Corporate Governance Best Practice: Tasks and Shortcomings

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1 Introduction

Corporate governance is one of the dynamically developing theme in the management and finance literature which offers important conceptualization of company functioning and delivers interesting practical insights. As noted by Larcker and Tayan (2011) corporate governance remains an empirical issue since it remains at the fundaments of company operation, the efficiency of stock market and institutional environment as well as investment decisions by individual and institutional investors. The assumptions of strong investor protection, enhancement of corporate disclosure and the efficient monitoring and oversight are the fundamental tasks and goals of corporate governance. These tasks are expected to empower investors and to meet their interests, increase trust, lower risk and in effect improve performance assuring for "long term sustainable value" (Baker & Anderson, 2011; Monks & Minow, 2004). The system of checks and balances is operationalized in the form of corporate governance codes and guidelines formulated at different forums in order to address main control inefficiencies (Clarke & Chanlat, 2009). The nature and efficiency of guidelines and recommendations proposed by governments, regulators as well as national and institutional organizations, must be confronted with expectations of different groups of investors and participants of the stock market.

The aim of the chapter is to discuss the main tasks and shortcomings of corporate governance best practice. More precisely, the goal is to present motivations and functions of adopting corporate governance guidelines as revealed by listed companies in the annual declaration of conformity included in the company report. And finally the chapter aims at referring them to potential shortcomings and limitations revealed in factual implementation of the guidelines in practice and their

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importance for the investment decision by investors. The arguments for best practice code and the statements of compliance with respect to the quality of corporate governance are to be confronted with the insights and observations by 20 invited respondents—board directors, corporate governance experts, auditors, lawyers and funds representatives. The chapter is organized as follows. The concept of corporate governance best practice is outlined in Sect. 2. The case of the Polish code of best practice with the reference to the specific characteristics and shortcomings of the corporate governance system is presented in Sect. 3. Sections 4–6 deliver the results of the series of interviews with corporate governance experts, lawyers, auditors and investors on the functions and role as well as shortcomings and limitations identified in the adoption of best practice code. Final remarks are presented in Sect. 7.

2 Corporate Governance Best Practice

Corporate governance aims at protecting investor rights, mostly with respect to the access to information about the company and the possibility to appoint representatives to the board, lowering risk of investing in company stock and assuring for the adequate rate of return (Tricker, 2012). Thus, on the operational level corporate governance offers as set of guidelines which address shareholder rights and the functioning of annual shareholder meeting, procedures and functioning of the board (structure, independent directors, diversity, committee), relations with creditors, whistle blowing policy, standards of transparency and the quality of investor relations as well as the practice of executive compensation (Lipman, 2007). These general guidelines to improve corporate governance may differ with respect to company history, tradition, specialization or sector or operation. Their implementation is strongly embedded in the political, social and cultural systems and are determined by the institutional (Stulz & Williamson, 2003). As comparative analysis indicates the political system and the power of various socio-political groups exert an impact on the shape of law (Roe, 2003). The dominance of certain political sentiments leads to the formulation and implementation of provisions of company acts, financial market regulation and property right law (Doidge, Karoly, & Stulz, 2007). The efficiency of court system and the quality of enforcement are determined by the strength of institutions (Fligstein & Choo, 2005). Social preferences and cultural values influence the time horizon of company operation and investor expectations with the reference to profit distribution, investment and development policy. In result, these factors have impact on the position and power of CEO and other executives, the structure of executive remuneration as well as influence the role of employees, creditors, outside investors and business practice.

Comparative studies reveal significant difference in corporate governance systems amongst countries and companies. Yet, the experience of corporate scandals and frauds help identify governance shortcomings and formulate a set of recommendations to respond to these inefficiencies (Isaksson, 2009; Kirkpatrick, 2009).

