Crises and Enhancing Organizational Decision-Making

Risk management and internal controls are essential elements of corporate governance, critical to the long-term sustainability and operational success of organizations. Effective risk management frameworks help companies identify, assess, and mitigate risks that could threaten their financial health, reputation, and strategic objectives. Internal controls, on the other hand, provide the checks and balances that ensure financial integrity, regulatory compliance, and operational efficiency. Together, risk management and internal controls safeguard organizations against financial crises, enhance decision-making processes, and promote transparency. This discourse explores the importance of these mechanisms in corporate governance, with real-world examples and case studies to illustrate their significance in maintaining organizational sustainability and investor confidence.

The Role of Risk Management in Corporate Governance

Risk management is a proactive process that involves identifying, assessing, and prioritizing risks, followed by the implementation of strategies to mitigate or manage those risks. These risks can range from financial and operational risks to legal, reputational, and strategic risks. As part of corporate governance, risk management ensures that organizations are prepared to handle uncertainties that could negatively impact their performance or ability to meet objectives. Effective risk management frameworks enable companies to anticipate and address potential challenges before they escalate into crises. According to Ribstein (2006)¹², risk management is not just about mitigating known risks but also about creating a culture of awareness and preparedness within the organization. This requires the involvement of the board of directors, senior management, and specialized committees, such as the Risk Management Committee, to oversee the risk management process and ensure that appropriate controls are in place.¹³

The importance of risk management became especially evident during the global financial crisis of 2008, when many organizations collapsed due to inadequate risk management

¹² L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) *Notre Dame Law Review* 1431

¹³ *Ibid*

practices. Lehman Brothers, for example, suffered from excessive risk-taking in the form of overexposure to subprime mortgage-backed securities, leading to its bankruptcy.¹⁴ The failure of Lehman Brothers serves as a stark reminder of the consequences of neglecting risk management, particularly in the financial services industry. Had Lehman implemented a more robust risk management framework, it could have identified and mitigated the risks associated with its investment strategy, potentially avoiding its catastrophic collapse.

Internal Controls: Safeguarding Financial Integrity and Enhancing Decision-Making

Internal controls refer to the policies, procedures, and processes implemented by an organization to ensure the accuracy and reliability of financial reporting, compliance with laws and regulations, and the efficient use of resources. Internal controls play a crucial role in safeguarding an organization's assets and preventing fraud, errors, and mismanagement. These controls are typically categorized into three types: preventive, detective, and corrective controls. Preventive controls are designed to prevent errors and fraud before they occur, while detective controls identify issues after they have occurred, and corrective controls address the issues to prevent their recurrence.

One of the most significant aspects of internal controls is their ability to enhance decision-making by providing accurate and timely financial information. Boards and senior management rely on this information to make informed decisions regarding the organization's strategic direction, financial investments, and operational activities. According to Dewing and Russell (2004)¹⁵, internal controls ensure that financial reports accurately reflect the organization's financial position, enabling stakeholders to assess the company's performance and risks. This level of transparency is crucial for maintaining investor confidence and ensuring the long-term sustainability of the organization.¹⁶

A well-known example of the failure of internal controls is the case of WorldCom, which collapsed in 2002 after it was revealed that the company had engaged in accounting fraud to inflate its earnings¹⁷. WorldCom's internal controls were insufficient to detect the manipulation of financial statements, allowing the company's executives to engage in fraudulent practices for several years without detection. The company's failure to implement strong internal controls led to one of the largest bankruptcies in U.S. history, resulting in significant losses for investors and the public.¹⁸ The WorldCom case underscores the importance of robust internal controls in preventing financial crises and ensuring the integrity of financial reporting.

Case Study: The Collapse of Barings Bank

The collapse of Barings Bank in 1995 is another notable example of the consequences of weak internal controls and inadequate risk management. Barings Bank, one of the oldest and most prestigious financial institutions in the United Kingdom, collapsed due to unauthorized trading activities conducted by a single employee, Nick Leeson. Leeson,

¹⁴ Ibid n3

¹⁵ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

¹⁶ Ibid

¹⁷ Ibid n2

¹⁸ Ibid n2

a derivatives trader, engaged in speculative trading on the Singapore International Monetary Exchange, accumulating losses of over \$1.3 billion, which ultimately led to the bank's insolvency.¹⁹

The Barings Bank case highlighted significant weaknesses in the bank's internal controls and risk management framework. Despite the size and scope of Leeson's trading activities, the bank's internal controls failed to detect or prevent his unauthorized actions. Leeson was able to circumvent the bank's control systems, exploiting gaps in oversight and risk management. The collapse of Barings Bank serves as a powerful reminder of the need for strong internal controls, particularly in high-risk environments such as financial trading, where the potential for catastrophic losses is high. In response to the Barings collapse, many financial institutions reevaluated their internal controls and risk management frameworks, implementing stricter oversight procedures and introducing new technologies to monitor trading activities in real time. The case also prompted regulatory changes, with authorities placing greater emphasis on the importance of internal controls in maintaining financial stability and protecting the interests of investors and the public.

Case Study: JP Morgan's "London Whale" Trading Losses

The JP Morgan "London Whale" incident in 2012 provides another example of how inadequate risk management and internal controls can result in significant financial losses²⁰. JP Morgan Chase, one of the largest banks in the world, incurred trading losses of over \$6.2 billion due to the actions of a trader nicknamed the "London Whale."²¹ The trader, Bruno Iksil, engaged in highly speculative trades involving credit derivatives, which went unnoticed by the bank's risk management team until the losses became too large to conceal. The incident revealed significant shortcomings in JP Morgan's internal controls and risk management framework. Despite the size and complexity of the trades, the bank's risk management system failed to identify and mitigate the risks associated with the trading activities. In particular, the bank's Value at Risk (VaR) model, which is used to measure the potential losses on investments, was flawed and underestimated the risks involved in Iksil's trades.²²

Additionally, there were gaps in communication between the bank's risk management team and senior management, preventing timely action to address the growing losses. In the aftermath of the "London Whale" incident, JP Morgan took significant steps to strengthen its risk management framework and internal controls²³. The bank revamped its risk oversight structure, improved its VaR model, and implemented new processes to enhance communication between risk managers and senior leadership. The case serves as a cautionary tale for organizations about the importance of continuously evaluating and improving their risk management practices to prevent financial crises and protect the interests of shareholders.

¹⁹ Ibid n2

²⁰ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

²¹ Ibid

²² Ibid n9

²³ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

Preventing Financial Crises through Effective Risk Management and Internal Controls

The aforementioned case studies illustrate the devastating consequences of inadequate risk management and internal controls. However, they also highlight the potential for organizations to learn from these failures and implement stronger governance practices to prevent future crises. Effective risk management frameworks and internal controls can help organizations identify and mitigate risks before they escalate, ensuring that potential issues are addressed in a timely manner and preventing financial crises.

One of the key elements of effective risk management is the establishment of a risk-aware culture within the organization. This involves not only the implementation of risk management frameworks and internal controls but also fostering a culture of accountability and transparency, where employees are encouraged to report risks and potential issues without fear of retaliation. According to Ribstein (2006)²⁴, organizations with a strong risk-aware culture are better equipped to anticipate and address risks, reducing the likelihood of financial crises and enhancing decision-making processes. In addition to fostering a risk-aware culture, organizations must also continuously evaluate and improve their internal controls to ensure they remain effective in an ever-changing business environment. This requires regular audits, both internal and external, to assess the effectiveness of existing controls and identify areas for improvement. By maintaining strong internal controls, organizations can prevent fraud, errors, and mismanagement, ensuring the integrity of financial reporting and enhancing the decision-making process.²⁵ Risk management and internal controls are critical components of corporate governance, essential for preventing financial crises and enhancing organizational decision-making. As demonstrated by the cases of Enron, WorldCom, Barings Bank, and JP Morgan, the failure to implement effective risk management frameworks and internal controls can result in significant financial losses and damage to an organization's reputation. Conversely, organizations that prioritize risk management and internal controls are better positioned to navigate uncertainties, protect their assets, and maintain investor confidence. By fostering a risk-aware culture, continuously evaluating internal controls, and ensuring that risk management practices are integrated into decision-making processes, organizations can enhance their resilience and ensure long-term sustainability. In today's increasingly complex business environment, the ability to effectively manage risks and maintain strong internal controls is more important than ever for the success and sustainability of organizations.

Transparency and Disclosure

Transparency and disclosure are essential pillars of corporate governance, critical to fostering stakeholder confidence and ensuring organizational sustainability. These concepts refer to the openness and clarity with which organizations communicate information to their stakeholders, including investors, employees, and the public. Transparent communication and comprehensive disclosure reduce information asymmetry, a situation in which one party has more or better information than the other,

²⁴ L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) Notre Dame Law Review 1431.

²⁵ Ibid n9

which can result in mistrust and poor decision-making²⁶. By providing accurate and timely information through mechanisms like the Board Charter, Annual Report, and Audit Report, organizations not only comply with regulatory standards but also enhance their reputation and reliability²⁷. This discussion explores the role of transparency and disclosure in corporate governance, emphasizing how they help reduce information asymmetry and build stakeholder confidence. Case studies will illustrate the importance of these mechanisms in sustaining trust and ensuring organizational success.

The Importance of Transparency in Corporate Governance

Transparency in corporate governance refers to the clear, honest, and accessible communication of an organization's operations, financial performance, risks, and strategic direction. This level of openness is crucial in maintaining trust between the company and its stakeholders, particularly investors who rely on accurate information to make informed decisions. According to Ribstein (2006)²⁸, transparency acts as a safeguard against corporate mismanagement and fraud by holding organizations accountable for their actions. This accountability ensures that stakeholders, especially shareholders, have the necessary information to evaluate the company's governance and financial health.²⁹ Disclosure of relevant information through documents such as the Annual Report and Audit Report allows organizations to present a comprehensive overview of their financial activities, operational risks, and future plans. The Board Charter, another key document, outlines the responsibilities of the board of directors and sets the standards for governance practices. Together, these documents provide stakeholders with a clear understanding of the organization's financial standing and governance framework, helping to bridge any information gaps between the company and its stakeholders.

Reducing Information Asymmetry through Disclosure

One of the primary purposes of disclosure is to reduce information asymmetry, which occurs when one party in a transaction or relationship has access to more or better information than the other. In corporate settings, information asymmetry can create a power imbalance between management and stakeholders, particularly investors. When investors lack critical information about a company's financial health or operations, they may make poor investment decisions or lose confidence in the organization. Transparency, through timely and accurate disclosure, mitigates this risk by ensuring that all relevant information is shared with stakeholders.

Chaney and Philipich (2002) highlight that transparency and comprehensive disclosure prevent the manipulation of information by management, reducing the potential for corporate scandals. In cases where companies fail to provide accurate and timely information, stakeholders may be left in the dark about potential risks or financial weaknesses, leading to misinformed decisions and a loss of trust. Transparent

26 Fung, Benjamin. "The demand and need for transparency and disclosure in corporate governance." *Universal Journal of Management* 2, no. 2 (2014): 72-80.

27 Ibid

28 L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) *Notre Dame Law Review* 1431.

29 Ibid n9

communication helps to establish a level playing field for all stakeholders, ensuring that they have the same access to critical information about the company's performance and prospects.³⁰

A notable example of the impact of information asymmetry is the collapse of Enron in 2001. Enron engaged in complex accounting practices that obscured the company's true financial condition, misleading investors and analysts about the company's profitability.³¹ By withholding key information and failing to provide transparent financial reports, Enron created a significant information asymmetry between the company's management and its stakeholders, which ultimately led to the company's downfall. The Enron scandal underscored the importance of transparent financial reporting and the need for rigorous disclosure standards to protect stakeholders from corporate malfeasance.

The Role of the Board Charter in Enhancing Transparency

The Board Charter is a governance document that outlines the roles, responsibilities, and decision-making processes of the board of directors. It serves as a guide for the board's operations and establishes the standards of governance that the company adheres to. By clearly defining the duties and expectations of the board, the Board Charter promotes transparency in governance practices and ensures that the board is accountable to its stakeholders. The Board Charter also contributes to reducing information asymmetry by providing stakeholders with a clear understanding of how decisions are made within the organization. This transparency in governance fosters trust among investors and other stakeholders, as it assures them that the company is being run in a responsible and ethical manner. According to Aguilera (2005)³², the Board Charter plays a key role in shaping stakeholder perceptions of the company's governance practices, particularly in environments where there is a lack of regulatory oversight or weak enforcement of corporate governance standards.³³

Annual Reports and Audit Reports: Tools for Financial Transparency

The Annual Report is one of the most important tools for financial transparency, providing a comprehensive overview of the company's financial performance, operations, risks, and future strategies. It is a key communication document that allows stakeholders to assess the company's health and make informed decisions about their investments. A well-prepared Annual Report includes financial statements, management's discussion and analysis, and an overview of the company's corporate governance practices, providing stakeholders with the information they need to evaluate the company's prospects.

Audit Reports, on the other hand, provide an independent assessment of the company's financial statements, ensuring that they are accurate and free from material misstatements. The Audit Committee, a subcommittee of the board of directors, works with external

30 PK Chaney and KL Philipich, 'Shredded Reputation: The Cost of Audit Failure' (2002) 40(4) *Journal of Accounting Research* 1221.

31 Ibid n2

32 D Branson, 'Enron: When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform' (2003) 48(4) *Villanova Law Review* 989.

