We have noted that corporate governance is based on both internal and external mechanisms. The internal mechanisms, which we consider in this chapter, are centered on three segments – the board of directors, executive management, and independent control functions – each with its own set of vital, and unique, responsibilities. In many systems the activities of the three groups are reinforced by codes of conduct that are intended to promote proper behavior.

If the corporate responsibilities associated with these functions are too vague and diffuse, subject to too much interpretation, or not diligently followed, the governance process is vulnerable. If they are too rigid and onerous, enforcement costs mount, shareholder returns decline, and actions centered primarily on form (rather than substance) may result. Internal mechanisms must therefore achieve an appropriate balance of flexibility and rigor, as indicated in the last chapter. Figure 2.1 summarizes key internal governance mechanisms.

In various national systems the law holds the board of directors and senior executives to certain standards in order to enforce proper accountability. These standards revolve around attention to business, fidelity to corporate interests, and exercise of reasonable business judgment. Theoretically, if these standards are upheld, shareholders and other stakeholders should be protected. Although multiple stakeholders always exist, the overriding legal accountability, certainly in pre-bankruptcy situations, is to shareholders, as the providers of risk equity. While this has always been true in the market model followed by companies in the United States and the UK, it can also be found in the relationship model used by companies in Japan and Continental Europe (which have traditionally counted employees/labor as the key
stakeholders, morally, if not legally). Accountability to multiple stakeholders on all issues is impossible to achieve when their objectives diverge; in such instances, directors and executives must generally give legal priority to shareholders.

In an ideal world the internal governance process operates efficiently, drawing on different expertise in order to keep the company running securely. In summary form, the board of directors, having considered the nature and requirements of its stakeholders, defines the purpose, mission, and ethical values of the firm, creates an appropriate business and risk strategy, discharges duties to management, ensures proper controls are in place, monitors management through use of various mechanisms (audits, risk limits, compensation, financial performance, and ethical standards), revisits the process on a regular basis, and makes adjustments as necessary, thus creating a cycle. Each element of the process has an important role to play in the furtherance of the company and must be performed diligently. Figure 2.2 highlights the basic elements of the internal governance process.