Such sets of recommendations are known as codes of best practice. Codes of best practice represent the self-regulation of listed companies and provide a range of recommendations addressing (Larcker and Tayan, 2011; Mallin, 2004; OECD, 2004, 2015; Tricker, 2012):

- Rights of shareholders, stressing the equal treatment of shareholders holding shares of the same class
- The procedures and rules shaping the functioning of the annual shareholder meeting (ASM) and measures empowering shareholders motivating them to active participation in ASM
- Responsibilities of executives who are accountable to shareholders and stakeholders
- The procedures and rules shaping the functioning of the board
- Transparency standards which describe the scope and content of information policy (company operation and strategy, financial situation, ownership structure, composition, structure and procedures of the board, company bylaws and regulations, executive compensation)

According to the concept of corporate governance best practice, the implementation of the code guidelines is based on voluntary approach by listed companies. As provided with the first code in 1992 by the document known as the Cadbury Report, companies follow the 'comply or explain' principles which means that listed firms should comply with the code guidelines (MacNeil & Li, 2006). If otherwise, they are expected to report the non-compliance and provide explanation for the non-compliance with the possible measures to be taken for the improvement (Cadbury Report, 1992). Companies report on the compliance with the code guidelines on the annual basis in the document called 'declaration of conformity' attached or being an integral part of the annual report.

The comply or explain principle is based on the assumptions of (1) the positive effect of corporate governance improvement on firm performance and value (Aguilera & Cuervo-Cazura, 2004) and (2) investor appreciation of the adoption of the code guidelines. Research reveals that regardless of the sector of operation, the company size and the country of origin better corporate governance is associated with better firm performance and higher firm value (Bauer, Gunster, & Otten, 2004). Better corporate governance measured by the quality of the board, transparency, investor activism, structure of executive pay results in improved monitoring and in a consequence leads to better financial results (Bistrowa & Lace, 2012; Goncharov et al., 2006; Renders, Gaeremynck, & Sercu, 2010). As shareholders expect increasing firm value they positively react to the adoption of widely recognized corporate governance guidelines as the compliance plays the function of the proxy for good and efficient monitoring. Taking into account the above listed companies should be interested in compliance with the best practice codes on the voluntary basis as in the long run this would benefit the company itself, its shareholders and stakeholders.

The concept of the best practice code and the comply or explain principles reveal however severe limitations. First, the declarations of conformity published by

companies are neither verified nor audited which means the lack of any external control over their content and relations to real company practice (Arcot, Bruno, & Faure-Grimaud, 2010; Chizema, 2008). This may be particularly problematic in countries with weaker institutional environment, lower transparency and weaker governance by external, market mechanisms (e.g. stock market). Second, the code guidelines are generally accepted and recognized standards which may be differently defined or interpreted in various cultural contexts. This may lead to differences in understanding certain guidelines and the lack of comparability of the conformity declarations. And third, the arguments on 'one size does not fit all' shows that the universality of code guidelines may post shortcomings in various institutional environments (Davies, 2008). The universal guidelines may not play their monitoring or governance functions in less developed economies or weak stock market (Aluchna, 2009; Cuervo, 2002; Hermes, Postma, & Zivkov, 2007). For instance, the recommendation on the presence of independent directors or the formation of specialized board committees may be too strong for countries where the group of professional board directors is still limited and boards are dominated by shareholders.

3 Polish Corporate Governance Code

Polish corporate governance has been developing for the last 27 years within the process of transition from command to market economy and socialistic regime to democracy. The privatization of the state owned enterprises, the establishment of the de novo firms, reforms of the financial market and legal system as well as creating new institutional order belong to the milestone on the way of the emergence of the corporate governance system. This process was additionally influenced by the inflow of foreign direct investments and harmonization of corporate governance regulation within the accession to the European Union. In result, currently Polish companies operate in the post transition emerging market reality (Berglöf & Claessens, 2006) characterized by following features:

- Significant ownership concentration with the stake of the largest shareholder estimated at ca. 40% (Aluchna, 2015)
- The engagement of industry shareholders as well as individual investors in the ownership structures. The control by industry shareholder is connected to the operation of the company within a Polish or international business group, while the individual investor in the shareholder structure is either the founder and/or an individual play an important role in management or governance (Aluchna, 2015)
- The moderate but rising use of control leveraging mechanisms such as pyramidal structures, dual class shares, shareholder agreements and other legal and statutory rules
- Two tier board model composed of supervisory and management boards. Supervisory boards are significantly dominated by the representatives of shareholders

and affiliated directors with low participation of independent directors and low participation of female directors (Campbell, Jerzemowska, & Najman, 2006, 2009)
- Insufficient investor protection and insufficient transparency combined with the low efficiency of legal system and contract enforcement