33 D Branson, 'Enron: When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform' (2003) 48(4) *Villanova Law Review* 989.

auditors to ensure that the financial reports are prepared in accordance with established accounting standards and that they present a true and fair view of the company's financial position. The role of the Audit Committee in overseeing financial reporting is crucial for maintaining stakeholder confidence, as it provides an additional layer of oversight and accountability.³⁴

The failure to provide transparent and accurate financial reports can have severe consequences for an organization, as demonstrated by the WorldCom scandal in 2002. WorldCom, a major telecommunications company, engaged in accounting fraud by misrepresenting its financial statements, inflating its assets by billions of dollars³⁵. The company's failure to provide transparent financial reports led to one of the largest bankruptcies in U.S. history, eroding investor confidence and leading to widespread financial losses.³⁶ The WorldCom case highlights the critical role of Annual Reports and Audit Reports in maintaining transparency and preventing corporate fraud.

Case Study: The Role of Transparency in the Volkswagen Emissions Scandal

The Volkswagen (VW) emissions scandal, also known as "Dieselgate," is a prime example of how a lack of transparency can severely damage a company's reputation and erode stakeholder confidence. In 2015, it was revealed that Volkswagen had installed software in its diesel vehicles to cheat emissions tests, making the cars appear more environmentally friendly than they actually were. For years, Volkswagen misled regulators, customers, and investors by failing to disclose the true environmental impact of its vehicles.³⁷

The lack of transparency in Volkswagen's communication and reporting led to a significant loss of trust among stakeholders. Investors suffered financial losses as the company's stock price plummeted, and the company faced billions of dollars in fines and legal settlements. Moreover, the scandal tarnished Volkswagen's brand reputation, leading to a decline in customer loyalty. The Volkswagen case underscores the importance of transparent communication and comprehensive disclosure in maintaining stakeholder confidence and protecting a company's reputation.

Transparency and disclosure are foundational to effective corporate governance, fostering stakeholder confidence and reducing information asymmetry. Through clear communication and comprehensive reporting mechanisms like the Board Charter, Annual Report, and Audit Report, organizations can ensure that stakeholders have access to accurate and timely information about the company's operations, financial performance, and governance practices. Case studies such as Enron, WorldCom, and Volkswagen illustrate the devastating consequences of failing to provide transparent and accurate information, highlighting the importance of transparency in maintaining organizational sustainability and investor trust. By embracing transparency and rigorous disclosure practices, companies can reduce the risk of corporate scandals, enhance decision-making processes, and build long-term relationships with stakeholders. In

³⁴ Ibid n3

³⁵ J Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006).

³⁶ Ibid n2

³⁷ Ibid n1

today's complex business environment, the ability to provide transparent and accurate information is more important than ever in fostering trust and ensuring the long-term success of organizations.

Continuous Improvement and Sustainability

The principles of accountability, transparency, and risk management are not only essential for maintaining investor confidence but also for fostering continuous improvement and organizational sustainability. These governance structures—comprising practices like transparent financial reporting, robust internal controls, and a well-functioning board—allow organizations to adapt to evolving risks, regulatory changes, and market demands. By embedding continuous improvement into their operations, organizations can enhance their long-term sustainability, ensuring they remain competitive and resilient in an ever-changing environment.

Governance Structures Driving Continuous Improvement

Governance frameworks such as the Board Charter, risk management policies, and audit mechanisms are integral to fostering a culture of continuous improvement. The Board Charter clearly outlines the roles and responsibilities of the board, which includes overseeing strategic initiatives and ensuring that the organization adheres to legal and regulatory requirements. A strong governance framework allows for continuous reassessment of business processes, encouraging leaders to refine their strategies and operations based on emerging risks and opportunities.³⁸

Audit committees, as part of governance, play a crucial role in ensuring that internal controls are effective and adaptable. By conducting regular audits and reviewing financial practices, these committees help organizations identify inefficiencies, operational risks, and potential compliance issues. This feedback loop is essential for making incremental improvements and fostering a culture of accountability. Moreover, transparency in financial reporting and regular audits builds investor confidence, as stakeholders can see that the organization is committed to continuous enhancement of its internal processes.³⁹

Enhancing Organizational Adaptability

Risk management is another core element of governance that contributes to an organization's adaptability. A robust risk management framework enables businesses to anticipate and mitigate potential threats, whether they arise from market fluctuations, regulatory changes, or operational failures. Organizations that are proactive in identifying risks and implementing mitigation strategies are better positioned to navigate uncertainties and ensure long-term sustainability.⁴⁰

Furthermore, transparency and accountability in risk management practices allow for better decision-making. When an organization's leadership is aware of evolving risks and

³⁸ Ibid n1

³⁹ Ibid n3

⁴⁰ L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81(4) *Notre Dame Law Review* 1431.

the necessary steps to manage them, they are more likely to adapt their business models, operational strategies, and governance practices accordingly. This adaptability is crucial in today's dynamic business environment, where regulatory frameworks and market conditions are constantly shifting.

Case Study: Johnson & Johnson's Continuous Improvement Approach

A notable example of continuous improvement through governance practices is Johnson & Johnson (J&J), which has embedded sustainability and risk management into its corporate governance framework. The company's Credo, a guiding governance document, outlines its commitment to accountability, transparency, and ethical business practices. In the wake of various challenges, including product recalls and legal disputes, J&J implemented stronger risk management and internal controls systems, continuously refining its operations and governance practices to mitigate future risks.⁴¹ J&J also emphasizes sustainability in its long-term strategic planning, regularly updating its governance policies to reflect evolving environmental and regulatory demands. By aligning its governance framework with its corporate sustainability goals, J&J has demonstrated how organizations can adapt to changing risks while ensuring continuous improvement and investor confidence.

Sustainability is a key outcome of effective governance structures. Companies that prioritize continuous improvement through rigorous internal controls and risk management frameworks are more likely to endure over the long term. According to Dewing and Russell (2004), integrating sustainability into governance practices—such as through transparent reporting and risk assessments—enables businesses to meet stakeholder expectations while navigating the challenges of regulatory changes and market dynamics.⁴²

Conclusion

In conclusion, governance structures that emphasize transparency, risk management, and accountability facilitate continuous improvement in business operations. These frameworks allow organizations to be adaptable and resilient, enhancing their ability to sustain growth and remain competitive. By regularly refining their practices to address emerging risks and regulatory demands, organizations can ensure long-term success and maintain stakeholder trust.

⁴¹ Ibid n2

⁴² Ibid n8

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CORPORATE GOVERNANCE RISE AND AFRICA'S HISTORICAL DEVELOPMENTS

OMOLLO VERA ACHIENG

Introduction

Corporate governance deals with structures, principles, and measures that guide the operations and leadership of companies. It also deals with all the measures that need to be put in place to ensure an organization is managed and operated ethically, morally, and in the best interest of the stakeholders and investors. Since the financial scandals and corporate frauds, people have demanded more accountability, giving rise to corporate governance and Africa being affected as its corporate governance structures are mostly a legacy of their colonialists. For this reason, this research primarily analyses the development of corporate governance and its growth within the African context. It comprehensively traces the historical development of the corporate governance concept, its global and regional effects, and the challenges currently faced. The goal is to present a comprehensive notion of how the development of the concept of corporate governance has occurred throughout history, affected the world, and has been adjusted locally to the African environment. Turning to corporations and their history would be worthwhile, as there can be no corporate governance without corporations. Hence, corporations have a long-standing history, from their European formation to the current huge global business entities. Corporations, therefore, developed as follows in Europe:

Early Corporations in Europe

Early corporations were groups of people who formed legal persons for trading or any public utility construction. During the 17th century, early corporations were formed in Europe, where non-profit institutions were formed to establish institutions for general profit, such as hospitals and universities.¹ These corporations had constitutions that underlined the substances of their responsibilities, and the government regulated the incorporation processes. In the 17th century, business owners wanted to earn money and were thus employed by European imperialists to control trade, wealth, and land in Asia, Africa, and America. An example of this type of corporation is the British East India Company, which worked mainly to conquer India. It had a private army and controlled at least one-fifth of the global population.² These corporations would seek royal charters from the monarch to perform colonial tasks. Due to this architecture, the said corporations were christened 'colonial trading companies.'

¹ 'A Short History of Corporations' (New Internationalist 5 July 2002) <<https://newint.org/features/2002/07/05/history>> accessed 1 November 2024.

² Tamaqua Area School District, 'The Age of Imperialism (1870-1914)' 1-16 <<https://www.tamaqua.k12.pa.us/cms/lib07/PA01000119/Centricity/Domain/119/TheAgeofImperialism.pdf>> accessed 3 November 2024.

Many revolutions occurred in different countries, such as the American Revolution of 1776 against British rule. The revolution was fanned by the meanness of monopoly powers that were Britain-owned companies managing American colonies.³ The British Royal Charters insisted that the raw materials be exported to Britain for processing while colonies were required to import the finished products. This, however, did not sit well with the Americans, who wanted the British gone so they could continue being in charge of the corporations.⁴ American corporations were granted charters ranging from ten (10) to forty (40) years after the country's independence in 1776 to carry out public objectives, including constructing infrastructural facilities.⁵ However, some checks regarding commercial interest were highlighted in the charters.

Over the years, it has become necessary to formulate laws regulating business entities' operations. The British, in 1844, passed the Joint Stock Companies Act that gave birth to incorporation, allowing corporations to state their motives/purpose. This saw the shifting of power from the government to the bench. The Act provided corporate status other than limited liability to the businesses formed under the Act. It took about a year, and later, there was a change in the part of the shareholders where they received the limited liability status. On the other hand, in the United States in the early days of being a republic, the courts came up with the concept of a corporation being an artificial person, and this was espoused by the then Chief Justice Marshall, who stated that: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence".⁶ A corporation was a creation of a legislator with some rights, which included the capacity to sue and be sued, holding and transfer of property, and perpetual existence regardless of change of its shareholding.⁷ This justifies the creation of laws over time to regulate corporate governance.

Towards the close of the 19th Century, capitalism fostered elements of monopoly, cartels, and the 'Robber Barons'. A severe industrial relations crisis emerged, which provoked the adoption anti-trust policies and a higher level of state intervention in organizations in the United States.⁸ There was also an expansion of corporations in industries that engaged in manufacturing steel, oil, and railroad works. The hierarchical organizational structures developed during the Industrial Revolution as large, elaborate business ventures known for properly organized management. This corporation form was seen through an amalgamation of the joint-stock and other related commercial associations. Participants noted that this form of corporation had transferability of shares, legal personality, limited

3 'American Revolution Facts' (American Battlefield Trust 2024) <<https://www.battlefields.org/learn/articles/american-revolution-facts>> accessed 3 November 2024.

4 Gregory Clark, Kevin Hjortshøj O'Rourke and Alan M Taylor, 'The Growing Dependence of Britain on Trade during the Industrial Revolution' (2014) 62 *Scandinavian Economic History Review* 109 <https://www.nber.org/system/files/working_papers/w19926/w19926.pdf> Accessed 3 November 2024.

5 Nikolas Bowie, 'Corporate Personhood v. Corporate Statehood' (Harvard Law Review 10 May 2019) <<https://harvardlawreview.org/print/vol-132/corporate-personhood-v-corporate-statehood/>> accessed 3 November 2024.

6 Blumberg, Phillip, 'The Corporate Personality in American Law: A Summary Review' (1990) 38 *The American Journal of Comparative Law*, pp. 49

7 *ibid*.

8 Steven G Calabresi and Larissa Price, 'Monopolies and the Constitution: A History of Crony Capitalism' [2012] *SSRN Electronic Journal* 1-10.

liability, and distinct ownership and control.⁹ It is also important to note that this form of corporation has been more evident in the market economies and has resulted in increased interplay between government regulations and business over the years.¹⁰ Therefore, the evolution of corporations as business structures has followed the progression of economic, political, and social conditions. This continuous development from early trading to modern business development underlines the need for an efficient governance structure to check transparency, accountability, and sustainability.

The origins of corporate governance

The evolving economic systems and the Centuries of large organizations separating owners and managers led to the gradual emergence of corporate governance at the beginning of the 20th Century. Berle and Means, in their work in 1932, pointed out that, in large firms, ownership and control are two different things, and there is a need to ensure that managerial conduct is loyal to shareholders' interests.¹¹ They further proposed what was known as the managerialism theory, which recommended that executives should not only consider the shareholders but also other broader stakeholders. According to their findings, as organizations grew, models in which the management chose on behalf of the shareholders gradually replaced the owner-manager business model.¹² To ensure that managers act appropriately and with integrity and always for the benefit of the shareholders, the above discrepancy requires new governance processes. It was noted that the modern theories of corporate governance are built on the facts established by Berle and Means, which pointed out the problem of accountability and organizational transparency in managing large corporations.

The Cadbury Report's (Financial Aspects of Corporate Governance) Impact

Corporate governance vastly changed in the 1990s, particularly in issuing the UK Cadbury Report. The report was prepared by 'The Committee on Financial Aspects of Corporate Governance' which was led by Sir Adrian Cadbury and provided suggestions on the structure of corporate boards and accounting mechanisms to address and perhaps reduce corporate governance problems and frauds. This was in response to several large corporations that produced corporate failures that revealed a weakness in the governance mechanisms in the earlier years.¹³ Some of the best ideas of the report included the need to establish an efficient board of directors, audit committees, and the relationship between executive remunerations and organizational performance.

The abovementioned principles were meant to enhance the Standard's effectiveness for corporate management responsibility by enhancing this significant corporate management regimen's transparency, accountability, and integrity. The Cadbury Report performed a significant turnover of corporate governance practices as it set up impacting methods

9 P Ireland, 'Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility' (2008) 34 Cambridge Journal of Economics 837 <<https://academic.oup.com/cje/article/34/5/837/1700679>> accessed 3 December 2024.

