1 Principles of Corporate Governance

1. Introduction

Poor corporate governance is the most widespread reason why a business gets into trouble. Substandard management manifests itself in many ways: for instance, by paying only lip service, or no attention at all, to forecasting and planning; failing to take account of changes in the marketplace and to position the company against market forces; falling behind advances in technology; and lacking sensitivity to product obsolescence. The consequence is top management turnover. ‘The average tenure of a chief executive in America declined from nearly nine years in 1890 to just over seven in 2001,’ The Economist suggests.1

The risks behind this statistic are business-related, and they are present in all companies all of the time (see section 4 on business risk). Other issues aggravated by poor corporate governance are the uncontrolled increases in the cost of production and distribution; an expansion policy which cannot be sustained through existing financial resources and therefore requires inordinate gearing; a major increase in the cost of debt; and growth or diversification of the business beyond available management skills.

Companies fail not only because their product loses its market appeal, but also as a result of reduced efficiency of their sales network, which often decouples itself from the market. Other management risks are those of developing location disadvantages, becoming subject to internal conflicts and musical chairs, paying only lip service to auditing, using creative accounting and having a CEO afraid to cut out dead wood.

Obsolescence in know-how; inadequate internal control systems; a tarnished image in the marketplace, for scandal or other reasons; non-compliance with the law; a rubber-stamp board and CEO malfeasance are still other business risks. As Figure 1.1 shows, business risk is a distinct family of exposures which has joined credit, market and operational risks – though operational risk and business-type exposures have in common management risk.2
In the frame of reference shown in Figure 1.1, each industry has its own list of what constitutes good corporate governance – and its antithesis. For instance, the reasons for failing in the task of positioning our company against market forces varies from one sector of the economy to the next, and from one company to another. As an example, in the financial industry market risk can morph into credit risk, and vice versa, redefining the boundaries of business exposure. Moreover, the global financial system evolves from one dominated by banks to one with deep and liquid capital markets. With this transition, many credit risks become market-tied, with the result that price volatility and transborder financial flows significantly increase.

Both the deepening and the changing nature of risks can be costly in capital adequacy terms. For instance, in the aftermath of the new capital adequacy framework (Basle II) by the Basle Committee on Banking Supervision, many

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**Figure 1.1** A global view of risk control and capital allocation in financial institutions