In line with the international initiative for improving corporate governance, the Warsaw Stock Exchange engaged in formulating the code of best practice. The concept of the code follows the international practice—it assumes the firms' voluntary approach, is based on the comply or explain principle and requires the annual publication of the declaration of conformity. The evolution of the code delivers interesting insights as it reveals significant improvements in corporate governance both at the country and the company level illustrating as the same time the shortcomings posted in emerging markets and weaker institutional contexts.

The first version of the code known as Best Practice Code was formulated in 2002 followed by quick amendments in 2004. The code consisted of 48 guidelines with the main goal of the company is to increase its the value for shareholders with the respect for the interests of different stakeholders (company creditors and employees). The guidelines addressed the functioning of the annual shareholder meeting, functioning of management and supervisory boards and company's relations with the third parties.

Starting from 2008 listed companies were required to follow a new document called Best Practices for Companies Listed on the Warsaw Stock Exchange which within a new structure offered a set of recommendations and guidelines addressing transparency standards, principles implemented by the management board, principles addressed to members of the supervisory board and guidelines for shareholders. Over the years 2007–2012 the code guidelines were amended, replaced and developed as presented in Table 1.

As shown in Table 1 over the years the code has been evolving addressing the aspects of disclosure and information policy, remuneration schemes, internal control and risk management, exercising shareholder rights and introducing interactive annual shareholder meetings. Starting from January 2016, a new code called Best Practice for GPW Listed Companies is effective. According to the document, "the objective of corporate governance is to develop tools supporting efficient management, effective supervision, respect for shareholders' rights, and transparent communications between companies and the market". The document covers the issues of (1) disclosure policy and investor communication, (2) management board and supervisory board, (3) internal systems and functions, (4) general meeting and shareholder relations, (5) conflict of interest and related party transactions and (6) remuneration.

Table 1 The development the best practice code on the Warsaw Stock Exchange

Resolution	Changes introduced	Effective from
Historical		
Resolution no. 12/1170/2007 of the WSE Supervisory Board Resolution of the WSE Supervisory Board	Adopting Code of Best Practice of WSE Listed Companies 2007, July 4, 2007	January 1, 2008
Resolution No. 1013/2007 of the WSE Management Board dated December 11, 2007	Adopting amendment of the WSE Rules and defining the principles of preparing reports on the application of the corporate governance rules in 2007	
Resolution No. 1014/2007 of the WSE Management Board dated December 11, 2007	Defining the scope and structure of reports partial waiver of the obligation to publish reports	
Resolution No. 17/1249/2010 of the WSE Supervisory Board dated May 19, 2010 concerning	Adopting amendments to Code of Best Practice for WSE Listed Companies • Increased transparency standards and disclosure requirements • Formulation of remuneration policy	January 1, 2011
Resolution No. 20/1287/2010 of the WSE Supervisory Board dated October 19, 2011	Adopting amendments to Code of Best Practice for WSE Listed Companies • Introducing disclosure on gender balance	
Resolution No. 15/1282/2011 of the WSE Supervisory Board dated August 31, 2010 concerning	Adopting of amendments to Code of Best Practice for WSE Listed Companies • Introducing interactive shareholder meeting and on line voting	January 1, 2012
Resolution No. 19/1307/2012 of the WSE Supervisory Board dated November 21, 2012	Adopting amendments to Code of Best Practice for WSE Listed Companies • Exercising of shareholder rights • Further increased transparency standards and disclosure requirements	January 1, 2013
Code of Best Practice for WSE Listed Companies	Adopting • New structure of the code, introducing general and specific rules • Introducing guidelines on internal control and risk management procedures • Introducing guidelines on the conflict of interest and related party transactions	Effective until December 31, 2015
Currently effective		
Resolution No. 646/2011 of the WSE Management Board	Defining rules of providing current and periodical information Introducing EBI system access application form	