10 *ibid.*

11 *ibid.*

12 ERIC HILT, 'When Did Ownership Separate from Control? Corporate Governance in the Early Nineteenth Century' (2008) 68 The Journal of Economic History 645.

13 A Cadbury, Report of the Committee on the Financial Aspects of Corporate Governance (Gee Publishing 1992) 10–22.

all around the globe, especially in Africa. Its suggestions helped define the direction of developing governance practices worldwide as the model for establishing corporate governance codes in several countries.

It should be noted that Dibra observes that: "Corporate governance is still an emerging concept, which received much attention all over the world in the last decade following the collapse of some landmark companies such as Enron, World com, Arthur Anderson, and others in the USA; HIH Insurance in Australia; Marconi in the UK, Parmalat in Italy, Regal Bank, Leisure Net and Krion in South Africa among others. In light of these publicized corporate scandals and the earlier financial crises that occurred in Asia in the late 1990s, there was a drive in many nations to encourage good corporate governance, accountability, and ethical business practices..."¹⁴ Based on the above analysis, the foregoing scandals led to the establishment of proper corporate governance and the need to strengthen the developed economy. Thus, within this context, the nations and the supranational organizations had to work out such principles.

Corporate Governance in Africa: The Path to Reform

The Colonial and Pre-Colonial Era

Other historical circumstances influence African corporations, such as pre-colonial and colonial eras. Traditional African systems of governance were communal systems that shared rather than separate propriety was in evidence as the governing policy.¹⁵ Traditional authorities in the management of resources and power of decision-making included legal norms, balanced and coordinated decisions, and cultural and moral principles. However, new corporate structures intended to achieve colonial goals were introduced by the arrival of European colonial masters.¹⁶ There was no coherent correlation between colonial corporate bodies and indigenous requirements throughout the colonial period because Europe-based corporations operated with minimal reference to local authority structures. This accounted for a significant degree of change in the governance practices where more foundations were laid for upgrading corporate governance in Africa.

Post-Independence Advancements

Following the attainment of independence mid of the twentieth century, African nations began developing their corporate governance codes that would correspond to their economic and regulatory environments. In the first instance, when emergent states attempted to alter existing orthodoxies to accommodate their newly evolved situations, these girds were severely hampered by the legal and regulatory infrastructure of erstwhile colonialism masters. Several African countries have, over the years been found to have developed more regionalized systems of government to address problems inherent in their political and economic systems. For example, laws and regulations regarding corporate governance were made relevant to the Kenyan, Nigerian, and South African settings, emphasizing enhancing shareholders' rights, responsibilities, and corporate

14 Rezart Dibra, 'Corporate Governance Failure: The Case of Enron and Parmalat' (2016) 12 European Scientific Journal, ESJ 283 <<https://core.ac.uk/download/pdf/236418354.pdf>> accessed 5 November 2024.

15 K Nkrumah, *Neo-Colonialism: The Last Stage of Imperialism* (International Publishers 1965) 55–70.

16 *ibid.*

transparency¹⁷. These changes pointed towards more general and specific trends of African governance in what may be described as more context and place-sensitive.

This paper has found that regional organizations have significantly shaped corporate governance standards in Africa because of the guidelines and suggestions they offer to the member governments. There are several projects that both the ECOWAS and the AU have set with a political objective to improve the standards of governance in Africa. There is the Africa Peer Review Mechanism (APRM) of the African Union which is one of such initiatives. In that way, states offer continuous and systematic evaluation and enhancement of their governance standards¹⁸. Pursuing socio-economic uplift and the enhancement of good governance, the APRM endeavors to make nations pursue reforms, coping with governance challenges. This regional strategy has greatly enhanced African nations' accountable and transparent culture.

In the past few years, corporate governance has emerged as a critical issue in Africa to attract investment and promote long-term economic development. Due to the emergence of new issues and to align their laws with those of international standards, several countries have, over the years, reviewed and enacted new legislation on corporate governance. For instance, the King IV Report on Corporate Governance developed in South Africa is a groundbreaking model integrating sustainability and stakeholders' engagement with governance.¹⁹ Africa has not come far in eradicating such major challenges as corruption, taxation regulation policies, and enforcement systems. The promise of solidifying the governance determinant is made even harder by the variation in the legal systems and the economic development of African nations. To tackle these challenges, sustained adaptations, renewed commitments, vigilance in building the regulation frameworks, and consistent and firm commitment toward promoting a culture of transparency and accountability are required.

Case Study: Comparison of Corporate Governance Structures

South Africa uses the King Code of Governance Principles known as King IV which has helped the country to become at the apex of corporate governance standards in Africa. This being a comprehensive framework for governance, the King IV Code has put much emphasis on moral leadership, systems thinking, and stakeholder engagement.²⁰ It has put forward ideas that extend past the traditional notions of economic gains, and it has espoused corporate governance and stewardship. Because of the current King IV Code, corporate governance practices have been taken to a higher level in South Africa and across the continent. It is thus a lesson to other African countries that seek to enhance their governance structures to emulate South Africa's approaches of exercising extensive governance processes while comprising all stakeholders.

17 A Osei-Tutu, 'Corporate Governance in Africa: Trends and Practices' (2001) 3(2) African Review of Economics and Finance 45–62.

18 African Union, African Peer Review Mechanism (APRM) Framework Document (African Union 2003) 12–28.

19 Institute of Directors in Southern Africa, King IV Report on Corporate Governance for South Africa (Institute of Directors 2016) 18–36.

20 D Moyo, Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa (Farrar, Straus and Giroux 2010) 98–114.

After several laws and regulations emerged, such as the Nigerian Code of Corporate Governance (2018), Nigeria has gone far in enhancing corporate governance. To achieve accountability and transparency in Nigerian businesses, the code provides recommendations on the board of directors, chief executive officers' remunerations, and shareholders' protection.²¹ Despite Nigeria's efforts to embark on corporate governance, it seems to have corruption problems, ineffective taxes, and a lack of efficient regulators. The following are some of the suggestions that point out that these troubles require a multi-dimensional approach, particularly those that involve establishing an effective building regulation authority, enhancing transparency, and cultivating an effective accountability mechanism. Therefore, Nigeria's case is reminiscent of how important it is to progress corporate governance principles more than continuing reforms to ensure efficiency in enforcement.

In Post-2015, Kenya did not start with having a good corporate governance code, as evidenced by the numerous scandals the country had experienced. Some scandals that rocked the country include the Euro Bank Scandal, considered among the most disastrous events in the banking industry. This bold-faced embezzlement was first instigated by Nahashon Nyagah, then the governor of the Central Bank of Kenya, in 2003 when various state health institutions, for instance, the Kenyatta National Hospital, lost pension fund money for its employees that was banked at the Euro bank.²² A total of 1.4 billion was lost during that period, which was attributed to high levels of fraud and embezzlement. The fluctuating and, in some cases, dwindling financial status of most companies and organizations has made it mandatory to enhance controls against fraud and embezzlement.

Contrary to what was supposed to have been done, none were conducted, and after some time, some of the charges were withdrawn against some individuals involved in the scandal, hence the bank's collapse. The Euro Bank scandals, along with other scandals, saw Kenya attempt to cover up for the situation and therefore went ahead into enacting the Companies Act 2015, the Mwongozo-code of Conduct 2015, and the Code of Corporate Governance Practices for Issuers of Securities to the Public 2015 are among few of the significant advancements that Kenya has made in the enhancement of corporate governance systems. Concerning the code of corporate governance practices, it has provided recommendations on risk management, disclosure, and board governance.²³ For the Kenyan frameworks, the stressed stakeholder involvement, the board independence, and the openness suggest a commitment towards improving the governance standards. Kenya does, however, have issues that are similar to those of other African nations including issues of corruption and tax collection. Therefore, overcoming these hurdles will require ongoing change, consolidation of the governance framework, and focus on the principles of responsiveness and openness.

However, it should not be lost to notice that adopting these frameworks has not been sufficient to remedy corporate governance weakness in Kenya. It is correct, however, to state that countries with stronger legal systems are in a better position if they apply their

21 Nigerian Code of Corporate Governance (Nigerian Corporate Governance Institute 2018) 34–50.

22 J Kamau, 'Forget the Eurobond, there once was a Euro Bank too' (2015) https://nation.africa/oped/opinion/Eurobond-Euro-Bank-/440808-3010944-w5png1z/index.html#google_vignette accessed 03 November 2024

23 Code of Corporate Governance Practices for Issuers of Securities to the Public (Capital Markets Authority 2015) 22–38.

legal frameworks to cope with corporate scandals.

Africa's Corporate Governance Future

New Innovations and Trends

Potential advancement in the future technological field and fashion will likely influence corporate governance in Africa. AI and blockchain applicability implications in corporations can potentially dictate new approaches to implementing corporate governance strategies because they reduce fraud and enhance the overall transparency of the decision-making process. A number of the issues that African states are confronted with in terms of governance standards and accountability can be addressed by these technologies.

Other considerations such as environmental, social and governance (ESG) are also being given more consideration and embraced as essential to stakeholders or investors. ESG components can thus be integrated into organized frameworks for managing companies and can resolve environmental issues and promote ethical business practices. Pollution of the environment is an important consideration and even more so when big multinational corporations are involved in doing business in countries with no strict environmental standards. A case in point that captures this problem is the class action that was commenced in 2023, whereby residents of the Niger Delta sued the Shell company, an international oil company. This lawsuit was put most, especially on the negative impacts of oil spills on the lives of the people and the physical environment.

Multinational companies' activities are always associated with critical issues about labor and human rights abuses. The majority of these corporations act with the intent to achieve maximum revenue and often engage in the employment of children and other forms of exploitation, such as outsourcing their production lines from developed countries to expanding their markets in developing countries. One of the most vivid examples illustrating this problem concerns Apple, which can be criticized for alleged participation in purchasing minerals from conflict areas in the Democratic Republic of Congo.

The challenges above have brought the responsibility aspect into light for multinational corporations, hence the concern for ESG standards. These standards promote the protection of the environment, labor welfare, and good ethical business practices. Fortunately, the example of practicing ESG indicators is gradually expanding among the MNCs, which means that they are improving their energy efficiency and social responsibility.

It is imperative for African nations to continuously strengthen their governance structures in a bid to progress the development of corporate governance. To this end, the regulatory authorities must be empowered, the enforcement mechanisms enhanced, and an effective and transparent governance culture created. Cooperation with governmental authorities, controlling organisations, and business will be important to achieve these tasks. Thus, one can mention the necessity of enhancing the governance frameworks to reflect the efficiency of the activities and adherence to the international standards; as a result, the approach may require a comprehensive strategy that would look into the legal aspect as well as the cultural aspect of governance in the organization.

Promoting good corporate governance in Africa can be enhanced through cooperation and sharing experiences. The ECOWAS and similar organizations can effectively contribute to the collaboration of member states of the same governance indicators, share information, and seek technical assistance. African nations can share common interests and enhance the practice of effective production patterns to pool their efforts, experiences, and resources. Encouraging regional integration will go a long way in enhancing the formulation of a united and efficient corporate governance framework across the continent, catalyzing sustainable economic growth and development, and boosting investors' confidence.

Conclusion

Colonial influences on current reforms are an important part of the evolution of African corporate governance. Nevertheless, this is not to say that there are no challenges even where frameworks have been put in place and procedures enhanced. Sustained efforts will, therefore, be required to build investor confidence, establish sound governance structures, and ensure greater disclosure to deal with these problems. The formation of African nations' economic growth and improvement of the standards of corporate governance can only be reached if African countries accept new trends, use the available technologies, and encourage regional integration. The current process of corporate governance in Africa is a combination of historical antecedents and constant change, which will likely shape the method of corporate governance in the

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Tamaqua Area School District, ‘The Age of Imperialism (1870-1914)’ <<https://www.tamaqua.k12.pa.us/cms/lib07/PA01000119/Centricity/Domain/119/TheAgeofImperialism.pdf>> accessed 3 November 2024

ENHANCING CORPORATE GOVERNANCE THROUGH ROBUST INTERNAL CONTROL MECHANISMS IN KENYA

COLLINS AKENGA

Introduction

Corporate governance is a critical element in the modern corporate world. This comprehensive concept denotes the framework of practices and rules that the Board of Directors uses to ensure transparency, accountability, and fairness as they relate to diverse stakeholders.¹ These could range from their shareholders, whose interests they represent, to financiers, the community, suppliers, customers, employees, and the government.² It, thus, refers to the structures, mechanisms, and processes that are used to control and direct corporations. Therefore, the corporate governance framework is instrumental in organizations as it enables them to mitigate against issues of conflict of interest by balancing the interests of all the firm's stakeholders,³ thereby fostering confidence, trust, and value-creation in the long term.

A look at the contemporary business landscape shows that corporate governance has become critical to the success and sustainability of firms. Corporate scandals that have hit the business world together with a massive financial crisis whose impact reverberated through the global economy have played a critical role in showing the necessity of accountability and transparency in the operations of corporate entities.⁴ While many components come together to inform effective corporate governance and the promotion of transparency and accountability, one of the components that have been identified as being critical in enhancing corporate governance is the internal control mechanism, which serves as a frontline defense against operational inefficiencies in a firm, mismanagement, and even fraud.

Internal Control Mechanisms

As a critical component of corporate governance, internal control refers to all the measures that firms take to protect their resources from inefficiency, fraud, or potential waste; ensure

1 Margarethe Wiersema and Haeyoung Koo, 'Corporate Governance in Today's World: Looking Back and an Agenda for the Future' (2022) 20 Strategic Organization 786 <<https://doi.org/10.1177/14761270221115406>> accessed 3 December 2024.