(continued)

Table 1 (continued)

Resolution	Changes introduced	Effective from
Resolution No. 718/2009 of the WSE Management Board dated December 19, 2009	Publication of reports on corporate governance rules by listed companies	
Commission Recommendation of February 15 2005	Defining the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board	
European Commission Recommendation of April 30, 2009 complementing Recommendations 2004/913/EC and 2005/162/EC (2009/385/EC)	Defining the regime for the remuneration of directors of listed companies	
European Commission Recommendation of December 14, 2004 (2004/913/EC)	Defining the appropriate regime for the remuneration of directors of listed companies	
Commission recommendation 2014/208 of April 9, 2014	Defining the quality of corporate governance reporting ('comply or explain')	
Best Practice of GPW Listed Companies 2016	Adopting: • New structure • Disclosure • Internal systems • General meeting and shareholder relations • Conflict of interest and related party transactions • Boards functioning • Remuneration	January 1, 2016

Source: own compilation based on WSE materials, http://www.gpw.pl/regulations_best_practices

4 The Research

4.1 *The Method*

The goal of the research is to identify the main functions and tasks of adopting by a company corporate governance best practice as represented by the declarations of conformity published with the annual report. Listed companies present their corporate governance structure according to recommendations and guidelines suggested by the best practice code, referring to the issues of transparency, functioning of supervisory and management boards, risk management, effectiveness of executive remuneration and policy empowering of shareholders. The adoption of the guidelines is believed to improve the monitoring and oversight over the company activity, to comply with regulation and assure for certain standards, to increase investors' trust and to lower risk of investment. Additionally, the study

Table 2 The breakdown of respondents

The type of respondents	The number of respondents
The representative of investors	5
Layers	2
Auditors	2
Board directors	8
Corporate governance experts	3

aims at revealing any potential shortcomings and limitations associated with the declaration of conformity.

The study was based on a series of in-depth interviews with board directors, corporate governance experts, auditors and layers and representatives of investment and pension funds. The number of respondents totaled 20 individuals. The breakdown of respondents is presented in Table 2.

The research questions were formulated as follows:

1. What are the main drivers for adopting corporate governance best practice by a company?
2. Which of the code guidelines are the ones least frequently adopted?
3. What are the main explanations for the non-compliance with the code guidelines?
4. Is the conformity with best practice a determinant for investment decision in a company?
5. Is the declaration of conformity a key document for assessing company's corporate governance?
6. What are the shortcomings of best practice conformity?

The declarations of conformity are included in the annual reports and are publicly available on the companies' website. Yet, these documents remain the declarations provided by the companies and are not verified by an auditor, authority or any other entity. The voluntary approach of the code guidelines adoption and the flexibility of the reporting on compliance are viewed as the efficient approach to self-regulation. This assumption is based on the belief that in the long term investors are able to identify the implementation of the guidelines and assess the quality of the declarations. The investors' reactions are viewed in the pricing effect. As this study focused on the practical dimensions of the best practice compliance, the respondents were asked to address the credibility of the declarations of conformity.

5 Results

The content of the insights provided by respondents was analyzed from the perspective of the paper goal and the research questions. First, with respect to the main drivers for adopting corporate governance best practice by a company (research question 1), the respondents aimed at the legitimacy aspects. The board directors and representatives of investors mostly argued for the importance of the adoption of the widely recognized recommendations to address the expectations of the stock market and its participants. The report on best practice compliance is required from all listed companies and listed companies simply need to meet this requirement. The respondents emphasized the aspects of the improved reputation, the mitigation of structural conflicts and enhanced transparency provided by declarations of conformity. These aspects are particularly significant in the case of large companies being in the public spotlight. The respondents addressed however the legitimacy argumentation arguing that the declaration of conformity may not actually be implemented and internalized in companies' practice. As one of the respondents mentioned "*The declaration is only a part of the story as nobody is able to verify the content of the document. The main issue is how the company behaves in practice. And this may be very different from what was declared*" (R1).

Addressing research question 2 respondents indicated that the guidelines on the presence of independent directors on board, formation of specialized board committees, selected aspects of disclosure and the e-voting installed during the annual shareholder meetings are amongst the ones least frequently adopted. Most precisely, with respect to transparency standards the companies do not want to report on the list of shareholders' questions and company replies on them, do not want to disclose the video coverage from the proceedings of annual shareholder meetings and refrain from publishing information which in their opinion may be detrimental to the company (information useful for competitors, disclosing private information). Weak compliance is also identified in the area of reporting on the remuneration policy. Additionally, companies are reluctant to assure for gender balance on board providing however the information on the balance (or rather lack thereof) of their investor relations websites.

According to the adopted rule of "comply or explain" listed companies which do not follow corporate governance guidelines need to provide an explanation and set the possible date for improvement. The respondents suggested that the most frequently found explanations for the lack of best practice compliance refers (research question 3):

- The compliance with hard law which is obligatory. The law sets adequate standards for company operations—some firms argue that as long as they follow the legal regulations they are not obliged to introduce additional rules and guidelines
- The primacy of company by-laws and shareholder interest over the set of best practice formulated by the stock exchange. Companies claim some recommendations either limit shareholder rights (e.g. to appoint the best board director not

necessarily the independent one) or may be at the cost of shareholders and their interest (e.g. disclosing names of shareholder present during annual meeting or disclosing the questions they ask)

- The threat of acting at the cost of the company and/or shareholders—this explanation is mostly used for non-compliance of certain disclosure guidelines (e.g. publishing information on the independence status of directors)
- The threat of inducing chaos or turbulence—such explanation is often used in the case of non-compliance with the recommendation on e-voting. Companies suggest that poor internet connections could cause disturbances in the proceedings of the annual shareholder meeting, lead to delays or even result in shareholders calling for repetition of the meeting to technical problems
- Additional costs for companies in the case of compliance—this explanation is often used for non-compliance with the transparency guidelines (the standards of the investor relations website, both in Polish and English) and providing interactive communication with shareholders and installing e-voting system

Addressing research question 4 all respondents admitted that the conformity with best practice is not a determinant for investment decision in a company. More precisely, the investment decision based these days mostly on the use of sophisticated algorithms, rely on the financial and technical measures which indicate the potential for increase of firm value and share price as well as the dividend payout. However, as argued by one of the respondents: "*although we do not include the corporate governance variable into our models, we cannot make a serious mistake investing in a company of a risky or fraudulent corporate governance as we are also responsible and accountable towards our clients or beneficiaries. The possible mistake would deteriorate our reputation showing that we do not understand risk management*" (R2). On the other hand the other respondent admitted that sometimes they "*need to invest in a company characterized by some inefficiencies in corporate governance, if the company is a large firm or is targeted by our competitor [another investment fund]. We need to invest in this company based on the benchmark strategy. When the investment in this company would prove to be profitable we would lose against our competitors and customers would blame us for to high risk aversion*" (R3).

The respondents also agreed on the research question 5 arguing that the declaration of conformity should be a key document for assessing company's corporate governance. It provides a general overview of the adopted mechanisms and rules that shape corporate governance at the firm level. The significant advantage of the compliance concept is that companies need to formulate and report their rules and practices. They also need to critically address the implemented solutions from the perspective of the efficiency of the company and the safety of the investment in their shares. The declaration delivers important information on the transparency standards, communication with investors, the structure of the board and the remuneration policy.

However, according to the interviewed respondents the declaration of conformity reveals some significant limitations (research question 6). As mentioned above

the declaration of conformity is not verified or audited. The content of the declaration is assessed by the general public of investors. However, as put by one of the respondents "*the compliance is rather checked in the behavior and practical actions the company undertakes and not necessarily has to be illustrated by the declaration of conformity*" (R4). Thus, the main shortcomings of best practice conformity as noted by respondents refers to the lack of the verification of the report and the difficulty to foresee how a certain company would act in a specific situation. Moreover, the shortcomings of the best practice code refer also to the "one size does not fit all" issue. As suggested by companies and argued by the respondents the general rules transmitted into the national code may not necessarily address the needs of the specificity of the Polish reality. Moreover, an additional limitation was revealed while discussing the possibility of the improvement of the compliance quality. The improvement may be blocked in the case of companies with stable ownership structure characterized by the dominance of the majority shareholder. In such situation even if in the institutional/financial investors are being engaged in the shareholder structure and propose improvements of corporate governance standards, their proposals may be blocked by the dominant owners.