2 Ruth Aguilera, 'Corporate Governance and Director Accountability: An Institutional Comparative Perspective' [2005] British Journal of Management <https://www.academia.edu/12805625/Corporate_Governance_and_Director_Accountability_an_Institutional_Comparative_Perspective_> accessed 3 December 2024.

3 *ibid.*

4 Ruth V Aguilera and Rafel Crespi-Cladera, 'Global Corporate Governance: On the Relevance of Firms' Ownership Structure' (2016) 51 Journal of World Business 50 <<https://www.sciencedirect.com/science/article/pii/S1090951615000826>> accessed 3 December 2024."plainCitation": "Ruth V Aguilera and Rafel Crespi-Cladera, 'Global Corporate Governance: On the Relevance of Firms' Ownership Structure' (2016)

that their operating and accounting data is reliable, ensure that they are compliant with the policies of the organization and assess the performance of the organization in all its units.⁵ Therefore, they are integral to an organization's business and financial policies. In practice, internal control mechanisms bring together a wide range of procedures, policies, and practices that firms design to ensure that they comply with the laws and regulations of the land, they can protect property, they have accuracy in the reporting of their finances and can improve their operational efficiency.⁶

As good business practices, an internal control system of an organization brings together several components. These include the control environment component, which seeks to establish the importance of integrity for all employees and commit to eliminating all improprieties, such as fraud.⁷ The component calls for putting in place personnel and internal systems that facilitate internal control. Thus, the environmental component sets the organization's tone and informs and influences people's consciousness. The essential makeup of this component is policies and procedures, ethical and integrity values, commitment to competence, philosophy, and operating style of leadership, together with how responsibility and authority are assigned and how the people are developed.⁸ This is why a legal and regulatory framework is put in place to ensure proper internal controls.

The second key component of internal control is risk assessment, which calls for the organization to regularly assess and identify any potential risk or loss. The firm then used its assessment findings to put more control levels in place and added focus that helped to contain or monitor the risk areas. The assessment is done in line with the firm's objectives, evaluating elements that threaten the achievement of the objective.⁹ This is a critical component, given that every organization faces various forms of risks that can either be drawn from internal or external sources. As such, they need to establish a way to manage these risks in line with the ever-changing regulatory, economic, and operating conditions. Further, the objectives of the firm, which need to be defined clearly before risk assessment, touch on operations that relate to efficiency and effectiveness in the firm, such as safeguarding resources, financial goals, and performance.¹⁰ Financial reporting objectives also touch on preparing and publishing reliable financial statements, while compliance objectives relate to laws and regulations to inform standards of behavior. As a whole, the processes in this component are ongoing.

The third key component of internal control is monitoring when the firm continually assesses and evaluates its internal systems to ascertain their viability and performance over time. The ongoing practice is undertaken during the normal course of operations.

5 Mitchell Franklin and others, '8.2 Define and Explain Internal Controls and Their Purpose within an Organization - Principles of Accounting, Volume 1: Financial Accounting | OpenStax' (11 April 2019) <<https://openstax.org/books/principles-financial-accounting/pages/8-2-define-and-explain-internal-controls-and-their-purpose-within-an-organization>> accessed 3 December 2024.

6 Oliver Henk, 'Internal Control through the Lens of Institutional Work: A Systematic Literature Review' (2020) 31 *Journal of Management Control* 239 <<https://doi.org/10.1007/s00187-020-00301-4>> accessed 3 December 2024.

7 Dan Sampson, 'Understanding Internal Controls'.

8 'Elements of Internal Control' (Kansas State University Control 2024). <https://www.k-state.edu/internalaudit/internal-controls/internalcontrols.html>

9 Kansas State University, Elements of Internal Control (2024) <https://www.k-state.edu/internalaudit/internal-controls/internalcontrols.html> accessed 4 December 2024.

10 *ibid.*

The frequency and scope of the evaluation are informed by the nature of risks and the system's effectiveness. The process, thus, calls for any inefficiencies to be reported upstream to the administrators and governing board.¹¹ The process sees internal control systems continually change as their effectiveness wanes due to the arrival of new employees in the firm, differences in training and supervision effectiveness, additional pressures, and constraints of resources and time.¹² These changing conditions, therefore, call for the management to continually monitor and determine the effectiveness of the internal control system.

The fourth component is information and communication, essential in clarifying roles and purposes necessary for internal control. It also helps members of the firm to understand and be committed to taking steps that allow them to undertake their jobs effectively.¹³ Firms need effective communication across the organization to ensure that all personnel have clear information from the top management about the control responsibilities they must take seriously. The process ensures that they understand their role in the internal control system and how their activities relate to their colleagues. It also allows them to communicate significant information to their top authorities.

The fifth component is the control activities, which denote the policies, processes, and courses of action taken to ensure that the firm has integrity in its internal control and complies with the regulatory requirements. The activities throughout the firm and at all levels range from authorizations, approvals, segregation of duties, security of assets, verifications, reviewing operational performance, and reconciliations.¹⁴ The process of control activities sees organizations establish their policies and set out the procedures that will be followed to implement the policy in a conscientious, thoughtful, and consistent manner.

Therefore, Internal control mechanisms are critical in modern corporate governance as they bring together a wide array of policies, procedures, and practices that mitigate a firm from risk, ensure that they are compliant with regulatory requirements, safeguard their assets, and improve their efficiency in operations. As a dynamic process, internal control in an organization is influenced by various stakeholders in the firm, from its management to the board of directors and various personnel.¹⁵ However, the process is designed so that it helps firms have reasonable assurances when it comes to achieving their objectives of compliance with laws and regulations, financial reporting reliability, and efficiency and effectiveness in operations.

11 Jacobson Jarvis and Co, 'Monitoring: An Integral Component to Internal Control | JJCO' (Jacobson Jarvis & Co, 13 December 2021) <<https://jjco.com/2021/12/13/monitoring-an-integral-component-to-internal-control/>> accessed 3 December 2024.

12 'Internal Controls' <<https://www.k-state.edu/internalaudit/internal-controls/internalcontrols.html>> accessed 3 December 2024.

13 Will Kenton, Julius Mansa, and Suzanne Kvilhaug, 'Internal Controls: Definition, Types, and Importance' (2024) <https://reciprocity.com/blog/the-importance-of-internal-controls-in-corporate-governance-mechanisms/> accessed 4 December 2024.

14 *ibid*

15 Shofia Yunus Manginte, 'Fortifying Transparency: Enhancing Corporate Governance through Robust Internal Control Mechanisms' (2024) 2(2) *Advances in Management & Financial Reporting Research* 72, DOI: <https://doi.org/10.60079/amfr.v2i2.173>.

The necessity of robust internal control mechanisms that help firms to enhance their corporate governance through enhancing elements of accountability and transparency has become widely recognized in the wake of such major corporate scandals as the fall of the Lehman Brothers, WorldCom, and Enron which showed the devastating impact of failures in corporate governance and weak internal controls. The fall of these major corporations significantly undermined investors' confidence and called for major legal reforms to strengthen the issue of accountability and transparency in firms. However, although diverse laws and regulatory procedures were enacted to promote proper corporate governance, the success of corporate governance relies on robust mechanisms within the organizational system.

Corporate Governance in the Kenyan Context

An evaluation of corporate governance within the Kenyan context shows that there has been a robust mechanism to enhance these practices using laws and regulatory measures. For example, a look at the legal framework that informs corporate governance shows a robust and wide body of laws that provides guidance and empowers the leaders of organizations to put proper corporate governance mechanisms in place. Some laws that inform the practice include the Constitution, the Companies Act, 2015; the Capital Markets Act (CMA) and Regulations; the Central Bank of Kenya Regulations; and the Public Finance Management Act, 2012.

Therefore, companies are required to ensure that their operations comply with the various laws and regulations to protect the interests and rights of investors and other stakeholders. For example, the Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015, which was put forth by the Capital Markets Authority (CMA), set out the requirements for public companies to ensure that the decisions that are made in the firm represent the best interest of the company together with the investors.

These legislations, such as the Companies Act, put in place a stricter regime for compliance in terms of corporate governance¹⁶ and establishes civil consequences in case of breach of duties for directors, promote transparency as it calls for the declaration of interest among directors, and appropriate principles for corporate governance to determine the compliance of the company each year. However, despite these laws, the nation still faces challenges in promoting proper corporate governance and compliance. This can be seen from the fact that the nation has experienced several major corporate failures, such as the collapse of major supermarkets like Uchumi, Tuskys, and Nakumatt. Other companies that have reported corporate failures include Imperial Limited Bank and Kenya Airways. This shows that despite the laws, which are mainly external measures, there is a need for internal processes and mechanisms geared towards ensuring greater compliance and promoting effective corporate governance, which is where internal control measures at the organizational level come in.

¹⁶ A Guide to Corporate Governance Excellence (KIOI & Co Advocates (2022). <https://www.kioi.co.ke/corporate-governance/> accessed 30th September.

Evidence on Internal Control Mechanisms Role in Corporate Governance

An evaluation of diverse scholarly articles shows that implementing robust internal control measures in organizations can help enhance corporate governance by mitigating risks, enhancing the firm's quality in financial reporting, and promoting ethical practices within organizations. For example, Piotrowski and Srinivasan show that through internal control quality, firms can promote information asymmetry between the management of the firm and their investor while also reducing cases of manipulating earnings.¹⁷ This implies that investors will have access to information that eliminates the possibility of information manipulation and misrepresentation, as in the case of financial performance.¹⁸ Further, through robust internal control systems, organizations can put into action and uphold corporate governance principles.

Al-Zwyalif, through their study, shows that when firms can focus on the five core elements of internal control, namely their risk assessment, control environment, communication and information, control activities, and monitoring, they can enhance the pillars that make up corporate governance namely transparency, responsibility, fairness and countability. They thus share that commitment to all the elements yields a high degree of enhancement for all the corporate governance pillars.¹⁹ Similarly, in their study, Wanjala and Riitho show that in the context of Saccos, implementing robust internal control measures is critical in mitigating fraud.²⁰ Therefore, they point out that for these financial enterprises to effectively deal with the persistent problem of fraud they experience in their operations and safeguard the interest of their shareholders, they need to implement robust internal control measures.²¹ Firms can protect their shareholders and reduce the issues of corporate scandals that affect companies by relying on internal control measures that promote a healthy interplay between the company's board of directors and the firm's shareholders.

Further, through their study, Johnson and Gray show that firms can promote more significant levels of accountability and transparency by having robust internal controls. They share that the impact of such exhibitions is that the firms can lower their cost of capital and improve investors' confidence in the firm.²² The culture firms promote through their internal control mechanisms, such as ethical behavior and integrity in their operations, allows them to promote proper corporate governance.²³ Denison et al. underscore the importance of firms ensuring that their cultures are value-driven so that they can prioritize elements of trust, accountability, and integrity in their operations.

17 JD Piotrowski and S Srinivasan, 'Regulation and Bond Returns' (2008) 63(5) *Journal of Finance* 2037-67.

18 V Oba, 'Internal Control Mechanisms in Corporate Governance: A Case of Nigeria' (2019) 19(3) *Corporate Governance* 532-45.

19 Inaam Al-Zwyalif, 'The Role of Internal Control in Enhancing Corporate Governance: Evidence from Jordan' (2015) 10(7) *International Journal of Business and Management*, 1-5.

20 Kevin Wanjala and David Riitho, 'Internal Control Systems Implementation and Fraud Mitigation Nexus among Deposit Taking SACCOs in Kenya' (2020) 2(1) *Finance & Economics Review* 11, DOI: <https://doi.org/10.38157/finance-economics-review.v2i1.59>.

21 Boaz A Nyakeri, 'The Law on Corporate Governance and Shareholder Protection in Kenya: A Case for Reduction of Corporate Scandals within Private Companies' (2020) <specific sections: abstract, summary findings, and conclusion>.

22 VE Johnson and JS Gray, 'Internal Control Weaknesses and Firm Performance' (2018) 50 *Journal of Corporate Finance* 37-52.

23 DR Denison, L Nieminen, and L Kotrba, 'Corporate Culture and Governance: A Humanistic Perspective' (2020) 30(2) *Human Resource Management Review* 100697.

Further, the changing nature of risks faced by organizations and the regulatory landscapes that inform corporate governance put a greater emphasis on the need for organizations to focus on monitoring, a key internal control component. Regulatory changes in the global arena, such as the enactment and implementation of the Sarbanes-Oxley Act and the General Data Protection Regulation (GDPR) by the EU, have highlighted the need for firms to reassess their operations and make necessary changes to strengthen their internal control measures and corporate governance as a whole. The case is the same for Kenyan firms, with the enactment of new legislative frameworks and changes in regulatory codes that require the firms to be compliant. Through the internal control component of monitoring, these firms can identify this change and take steps to mitigate against any risk while ensuring compliance. These elements, therefore, show that the connection between an organization's internal control measures and corporate governance's implementation is strong and dynamic as it shifts and aligns with the changes in the business environment. These scholars, therefore, show how critical it is for organizations to ensure that they have robust internal control measures that address the different facets of their operations and enhance transparency in their operations and the practice of corporate governance.

Internal Control Measures in a Changing Environment

One of the things that recent studies in the area of corporate governance and internal control show that there is a need for organizations to refine their internal control measures so that they can be able to address the emerging risks that are faced within the business landscape today. They, therefore, serve as sources of insight on how firms can adapt their practices and operations to the prevailing times to address and mitigate against any potential challenges quickly. For example, Chen et al. identified the critical need for organizations to ensure they incorporate advanced technological capabilities that are available today into their internal control framework to deal with present-day challenges.²⁴ Some of the technologies that the scholars identify include data analytics and artificial intelligence, which they point out can be instrumental in enhancing the practice of risk detection and mitigation, which are part and parcel of corporate governance. The practices will allow the firm to show proactiveness in its internal control measures as it becomes data-driven and aligns with the digital transformation that is taking place in government practices to meet the challenge of the existing business environment. Within the Kenyan context, such proactiveness has been hinted at within government agencies such as KRA to enhance its efficiency in the collection of revenue and its corporate governance practice.

Similarly, Kim et al. show that artificial intelligence and machine learning can be incorporated into the internal control frameworks to detect anomalies and potential risks, enabling the firm to optimize their control strategies in real time.²⁵ They assert that the advances in digitization and data analytics can be explored to help firms strengthen their control mechanisms, identify risks, monitor them, and improve the decision-making process. They thus show that technology plays a critical role in shaping the relationships between internal controls and governance in firms.

24 J Chen, X Chen, and T Shevlin, 'Does Internal Control Quality Mitigate the Negative Effect of Managerial Ability on Firm Performance?' (2020) 71(1) *Journal of Accounting and Economics* 101442.

25 H Kim, Y Kim, and J Shin, 'Internal Control and AI-Driven Business Process Automation' (2022) 36(1) *Journal of Information Systems* 1-19.

Further, Lim et al., in their study, show that as part of their internal control measures, firms can use blockchain technology to enhance corporate governance. The scholars expressly point to the technology's viability as promoting transparency in the firm's financial reporting, supply chain, and shareholder voting.²⁶ Scholars show that technology can enhance the governing mechanism of a firm as it provides solutions to data integrity and security issues.

Internal control mechanisms can also be adapted to help firms ensure compliance with requirements that come with the changing regulatory landscape and risk. As Smith and Wesson share, firms can deal with regulatory changes such as the GDPR framework that the EU and the Dodd-Frank Act implemented through internal control mechanisms. The scholars point to an increased focus on risk management, disclosure requirements, and streamlining internal processes to meet the heightened scrutiny.²⁷ Further, they show that internal control measures have also evolved to include organizational notions such as ethical conduct and organizational culture.

Other features that have been brought to the fold as part of internal control and which help firms enhance their corporate governance are cybersecurity issues and data governance. Therefore, scholars such as Lee et al. show that organizations need to ensure that cybersecurity issues are incorporated into internal control's control and risk management framework.²⁸ The practice would, therefore, enhance the effectiveness of the firm's corporate governance as it propels the firm to have robust measures to protect its data, engage in regular assessment of cybersecurity issues, and create awareness and training among employees to address cybersecurity challenges effectively. Firms can, therefore, enhance their corporate governance practices and deal with present-day challenges in corporate governance by integrating insights that recent findings in research have brought about in terms of regulatory developments, technological development, and cultural imperatives.

Robust Internal Control Mechanisms as a way of enhancing Corporate Governance

The board of directors in a firm is quite instrumental in influencing the oversight and culture of the organization's integrity. They do so by communicating the firm's objectives, values, and risk appetite, shaping the organization's culture, and informing how internal controls are designed and implemented.²⁹ However, as a whole, the internal control mechanisms represent the operational manifestation of corporate governance principles. They translate the objectives of governance and formulate them as tangible policies and procedures that work to guide the organization's conduct. Monks and Minow share that as the operational arm, internal controls inform the firm's day-to-day operations. Therefore, firms must align their internal control practices with the governance objectives

26 CY Lim, DS Sharma, and CL Sia, 'Blockchain Technology and Corporate Governance: A Systematic Literature Review and Agenda for Future Research' (2021) 67 Pacific-Basin Finance Journal 101605.

27 A Smith and N Wesson, 'The Effect of Regulation on Internal Controls and Financial Statement Quality: Evidence from the Dodd-Frank Act' (2019) 54 Journal of Corporate Finance 73.

28 E Lee, S Lee, SH Lee, and J Lee, 'Internal Control and Cybersecurity: Integration and Implications for Organizational Resilience' (2022) 24(1) Information Systems Frontiers 159.

29 RA Monks and N Minow, *Corporate Governance* (John Wiley & Sons 2017) Conclusion.

to improve their risk management capabilities and resilience.³⁰ They also ensure that the organization has effectiveness and coherence in its operations. The alignment implies that the internal control measures that the firm adopts will be driven by the need for compliance and work towards ensuring that the firm attains its strategic objectives and strives to meet the expectations of stakeholders.

Overall, implementing and relying on internal control measures to enhance corporate governance helps firms meet diverse requirements. On one hand, it enables the firm to meet its stakeholders' trust and accountability needs. This is because the control mechanisms mitigate risks, safeguard all their interests, and ensure the firm adheres to ethical conduct. As Freeman et al. share, internal control mechanisms help firms promote accountability, transparency, and responsible behavior that uphold the stakeholders' trust.³¹ In terms of legal and regulatory perspectives, internal control plays a critical role in ensuring that firms comply with the laws, regulations, and standards set within the industry. Therefore, in such a situation where such laws as the GDPR in the EU, Sarbanes-Oxley Act (SOX) in the United States, and even the Companies Act of 2015 in Kenya set out stringent measures for corporate governance, firms need to ensure that they use their internal control practices to promote compliance.

As Jensen et al. assert, a firm's obligation to ensure that they are regulatory compliant requires them to put in place robust measures of internal control that allow them to effectively detect fraud, mitigate against risks, and safeguard their sensitive information.³² When firms fail to comply with these regulatory requirements, they will likely face financial penalties, legal liabilities, and damage to their reputation, showing internal control's critical nature when navigating the complex regulatory landscape. However, for firms to have robust internal controls, they need to prioritize open communication, ethical leadership, and commitment to integrity, allowing them to have accountability, transparency, and ethical behaviors at all levels.³³ It is, therefore, incumbent upon the firms to strictly adhere to the regulatory framework in place.

Robust internal control also implies the financial perspective of the firm, which, as Beasley et al. share, helps to mitigate against the risks of errors, financial misstatements, and irregularities, thus helping firms improve their market credibility and investor confidence.³⁴ Therefore, when firms align their internal control measures with the governance objectives, they can mitigate mismanagement, non-compliance risk, and fraud and enhance their financial integrity. Therefore, scholars such as Manginte et al. show that organizations must integrate robust internal control mechanisms into their corporate governance framework.³⁵ These mechanisms will enhance their corporate governance

30 L Wang and MS Beasley, 'Internal Control Deficiencies and the Cost of Equity: Evidence from SOX Section 404 Disclosures' (2020) 69(1) *Journal of Accounting and Economics* 101278.

31 RE Freeman, KE Martin, and B Parmar, 'Stakeholder Capitalism: A Global Economy that Works for Progress, People, and the Planet' (Columbia University Press 2020) Abstract.

32 MC Jensen, WH Meckling, and OE Williamson, 'The Impact of Regulation on Internal Control Practices: Evidence from the Financial Industry' (2021) 59(3) *Journal of Accounting Research* 697-711.

33 A Jones and M Parker, 'Principles for Building an Ethical Organization' *Harvard Business Review* (2021) Conclusion.

34 MS Beasley, JV Carcello, and DR Hermanson, 'Internal Control Weaknesses and Information Uncertainty: Evidence from Quarterly Disclosures' (2005) 80(3) *The Accounting Review* 953.

35 Shofia Yunus Manginte, 'Fortifying Transparency: Enhancing Corporate Governance through Robust Internal Control Mechanisms' (2024) 2(2) *Advances in Management & Financial Reporting Research* 72, DOI: <https://doi.org/10.60079/amfr.v2i2.173>.

practices by enhancing their accountability and transparency, promoting ethical conduct, and mitigating potential risks. However, they point out that the effectiveness of internal control measures can be improved by ensuring that they strive to maintain compliance with constantly evolving regulations, foster a culture of integrity, and continually adopt emerging technological innovations.

Conclusion

In summary, a reflection on the internal control component of corporate governance shows that it is an instrumental tool in enhancing a firm's corporate governance practices and standing. The review of various scholarly works shows that corporate governance enjoys a symbiotic relationship with internal control mechanisms, which are instrumental in helping organizations achieve effective risk management and organizational oversight. As such, the company's overall performance, accountability, and ethical climate are informed by the interplay between control practices adopted in a firm and the principles of governance. Research by diverse scholars shows a reciprocal relationship between internal control measures and the corporate governance framework. Specifically, corporate governance serves as the bedrock of the firm's operations as it provides insight into how the firm's internal control mechanisms are set to operate. In other words, it provides the overall framework that outlines the expectations of such issues as accountability and ethical behavior within the firm.

Therefore, for Kenyan firms to ensure that their operations and practices comply with the different laws and regulations, do not waste resources, and safeguard the interests of various stakeholders, they need to implement robust internal control frameworks. Through these frameworks, the firms can put corporate governance principles into action and ensure that they align with accountability, transparency, and fairness.

Further, as various scholars have pointed out, these firms need to continually reevaluate and update their internal control measures to ensure that they are aligned with the changing legal and regulatory environment and the risk environment. In the ever-changing digital environment, firms have to align their internal control measures and adopt such technological tools as artificial intelligence, digital analytics, and blockchain technology to identify, analyze, and mitigate the challenges that come with the new systems. Thus, firms can streamline their internal operations using new technologies, greatly enhancing their corporate governance practices.

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PERFORMANCE CONTRACTING AS A TOOL FOR EFFICIENT GOVERNANCE OF PARASTATALS IN KENYA

CARREN CHEROP MELI

Introduction

Parastatals/ State-Owned Enterprises (SOEs), have played a pivotal role in Kenya's economic landscape. Their evolution can be traced back to the colonial era when the British established various public corporations to facilitate the extraction and exportation of resources to Britain.¹ Initially, parastatals were controlled and managed by the colonial administration, with minimal involvement of native Kenyans.² Post-independence, the Kenyan government inherited these structures and further expanded the role of parastatals. Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning in Kenya, articulated the government's vision for development, emphasizing the importance of state intervention in the economy. This policy document laid the foundation for the establishment and expansion of parastatals, aimed at promoting industrialization, job creation, and equitable distribution of resources.³

Role of Parastatals in National Development

The Parastatal Task Force of 2013 identified five roles of parastatals in the national development effort. First, parastatals are important in promoting or accelerating economic growth and development. Second, these entities are critical to building the capability and technical capacity of the state in facilitating and/or promoting national development. Third, they are important instruments in improving the delivery of public services, including meeting the basic needs of citizens. Fourth, they have been variously applied to the creation of good and widespread employment opportunities in various jurisdictions. Fifth, parastatals are useful for the targeted and judicious building of international partnerships. In enabling states to achieve the above goals, parastatals play a major role in enabling the social and economic transformation of the economies in which they operate.⁴

Justification for use of Performance Contracting

Early parastatals in Kenya faced numerous challenges that hindered their effectiveness

1 Kibua, T. N., & Mwabu, G. (2008). Decentralization and Devolution in Kenya: New Approaches. University of Nairobi Press.

2 Himbara, D. (1994). Kenyan Capitalists, the State and Development. Lynne Rienner Publishers.

3 Republic of Kenya. (1965). Sessional Paper No. 10 of 1965: African Socialism and Its Application to Planning in Kenya <https://repository.kippira.or.ke/handle/123456789/2345> accessed on 1st September, 2024.

4 Report of the Presidential Task Force on Parastatal Reforms, 2013 <https://academia-ke.org/library/download/report-of-the-presidential-task-force-on-parastatal-reforms-october-2013> accessed on 11th September, 2024.

and governance. These challenges arose from structural, operational, and external factors that collectively impacted their ability to fulfill their mandates.⁵ One significant issue was political interference, where parastatals were often used as tools for political patronage. Appointments to key positions were frequently based on political loyalty rather than merit, leading to operational inefficiency and undermining the ability of these organizations to function effectively.⁶

Another issue was the blatant lack of accountability, compounded by inadequate auditing and reporting systems, made it challenging to monitor resource utilization effectively, resulting in financial mismanagement and losses.⁷ Additionally, inconsistencies in the regulatory framework and laws governing parastatals created exploitable loopholes, fostering inefficiency and corruption and eroding public trust in these institutions. Overlapping mandates among various regulatory bodies further exacerbated conflicts and coordination issues, complicating governance and oversight.⁸

It is against this backdrop that the government of Kenya introduced performance contracting as a management tool to enhance service delivery in parastatals. This initiative was outlined in the Parastatal Reform Strategy Paper approved in 1991, which proposed the implementation of performance contracts on a pilot basis in two agencies: the Kenya Railways Corporation and the National Cereals and Produce Board.

In 2003, the late President Mwai Kibaki reintroduced performance contracting as part of the Economic Recovery Strategy for Wealth and Employment Creation (2003–2007). To operationalize this initiative, an executive order was issued on January 15, 2004, mandating that all permanent secretaries and accounting officers of ministries and departments, as well as chief executive officers of state corporations, be placed on performance contracts by June 2004.⁹

Current status on Implementation Performance Contracting

Currently, Performance Contracting (PC) is implemented across all Ministries, Departments, and Agencies (MDAs) in Kenya, building on its demonstrated benefits in improving administrative efficiency, financial performance, and service delivery. Ministries are now required to work toward specific targets, establish service charters with their clients, and benchmark their performance against global best practices.¹⁰

5 Kimia JN, 'Interrogating Problems Facing Parastatals in Kenya' (2019) 6 International Journal of Economics and Management Studies 92, vol. 6, no. 6, 25 June 2019, pp. 92–96, <https://doi.org/10.14445/23939125/ijems-v6i6p114> accessed on 11th September, 2024.

6 Mwaura, K. (2007). The Failure of Corporate Governance in State-Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya. *Fordham International Law Journal*, 31(1), 34–75.