6 Discussion

The analysis of the collected material shows that the functioning of the best practice code and the shortcomings of the compliance with the code recommendations corresponds with the structural problems of Polish corporate governance. First, Polish companies operate in the post-transition, emerging market and are characterized by the significant ownership concentration in the hands of mostly industry shareholders or individual investors who often tend to be founders and/or play a key position on management board. Such ownership and governance reality limits the willingness of companies to adopt some of the best practice. As the study on the degree of compliance reveals and as the interviews indicate there is a significant group of companies which do not follow best practice on the presence of at least two independent directors on the supervisory board, formation of the specialized board committees (audit and remuneration), disclosure of the proceedings of annual shareholder meeting and installing on line voting system. The non-compliance with the board best practice may be to some extend explained by the dominant position of the majority shareholders who are not eager to share control on the board with minority shareholders. The non-compliance with the e-voting recommendation is also result of the dominance of the majority shareholders not willing to empower small investors to actively participate in the annual meeting. Thus, some of the best practice are problematic to be implemented due to the national specificity and structural shortcomings. This may support the one size does not fit all approach making some of the recommendations inactive.

Second, Polish corporate governance has relatively short history of 27 years still facing insufficient investor protection and insufficient transparency. The

institutional structures are weak and in line with the fundaments of the best practice code the declaration of conformity published by companies are not verified, the real degree of compliance may be even lower as reported. As argued by respondents the declaration is a subject of a good will, communication policy and probably in some cases imagination of companies and may not necessarily be internalized at the organizational level. Thus, companies declaring compliance may not implement some of the recommendations in practice. Respondents identify this risk claiming that the real compliance is rooted in company behavior and its practice on the market speaks for itself as opposed to the declaration of conformity.

Third, the lack of verification of the compliance statements, the lack of strong liquid stock market combined with the passivity of institutional/financial investors may also lead to the instrumental treatment of either the declaration of conformity or the contents of the explanations (Arcot et al., 2010; Zattoni & Cuomo, 2008). Companies may incrementally resist implementing best practice providing general explanation for the non-compliance not perceiving it as a process of improvement.

And finally, respondents also linked compliance to some additional efforts to be undertaken by companies, costs incurred and adjustments made (e.g. investor relation, the content of the website, translation of corporate materials and documents from Polish into English). Thus, the respondents indicated that the compliance may be endogenously driven in the case of larger companies, companies with largest budgets or companies at the public and market spotlight (e.g. state controlled companies, banks, companies operating in petrochemical industry). Companies being in a weaker interest of investors and market analysts are to lesser extend exposed to public pressure and control on compliance. This may lower their motivation to adopt the code guidelines.

7 Conclusion

The chapter aimed at discussing practical implications of the adoption of corporate governance code by Polish companies seen by the eyes of board director, fund representatives and corporate governance experts. The main goal was to confront the concept of the self-regulation provided by the best practice code and the statistics of the compliance with the recommendations as reported in the declarations of conformity against the opinion of invited respondents. As long as companies follow official line of communication with the market and declare formal governance policy, some aspects of practical adoption of the code remain unidentified. Yet, the insiders and experts who are exposed to the corporate practice may provide an important and unique insights into the way the compliance really works. The material collected during the interviews with board members, auditors, investment and pension funds representatives and other corporate governance experts revealed essential functions and tasks of the code guidelines indicating at the same time significant limitations. Respondents agree that the declarations of conformity published in annual reports deliver important information on the

practice of corporate governance in listed companies. At the same time they however point the threat of the instrumental treatment of the compliance statement under the conditions of weak market, passive institutional investors, insufficient investor protection and lack of the verification of the contents of companies' reports. This weakens the message provided by the declaration of conformity and encourages market participants to carefully observe the daily behavior of listed companies.

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