7 Obado, P. (2015). Political Patronage and Its Effects on the Quality of Governance in African States: A Case Study of Kenya. *Journal of African Political Economy and Development*, 10(1), 45–67.

8 Kang'ethe, J. (2020). Governance and performance of state-owned enterprises in Kenya. *Journal of Public Administration and Policy Research*, 12(1), 23–34.

9 Kobia, M. and Mohammed, N. (2006) The Kenyan Experience with Performance Contracting: Discussion Paper, 28th AAPAM Annual Roundtable Conference, Arusha, Tanzania.

10 Paul Mbua and Joseph Ole Sarisar, 'Concept of Performance Contracting –Kenyan Scenario/Experience' (2013) 3 Developing Country Studies 101. 12 Paul Mbua and Joseph Ole Sarisar, 'Concept of Performance Contracting –Kenyan Scenario/Experience' (2013) 3 Developing Country Studies 101.

The introduction of performance contracts aimed to achieve several outcomes, including enhanced service delivery, improved efficiency in resource utilization, the institutionalization of a performance-oriented culture in the public service, measurable evaluation of performance, and linking rewards or sanctions to tangible results. Other objectives included reducing reliance on exchequer funding by public agencies, fostering accountability for results at all levels, and ultimately enhancing organizational performance.¹²

Theoretical Framework

Firstly, is the Agency theory which is based on the principle of the separation of powers between the principal and their agent. In situations where the principal delegates decision-making authority to the agent, and the agent utilizes the resources provided by the principal to further the principal's interests, agents may sometimes engage in moral hazards by prioritizing their own interests over those of the principal.¹¹

State corporations can therefore be viewed as agents whereas the instituting authorities as principals. The state corporations (agents) are expected to be custodians of both the government and public interest as per their performance contract and are bound by the terms.

Secondly, the Goal-setting theory of motivation was introduced in the 1960's by Edwin Locke where he stated that goal setting is linked to task performance and that specific and challenging goals along with appropriate feedback contribute to higher and better task performance. Therefore, goals indicate and give direction to an employee about what needs to be done and how much effort is required to be put in.¹²

Regulatory Framework for Performance Contracting in Kenya

The Constitution of Kenya, 2010

The Constitution provides a broader legal framework that emphasizes principles of accountability, transparency, and efficiency in the management of public affairs. It sets the foundation for various policies and regulations aimed at enhancing governance and service delivery, including performance contracting.

Article 10 provides for the national values and principles of governance including patriotism, national unity, sharing and devolution of power, the rule of law, democracy, and participation of the people; human dignity, equity, social justice, inclusiveness, equality, human rights, nondiscrimination, and protection of the marginalized; good governance, integrity, transparency and accountability; and sustainable development.

11 Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of financial economics*, 3(4), 305- 360

12 Sylvester Odhiambo Obong, 'IMPLEMENTATION of PERFORMANCE CONTRACTING in KENYA' (2009) 10 *International Public Management Review - electronic Journal* <<https://core.ac.uk/download/pdf/228870688.pdf>> accessed 11 September 2024.

While Article 232 outlines the values and the principles of public service which include high standards of professional ethics; efficient, effective and economic use of resources; responsive, prompt, effective, impartial and equitable provision of services; accountability for administrative acts; fair competition and merit as the basis of appointments and promotions; representation of Kenya's diverse communities; and affording adequate and equal opportunities for appointment, training and advancement, at all levels of the public service, of: men and women and members of all ethnic groups. These values and principles of public service are to apply to public service in all State organs in both levels of government; and all State corporations.¹³

The Public Service Commission Act, 2017

The Public Service Commission Act establishes the Public Service Commission (PSC) as the body responsible for overseeing human resource management and development within the public service. The PSC plays a crucial role in the implementation and monitoring of performance contracts for civil servants.

The State Corporation Act, Cap 466

This is an Act of Parliament to make provision for the establishment of state corporations; for control and regulation of state corporations; and for connected purposes. The Act was first established in 1986. According to the Act, "state corporation" means a state corporation established under section 3; a body corporate established before or after the commencement of the Act by or under an Act of Parliament or other written law; a bank or a financial institution licensed under the Banking Act Cap. 488 or other company incorporated under the Companies Act, the whole or the controlling majority of the shares or stock of which is owned by the Government or by another state.¹⁴

In this Act, performance contracts for each financial year should be signed between the Board of a state corporation and the parent Ministry and counter-signed by the Treasury every last month of the financial year in order to become effective on the first month of the financial year.

The State Corporations (Performance Contracting) Regulations, 2004

In Kenya, the process of performance contracting began with the establishment of a Performance Contract Steering Committee in 2003, followed by the issuance of Legal Notice No. 93 and the State Corporations (Performance Contracting) Regulations, 2004. According to the State Corporations (Performance Contracting) Regulations of 2004, every state corporation is granted all the necessary powers to carry out its functions.

The Board of a state corporation is responsible for implementing budgets approved by the Treasury and the parent Ministry, recruiting staff—including the chief executive officer of the state corporation—and developing and negotiating performance targets with the

¹³ Article 232 (2) of the Constitution of Kenya, 2010

¹⁴ Section 2 of the State Corporation Act, Cap 466

parent Ministry for each financial year. Additionally, the Board is tasked with developing, maintaining, and regularly reviewing the strategic plan for the state corporation, managing its assets, entering into and implementing performance contracts with the CEO, and submitting quarterly performance reports to the parent Ministry, the Treasury, and the Inspector-General (Corporations). The Board is also responsible for performing any other duties necessary to ensure the effective implementation of performance contracts.¹⁵ The Act defines “performance” as the means evaluated results of achievement of agreed performance targets; and “performance contract” means a contract entered into between the Government and a state corporation. The Act state that performance contracts in Kenya is, indiscriminately, applicable to all state corporations.¹⁶

The State Corporations (Performance Contracting) Regulations of 2004 also states that no state corporation shall begin a new financial year before signing a performance contract. The County Governments Act, 2012

For county governments, Section 47 of the County Governments Act requires the operationalization of a performance management framework. The County Governments Performance Contracting Guidelines provide a model performance contract for county departments, corporations, boards and tertiary institutions to use.¹⁷

Performance Contracting Guidelines

The Guidelines are intended to ensure clarity and standardization of the Performance Contracts. A Model Performance Contract and a Performance Contract Matrix for each category of public institutions form part of these guidelines as provided in Annex 1A and 1B. To ensure standardization, the model contract and matrix should not be amended or altered.

Performance Evaluation Criteria and Methodology

Kenya started the process of adopting performance contracting by setting up a Performance Contract Steering Committee in August 2003 with a mandate to spearhead the introduction and implementation in the entire public sector and by issuing Legal Notice No. 93, the State Corporations (Performance Contracting) Regulations (2004). According to these regulations, performance is defined as evaluated results of achievement of agreed performance targets. It is freely negotiated performance agreement between the Government and the respective Ministry, Department or Agency which clearly specifies the intentions, obligations and responsibilities of the two contracting parties.¹⁸

The process of identifying performance targets is carried out after the budget process has been completed and institutions informed about their resource allocation. This ensures that targets are realistic and achievable within the available resources. The targets

¹⁵ Section 4 of the State Corporations (Performance Contracting) Regulations, 2004

¹⁶ Regulation 2 of the State Corporations (Performance Contracting) Regulations, 2004

¹⁷ Section 47 of the County Government Act, 2012

¹⁸ 'From the Secretariat of the African Community of Practice on Managing for Development Results' <https://elibrary.acbfpact.org/acbf/collect/acbf/index/assoc/HASH9afe/ea5084cd/de43375c/e3.dir/AfCoPCaseStudy_023.pdf> accessed 11 September 2024.

emanate from the institutions and are freely negotiated and not imposed arbitrarily by the government.¹⁹

Negotiation on the other hand is carried out in two phases. The first phase is the pre-negotiation consultations. At this stage the negotiating parties carry out a SWOT analysis in order to determine the institution's performance capacity. This helps to determine whether the targets being developed are realistic, achievable, measurable, growth oriented and benchmarked to performance of similar institutions. This stage in the process is a storming stage where parties hold lengthy meetings, often disagreeing but finally come to a consensus. The second phase in the negotiation process is where all oriented and relevant to the mandate of the institution.

The performance contracts are signed at two levels. In case of government ministries, the contract is signed between the Head of the Public Service and Secretary to the Cabinet, representing the Government on the one side and the permanent secretary of a ministry on the other side. To ensure that ministers, who represent the political body, are bound by the commitments of their permanent secretaries, they are required to counter sign the performance contracts. In the case of state corporations, the first level is between the government and the board of directors. The permanent secretary representing the parent ministry of the corporation signs with the board of directors on behalf of the government, while the board chair and one independent director sign on behalf of the board.

The board subsequently signs a performance contract with the chief executive to transfer the responsibility of achieving the targets to the management. This guarantees operational autonomy given that board of directors are not executive and are not therefore involved in the day-to-day management of their corporations. Similar arrangements are replicated in the local authorities where the first level entails signing the contract between the chairperson/mayor of a council and the permanent secretary in charge of local government.²⁰

The evaluation exercise is done *ex ante*, hence performance evaluation by the ad hoc evaluation committee is based on a comparison of achievements against the targets agreed at the signing of the contract. The negotiation of targets to be included in the contract is conducted by the ad hoc negotiation committee. The final contract is however between the government and the agency. The performance indicators are agency specific and are developed by the respective agencies upon agreeing on the targets.

The actual achievements of the agencies are rated against the set performance targets negotiated and agreed upon at the beginning of the period. The resultant difference is resolved into weighted scores and ultimate performance denominated to a composite score- the value of a weighted average of the raw scores in a performance agreement. The critical requirement for each target is that they must be growth oriented and therefore

19 Kobia, M. and Mohammed, N. (2006) The Kenyan Experience with Performance Contracting: Discussion Paper, 28th AAPAM Annual Roundtable Conference, Arusha, Tanzania.

20 Sylvester Odhiambo Obong, 'IMPLEMENTATION of PERFORMANCE CONTRACTING IN KENYA' (2009) 10 International Public Management Review - electronic Journal <<https://core.ac.uk/download/pdf/228870688.pdf>> accessed 11 September 2024.

must be improving with time.²¹

Impact of Performance Contracting on Governance of Parastatals

Performance contracting is an emerging tool that effectively supports organizational planning by addressing various aspects that are often overlooked. This approach involves comprehensive corporate planning, where a detailed plan for the organization is developed, outlining the tasks and activities to be carried out over the year. It establishes effective mechanisms to assess and evaluate the outcomes of the planned activities, while ensuring that adequate financial resources are allocated to support these initiatives.

Performance contracting has been praised for promoting accountability by clearly defining the roles, responsibilities, and levels of accountability for each performance aspect. It has also created a platform for comparing public agencies against reliable benchmarks, particularly during the negotiation phase, where members of an independent team—comprising leading industry experts—are selected. This approach has fostered a high level of accountability and transparency in setting performance targets. The ranking of public agencies serves as an indicator of the capability of each agency and its management to meet established goals. This process not only encourages healthy competition among public agencies but also enhances overall performance and service delivery.²⁴

Different Factors affect the effectiveness of performance contracts as a management tool. This includes, the clarity of terms and conditions. Improvement of terms and conditions in the performance contracts would lead to positive increase in organizational performance. This is because performance contracting enables organizations to increase revenue, reduce customer turnaround time and streamline reporting and operational structures.²² Goal Setting and Objectives also affect organizational performance. The Goal Setting theory advocates for goals that are smart, precise, measurable, realistic and timebound to ensure that an organization achieves the desired goal.²⁶ Consequently, improving both individual employee performance, overall effectiveness of a corporation, and service delivery can be achieved by setting clear goals and well-defined targets.

Additionally, Employees attitudes towards performance contracting play a critical role in its effectiveness. Positive perceptions can foster a results-oriented culture, while negative attitudes may hinder engagement and performance. Ensuring that employees understand the benefits of performance contracts and feel supported in achieving their goals can enhance overall effectiveness.²³

The success of performance contracting is often contingent upon political good will and the support of leadership within organizations. The good will of the political class and strong leadership can facilitate the implementation of performance contracts and ensure

21 Trivedi, P. (2000) How to Evaluate Performance of Government Agency: A manual for Practitioners. World Bank.

24 Sylvester Odhiambo Obong, 'IMPLEMENTATION of PERFORMANCE CONTRACTING in KENYA' (2009) 10 International Public Management Review · electronic Journal <<https://core.ac.uk/download/pdf/228870688.pdf>> accessed 11 September 2024.

22 Kitsao, L. (2018), "Performance Contracting and Performance of Parastatals in the Ministry of Transport, Kenya" 26 Kleiman, T. (2011). Non-conscious goal conflicts. *Journal of experimental social psychology*, 47(3), 521-532.

23 Kitsao, L. (2018), "Performance Contracting and Performance of Parastatals in the Ministry of Transport, Kenya"

that there is a commitment to accountability and performance improvement.

The political class can ensure that they do not interfere with the management of parastatals by avoiding skewed appointments to the parastatals boards which is based on political alignment as opposed to merit. Additionally, the political class should ensure that they give the parastatals management enough support in terms of implementing policies and creating an environment for growth as opposed to appeasing political interests.

The Kenyan performance contracting is based on a Presidential Decree. Although, this approach has been effective in launching the system and establishing its viability, a solid legal foundation is necessary. The legal framework should set out the basic premises and the status of the contract capable of being legally enforced so as to avoid fragmented and ad hoc solutions.²⁴

The importance of a legal framework is seen as an important step in ensuring that sanctions as well as incentives emanating from the performance contract is well executed and can be easily enforced.²⁵

Recommendations

In 2007, Kenya's performance contracting initiative received international recognition, winning the United Nations Public Service Award in the first category for improving transparency, accountability, and responsiveness in the public service. The effectiveness of the public service has significantly improved due to performance contracting, which has led parastatals to focus more on their core business and mandates. This has resulted in a notable increase in profitability for commercial parastatals and the successful implementation of citizen service delivery charters, enhancing the public service's ability to meet citizens' needs. Furthermore, the levels of transparency, accountability, probity, and integrity have improved, as all public agencies' obligations are included in publicly signed performance contracts, which are often uploaded to the agencies' websites.

Another key consideration is adequate funding, as budget constraints or misallocation can hinder the achievement of set targets, ultimately affecting the overall effectiveness of these institutions.

Additionally, structures should be established to ensure that performance contracts are negotiated fairly, with third-party evaluations to guarantee transparency and fairness. Emphasis should be placed on the positive use of performance data, rather than punitive measures, to encourage buy-in from stakeholders and avoid setting unrealistic targets until there is sufficient experience with the performance management process. Finally, the evaluation process must be linked to an incentive system to sustain high performance.

24 Trivedi, P. (2000) How to Evaluate Performance of Government Agency: A manual for Practitioners. World Bank.

25 Kobia, M. and Mohammed, N. (2006) The Kenyan Experience with Performance Contracting: Discussion Paper, 28th AAPAM Annual Roundtable Conference, Arusha, Tanzania.

Conclusion

This in turn will ensure enhanced service delivery, improved efficiency in resource utilization, the institutionalization of a performance-oriented culture in the public service, measurable evaluation of performance, and linking rewards or sanctions to tangible results.

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THE IMPACT OF ESG ON CORPORATE GOVERNANCE

ELIZABETH WANGAI NDWIGA

Introduction

Environmental, Social and Governance (ESG) criteria comprise an integral part of the analysis of sustainability and ethical influence of business conducted under modern corporate governance. ESG encompasses three broad concepts that determine how the corporation meets its obligations with its stakeholders and wider society. This trend toward ESG is away from the classical, profit-driven theories of corporations to more holistic interests that environmental stewardship, social responsibility, and sound governance structures embody. Breaking down the ESG framework reveals its three critical components: environmental, social, and governance factors, each playing a distinct yet interconnected role in assessing corporate behavior.

Environmental factors examine a company's impact on the planet, emphasizing its interaction with the natural environment. Key considerations include carbon emissions, waste management, energy efficiency, and resource conservation. Companies concerned with environmental sustainability aim to reduce their ecological footprint and contribute to addressing climate change and other environmental challenges. Blumberg (1990) argued that historically, businesses often neglected their environmental responsibilities due to the dominance of profitability in earlier corporate governance models.¹

Social factors assess a company's relationships with employees, customers, suppliers, and the communities where it operates. They include fair labor practices, diversity and inclusion, consumer protection, and community well-being. Freedman (2000) highlighted how corporations have historically wielded significant social influence, leading to increased demands for accountability and socially conscious practices.² Governance refers to internal practices and policies that direct and control a corporation. Good governance ensures transparency, accountability, and ethical decision-making. Issues such as executive compensation, board diversity, shareholder rights, and corporate reporting integrity are central. Ireland and Kelly (1987) argued that modern company law increasingly seeks to address conflicts between shareholders and other stakeholders, advocating governance frameworks that promote balance and accountability.³

Importance of ESG in Modern Corporate Governance

The rising prominence of ESG criteria reflects a significant shift from traditional corporate theories prioritizing shareholder value above all else. Berle (2004) discussed how classical

1 Phillip Blumberg, 'The Corporate Personality in American Law: A Summary Review' (1990) 38 Am J Comp L 49.

2 Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 MLR 317.

3 Paddy Ireland and David Kelly, 'The Conceptual Foundations of Modern Company Law' (1987) 14 J Law and Soc'y 149.

economic theories focused on profit maximization without considering broader societal or environmental impacts. However, evolving expectations now demand corporations operate responsibly and with greater accountability.⁴

Today, ESG factors are the nature and fabric of how investors, regulators, and consumers score companies. Those firms perceived to adopt ESG codes are labeled less risky, more sustainable, and in tandem with long-term attitudes regarding the social community. As Vogel(1975) reminds us, large-scale corporations can often wield something akin to a quasi-governmental authority with respect to many matters that pertain not just to internal market dynamics but extend into the breadth of social and environmental contexts. ESG integrated into corporate governance allows addressing these issues, as it subjects businesses to accountability for the consequences of their operations that stretch beyond the immediate boundaries.⁵

In summary, the emphasis on ESG criteria is a reflection of change towards corporate governance to recognize the wider ramifications of corporate behavior on the environment, society, and internal governance practices. With the integration of the criteria, corporations will be well positioned to meet the expectations of modern stakeholders who include investors, employees, consumers, and regulators, and who expect responsible, transparent, and ethical behavior in business.

Corporate governance has undergone various metamorphoses, from traditional models concerned mainly with profit maximization to comprehensive frameworks encompassing the criteria of Environmental, Social, and Governance aspects. It reflects a greater understanding and realization of a corporation's wider responsibilities towards the community at large and the environment. Indeed, ESG imperatives signal a shift in corporate governance away from pure shareholder-value maximization to multi-stakeholder orientation that would include employees, customers, and the environment as important stakeholders.

Emergence of ESG Criteria in Corporate Governance

Due to a growing concern for improving corporate governance, rather than just trying to make as much profit as possible, corporate governance began to develop that included wider concerns. Increasingly, the use of ESG criteria marks an important juncture in which it is expected that corporations will conduct their business. As could be expected, ESG factors refer to Environmental, Social, and Governance variables that provide a more holistic version for corporate performance evaluation, where the company will take into consideration its impact on the environment, social responsibilities, and quality of governance structures.

A switch in focus by corporate governance-from purely profit-centered models to those allowing for ESG criteria-implies a greater ongoing process within society with regard to

4 Adolf Berle, 'The Impact of the Corporation on Classical Economic Theory' in Thomas Clarke (ed), *Theories of Corporate Governance* (Routledge 2004).

5 David Vogel, 'The Corporation as Government: Challenges and Dilemmas' (1975) 8 *Polity* 5.

the concept of sustainability and ethical responsibility. This also means that corporations can meet the needs of a new generation of stakeholders who require more responsible, transparent, and sustainable business behavior. This is an important step toward the goal of realignment in corporate activities according to the long-term interests of society and the planet.

Environmental Criterion

Of the three components, environmental criteria have emerged as very important with growing global awareness of climate change, resource depletion, and biodiversity loss. This aspect checks the commitment of the company towards environmental sustainability, its capability to handle risks associated with environmental deterioration, and obedience towards relevant regulatory frameworks. This section discusses the implication of environmental criterion in corporate governance by focusing on environmental sustainability practices, compliance with regulations, and risk management, and shows various examples of companies with excellent environmental governance.

Impact on Corporate Governance

However, the inclusion of environmental concerns into the overall framework of corporate governance largely departs from conventional business models, which mostly centered on seeking the maximization of shareholder value. Companies were previously operating in a constrained manner regarding environmental concern, largely protected by legal mechanisms such as limited liability. This, in a sense, was Blumberg's (1999) argument: through the legal infrastructure of the corporation, the costs of ecological destruction could be externalized, passed on to the public and the state. In that sense, this approach, which prioritizes financial profits, puts into place an unsustainable dynamic whereby corporations are able to grow exponentially without having to grapple with the ultimate repercussions of their actions.⁶

With the evolution of corporate governance, the inclusion of environmental criteria became critical for modern business. As Vogel (1975) says, many large corporations act as quasi-governments given the degree to which their scale of operations can have immense power over the environment. Today, every corporate board and body of top executives are expected to consider the environmental implication of their decisions because stakeholders-investors, consumers, and the regulatory community-demand more accountability.⁷

Environmental Sustainability Practices

Businesses are now exploring alternative ways to make environmental sustainability a part of their operational strategies. Environmental sustainability refers to the practices a company adopts to reduce its ecological footprint, encourages resource efficiency, and also supports activities meant to be beneficial to the health of the Earth in the long run. These

⁶ Ibid n1

⁷ Ibid n5

vary in form: carbon emission reduction, using energy-efficient technologies, effectively handling waste, and conserving water and other natural resources. In this regard, many companies have come to a point of identifying concrete sustainability goals, such as being carbon-neutral by 2050 or embracing a circular economy to avoid generating waste.

Judith Freedman (2000) highlights that large corporations, in particular, have been at the forefront of integrating environmental sustainability into their operations. In response to growing public concern about climate change and environmental degradation, many corporations now report their sustainability performance alongside their financial results.⁸ This trend is part of a broader shift toward integrated reporting, where companies provide a holistic overview of how they create value not only for shareholders but also for the environment and society. However, as Freedman notes, while large corporations are leading this shift, small firms often face greater challenges in implementing sustainability practices due to limited resources.

Case Studies of Companies with Strong Environmental Governance

A few companies have started to stand out regarding environmental governance, setting examples of how well corporations can integrate environmental criteria into their decision-making processes. One such leader in this respect is Unilever, a British-Dutch multinational consumer goods company that has made much noise regarding its commitment to sustainability. The company has set some pretty ambitious targets on the environmental front, such as reducing its carbon footprint and ensuring that raw materials are sourced in a sustainable manner. The company's governance structure ensures that the environmental considerations are well entrenched in the business strategy and have a long-term value creation perspective for both the shareholders and the environment. Unilever has made efforts to earn recognition as one of the most sustainable corporations in the world.

Another is Tesla, which revolutionized the face of automobile firms through the creation and popularization of electric cars as an environmentally friendly replacement for gas guzzlers. Tesla's business model is centered on minimizing carbon footprints through ingenuity. The huge focus on environmental sustainability within Tesla has contributed not only to its bottom line but also reshaped the automotive industry, impressing electric vehicle technology onto other car manufacturers. Environmental governance supports Tesla's commitment to transparency by the routine issuance of its sustainability reports detailing its performance in light of emission reductions and promotion of renewable sources.

The incorporation of environmental criteria into corporate governance illustrates the radical shift in how contemporary business enterprise management is conducted. With growing emphasis on environmental sustainability, it is likely that businesses in the contemporary scenario would be obligated to follow operational practices that guarantee minimum ecological footprint, strict adherence to regulations, and effective management of environmental risks. Others, such as Unilever and Tesla, demonstrate the role of good

⁸ Ibid n2

environmental governance in helping the planet and ultimately succeeding financially. As corporate governance continues to evolve, environmental criteria will be at the core to ensure businesses are run responsibly and sustainably in an ever environmentally conscious world.

Social Criterion

Social criterion, from a modern standpoint on corporate governance, reflects the way in which business interacts with employees, customers, and the communities or society at large. With heightened stakeholder pressure for firms to be responsible socially, it has become apparent that the social criterion directs their ways of governance. This discussion shall explore how the social criterion affects corporate governance by discussing employee relations, community engagement, diversity, equity, and inclusion initiatives, and case studies of companies showing strong social governance.

A corporation's approach to employee relations and labor practices is a fundamental aspect of social criterion in governance. Companies are expected to treat their employees fairly, ensuring safe working conditions, fair wages, and equitable treatment. Freedman (2000) discusses how limited liability historically allowed large corporations to escape the social consequences of exploitative labor practices. However, in response to growing demands for ethical labor practices, modern governance structures have evolved to prioritize employee well-being.⁹ Incorporating strong labor practices into corporate governance not only fosters employee loyalty and productivity but also enhances a company's reputation. Companies that engage in fair labor practices, promote work-life balance, offer opportunities for professional development and are more likely to attract top talent and maintain a positive public image.

Corporations are increasingly expected to engage with the communities in which they operate. Community engagement and social responsibility involve contributing to the well-being of local populations through philanthropic efforts, volunteer programs, and economic development initiatives. Ireland and Kelly (1987) emphasize that traditional company law often neglected these social responsibilities, focusing primarily on the interests of shareholders. However, modern governance frameworks recognize that businesses have a duty to contribute positively to society beyond their economic activities.¹⁰ Companies are now judged not only by their financial performance but also by the social impact they generate. Engaging with local communities, supporting social causes, and contributing to economic development initiatives can improve a company's standing and foster goodwill among stakeholders.

Diversity, equity, and inclusion (DEI) initiatives are another critical component of the social criterion. Companies are expected to create inclusive workplaces that promote diversity across all levels, from entry-level positions to executive leadership. DEI initiatives seek to address systemic inequalities by ensuring that people of all backgrounds, regardless of race, gender, or other characteristics, have equal opportunities in the workplace.

⁹ Ibid n2

¹⁰ Ibid n3

Vogel (1975) points out that large corporations often function like quasi-governments, wielding significant power over societal outcomes. As such, they have a responsibility to address social issues like inequality through DEI programs. Corporations with strong DEI policies not only benefit from a diverse workforce but also create a more innovative and competitive business environment. Inclusive companies tend to attract a broader customer base and are better equipped to navigate diverse markets.¹¹

Case Studies of Companies with Strong Social Governance

Several companies have emerged as leaders in social governance, demonstrating the importance of social criteria in corporate decision-making. One notable example is Salesforce, a technology company known for its strong commitment to social responsibility. Salesforce has implemented comprehensive DEI initiatives, focusing on increasing representation of women and minorities in leadership positions. The company also invests heavily in community engagement through its philanthropic arm, Salesforce.org, which supports education and workforce development programs worldwide. Another example is Starbucks, which has embedded social responsibility into its corporate governance through its ethical sourcing practices and commitment to fair labor conditions. Starbucks also promotes community engagement by offering programs that support local communities, such as the Starbucks Foundation's grants to local non-profit organizations.

Social criterion has become a critical part of corporate governance as businesses are increasingly held accountable for their impact on employees, communities, and society. By prioritizing fair labor practices, community engagement, and DEI initiatives, corporations can build more sustainable and ethical business models. Companies like Salesforce, Starbucks, and Patagonia demonstrate that strong social governance not only contributes to societal well-being but also enhances corporate performance in a competitive, socially conscious market.

Governance Criterion

Governance criterion, one of the key pillars of the ESG framework, depicts how a company is directed, controlled, and held accountable. It ensures that corporations are conducted in an ethical, transparent, and responsible manner while considering the interests among shareholders, employees, and other stakeholders. These sessions have explained corporate governance, based on one of the criteria of governance, by researching board composition and diversity, executive compensation, shareholder rights, and corporate transparency by taking case studies of companies that have the best practices in governance.

Impact on Corporate Governance

Corporate governance has evolved from traditional models focused solely on profit maximization to more inclusive frameworks that prioritize ethical decision-making and stakeholder engagement. Blumberg (1990) notes that historically, corporate governance in American law emphasized the "corporate personality," often protecting the interests

¹¹ Ibid n5

of shareholders while neglecting broader ethical responsibilities. Modern governance criteria, especially those related to board composition, executive accountability, and transparency, aim to rectify these imbalances by promoting fairness and responsibility within the corporate structure.¹²

The composition and diversity of corporate boards are fundamental to governance criteria. A diverse board brings a range of perspectives and experiences, which enhances decision-making and reduces the risk of groupthink. Ireland and Kelly (1987) discuss how traditional company law prioritized the interests of a small group of shareholders, often resulting in homogenous board structures dominated by individuals with similar backgrounds and interests. However, the push for diversity in board composition, including gender, race, and professional diversity, ensures that a wider range of stakeholder concerns are addressed, leading to better governance outcomes.¹³ Diverse boards are more likely to consider the long-term sustainability of corporate decisions and the impact on all stakeholders, including employees, communities, and the environment. Companies with diverse boards are also better equipped to navigate complex regulatory and market environments, ultimately improving corporate performance and accountability.

Executive compensation is another critical aspect of governance criterion. Compensation packages should align the interests of executives with those of shareholders and the broader community. Excessive executive pay, especially when unlinked to performance, has been a long-standing issue in corporate governance. Freedman (2000) highlights that limited liability in large corporations historically allowed executives to prioritize profit generation, often at the expense of long-term sustainability and social responsibility.¹⁴

To mitigate this, modern governance practices emphasize pay-for-performance models, where executive compensation is tied to achieving specific financial, social, or environmental goals. This aligns executive decision-making with the long-term success of the company and its stakeholders. Furthermore, increased transparency around executive pay helps ensure accountability, as shareholders and the public can scrutinize whether compensation is justified by performance.

Shareholder rights and corporate transparency are essential components of the governance criterion. Shareholders have the right to vote on key issues such as executive compensation, mergers and acquisitions, and board appointments. In addition to their voting rights, shareholders demand transparency from corporations regarding their financial performance and governance practices. Vogel (1975) discusses how large corporations historically wielded significant power, often functioning as quasi-governments with little accountability to shareholders or the public.¹⁵ Modern corporate governance frameworks stress the importance of transparency in decision-making processes, corporate reporting, and risk management. Transparency allows shareholders to make informed decisions and hold corporate leaders accountable for their actions. It also fosters trust between corporations and their stakeholders, leading to better long-term outcomes for both the

¹² Ibid n1

¹³ Ibid n3

¹⁴ Ibid n2

¹⁵ Ibid n5

company and the public.

Case Studies of Companies with Strong Governance Practices

Several companies have emerged as leaders in governance, demonstrating the importance of the governance criterion in corporate decision-making. For example, Unilever has been recognized for its strong governance practices, including a commitment to board diversity, transparency, and sustainable executive compensation models. The company's long-term strategy focuses on balancing profitability with sustainability, ensuring that its governance structure reflects the interests of all stakeholders. Another example is Microsoft, which has consistently demonstrated good governance by prioritizing transparency, executive accountability, and shareholder engagement. Microsoft has implemented robust governance frameworks that ensure its leadership remains accountable to both its shareholders and the broader community, reflecting its commitment to ethical corporate behavior.

Governance criterion is a vital aspect of modern corporate governance, ensuring that companies are managed ethically and transparently. By prioritizing board diversity, aligning executive compensation with long-term performance, and enhancing shareholder rights and transparency, corporations can create governance structures that promote accountability and sustainability. Companies like Unilever and Microsoft exemplify the benefits of strong governance, demonstrating that ethical governance practices lead to long-term success and stakeholder trust.

Benefits of ESG Integration

The integration of Environmental, Social, and Governance (ESG) criteria into corporate practices has gained significant momentum over the past decade, reflecting a shift in how businesses approach sustainability, ethics, and long-term value creation. ESG integration offers a variety of benefits, particularly in the areas of financial performance and corporate reputation.

Research has increasingly demonstrated that companies with robust ESG practices tend to outperform their peers in financial performance. This is primarily because ESG-driven companies are better equipped to manage risks and capitalize on opportunities arising from environmental regulations, social expectations, and governance structures. Blumberg (1990) argues that corporate governance has historically been dominated by a profit-maximization model, often at the expense of ethical or sustainable practices. However, the integration of ESG criteria is changing this paradigm, with businesses recognizing that responsible governance can lead to enhanced profitability in the long term.¹⁶

Freedman (2000) emphasizes that the principle of limited liability in corporate structures often encouraged risk-taking without proper accountability. By integrating ESG principles, companies can mitigate risks related to environmental, social, and governance issues, which in turn can protect them from regulatory fines, reputational damage, and operational disruptions. ESG integration, particularly through environmental sustainability practices,

¹⁶ Ibid n1

can also lead to cost savings, such as reducing energy consumption, optimizing resource efficiency, and minimizing waste.¹⁷

Studies have shown that companies with high ESG ratings tend to enjoy lower capital costs, as investors view them as less risky and more sustainable in the long term. This is because ESG-focused companies are seen as proactive in addressing potential risks related to climate change, labor practices, and governance issues, which reduces the likelihood of financial volatility.¹⁸ Ultimately, companies that prioritize ESG not only safeguard their business against emerging risks but also position themselves to thrive in a future where sustainability and ethical practices are paramount.

One of the most significant benefits of ESG integration is its potential to mitigate risks and enhance long-term sustainability. As such, ESG integration helps companies navigate the complex regulatory and social landscapes by ensuring compliance with environmental regulations, fostering positive relationships with stakeholders, and maintaining transparent governance practices.¹⁹ Risk mitigation also extends to social factors, such as labor practices and community engagement. By adopting strong social governance, companies reduce the likelihood of labor disputes, boycotts, or reputational harm stemming from unethical business practices. ESG-driven companies are better able to adapt to regulatory changes, shifting market expectations, and consumer preferences, all of which contribute to their long-term sustainability.²⁰

In addition to financial benefits, ESG integration significantly enhances a company's reputation and brand value. Companies that embrace ESG practices are often seen as responsible and trustworthy by stakeholders, including investors, customers, and employees. Ireland and Kelly (1987) emphasize that modern company law and governance must balance the interests of shareholders and other stakeholders. This alignment is crucial for maintaining a positive corporate reputation.²¹

Consumers and investors increasingly prefer companies that demonstrate commitment to environmental sustainability, social responsibility, and ethical governance. Companies with strong ESG practices can differentiate themselves in the marketplace, gaining a competitive advantage. For example, companies that prioritize environmental sustainability are more likely to attract eco-conscious consumers, while businesses that champion diversity and inclusion can attract a broader and more loyal customer base. Stakeholder trust is a crucial asset in today's business environment, and companies that integrate ESG effectively are more likely to foster long-term loyalty and goodwill. Berle (2004) argues that corporations wield significant power over societal outcomes, and those that act responsibly by integrating ESG practices enhance their brand equity and market positioning.²²

¹⁷ Ibid n2

¹⁸ Ibid n5

¹⁹ Ibid n5

²⁰ Ibid n11

²¹ Ibid n3

²² Berle A, 'The Impact of the Corporation on Classical Economic Theory' in Thomas Clarke (ed), *Theories of Corporate Governance* (Routledge 2004).

Companies that lead in ESG practices often enjoy a competitive edge over their rivals. This advantage stems not only from cost savings and risk mitigation but also from enhanced market perception and stakeholder engagement. Businesses that actively engage in ESG initiatives are seen as innovators, often setting industry benchmarks that competitors struggle to match. This not only boosts their standing in the eyes of consumers but also helps them attract top talent, as employees are increasingly drawn to organizations with strong ESG values.

Challenges and Criticisms of ESG Integration

Environmental, Social, and Governance (ESG) integration has become a critical aspect of modern corporate governance. However, despite its widespread acceptance, there are numerous challenges associated with its implementation, as well as criticisms of its effectiveness. One of the primary challenges in implementing ESG practices is the cost and resource allocation required. For many companies, particularly smaller firms, the financial burden of adopting sustainable technologies or developing comprehensive ESG frameworks can be significant. As Freedman (2000) points out, smaller firms, which often operate under more constrained budgets, face a disproportionate challenge compared to large corporations, which have more resources to allocate toward ESG compliance. The disparity in resources creates a barrier for smaller companies to effectively integrate ESG criteria into their operations.²³

Measuring and reporting ESG performance is another significant challenge. Unlike financial metrics, which are relatively straightforward to quantify, ESG factors are often more complex and subjective. For instance, while carbon emissions can be measured with relative accuracy, assessing social factors like employee satisfaction or community impact is less precise and varies across industries and regions.²⁴ Companies struggle with developing standardized reporting methods that are both transparent and accurate, further complicating efforts to implement meaningful ESG practices.

Criticisms of ESG

A prevalent criticism of ESG is the issue of greenwashing, wherein companies adopt superficial or misleading ESG practices to enhance their public image without making substantive changes. Greenwashing undermines the credibility of ESG initiatives and can erode stakeholder trust. Vogel (1975) notes that the quasi-governmental nature of corporations often leads them to influence public policy in ways that favor their interests. This can result in companies making token ESG gestures that prioritize optics over genuine corporate responsibility. The gap between corporate claims and actual practices has led to growing skepticism about the true impact of ESG initiatives.²⁵

Additionally, there is an ongoing debate about the financial impact of ESG practices. While many studies suggest a positive correlation between ESG integration and financial

²³ Ibid n2

²⁴ Ibid n1

²⁵ Ibid n5

performance, critics argue that ESG can divert attention and resources away from profit-maximizing activities.²⁶ There is concern that ESG frameworks, particularly in their early stages, may impose higher costs on companies, leading to reduced profitability in the short term. This debate continues to shape discussions around the balance between profitability and sustainability.

Future Trends

Despite these challenges and criticisms, ESG practices are evolving, with emerging trends that point toward greater integration and standardization. One significant trend is the development of evolving ESG standards, driven by regulatory bodies and international organizations. Governments and regulatory agencies worldwide are implementing more stringent guidelines on ESG reporting and compliance, encouraging companies to adopt more robust and transparent ESG practices. This regulatory push is expected to lead to more consistent standards for ESG performance.²⁷

Technological advancements are also shaping the future of ESG reporting. Innovations in data analytics, block chain, and artificial intelligence are enabling companies to measure and track ESG metrics with greater precision and transparency. These technologies hold the potential to simplify the complex task of ESG reporting, making it easier for companies to meet evolving regulatory requirements.²⁸

Global Perspectives

ESG practices are not uniform across regions and industries. Different countries have adopted varying approaches to ESG, with some regions prioritizing certain factors over others. For example, European countries have been leaders in environmental sustainability, driven by strong regulatory frameworks like the European Green Deal. In contrast, ESG practices in the United States have focused more ,historically, on governance and shareholder rights, although environmental and social issues are gaining traction. These regional differences highlight the need for international collaboration and standardization to ensure consistent ESG practices across borders.²⁹

International collaboration is becoming increasingly important as companies operate in a globalized economy. Cross-border initiatives, such as the United Nations' Principles for Responsible Investment (PRI), promote the standardization of ESG practices and encourage companies to adopt globally recognized sustainability frameworks. Such efforts are essential in driving the future of ESG integration and ensuring that companies worldwide can contribute meaningfully to sustainable development.

Conclusion

Incorporating Environmental, Social, and Governance (ESG) criteria into corporate

²⁶ Ibid n11

²⁷ Ibid n2

²⁸ Ibid n1

²⁹ Ibid n5

governance has significantly reshaped how companies operate and are evaluated. ESG practices have moved beyond mere compliance to become central to sustainable business strategies. As discussed, ESG criteria influence corporate governance by emphasizing environmental sustainability, social responsibility, and robust governance frameworks.³⁰ This shift reflects a broader recognition of the need for companies to account for their impact on society and the environment while maintaining transparent and ethical operations.

Looking ahead, the future of ESG in corporate governance appears promising. As the regulatory frameworks evolve and technological advancements facilitate more accurate ESG reporting, companies are likely to face greater pressure to adhere to high standards of sustainability and responsibility.³¹ International collaboration and standardized ESG practices are expected to enhance consistency and effectiveness in corporate governance globally.³² This evolving landscape will likely continue to drive businesses towards more sustainable and ethical practices, aligning corporate operations with long-term societal goals.

30 Phillip Blumberg, 'The Corporate Personality in American Law: A Summary Review' (1990) 38 Am J Comp L 49; Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 MLR 317.

31 Ibid n31

32 Dobson J, 'Lifting the Veil in Four Countries: The Law of Argentina, England, France and the United States' (1986) 35 International and Comparative Law Quarterly 839-863.

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