ACCOUNTABILITY, CORPORATE GOVERNANCE AND THE ROLE OF THE STATE

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Abstract

The prior literature dealing with corporate governance has largely neglected the role of the State, focusing instead on relationships between boards of directors, managing directors, shareholders and other stakeholders. This paper seeks to overcome this limitation through a historical summary of the evolution of the role of the State in corporate governance both in Europe and the United States. Developments in corporate governance have often been associated with financial scandals and crises, leading to interventions by governments in order to restore economic stability and resolve conflicts among contending parties. We believe that acknowledging the historically important role of the State in corporate governance will lead to a better understanding of the dynamics of regulation in advanced capitalism.

Key Words- corporate governance, the State, business history, legitimacy, ideology, performance

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1. INTRODUCTION

Following the seminal paper by Burchell et al. (1980) in *Accounting, Organizations and Society*, accounting researchers have recognized that accounting practices and accountability relationships are not merely functional; they are implicated in the formation of both organizational and social practices. The topic of corporate governance has become increasingly prominent in recent years (see for example, the special issue of *Accounting, Auditing & Accountability Journal* edited by Brennan and Solomon, 2008). The purpose of this paper is to examine the historical role of the nation state in promoting greater accountability in corporate governance. Most theoretical approaches to corporate governance have not acknowledged the role of the State[1], focusing instead on relationships between boards of directors, managing directors, shareholders and other stakeholders. The historical evolution corporate governance, which has often taken place in the wake of financial crises, demonstrates that the role of the State is a key factor in gaining a better understanding of regulation in advanced capitalism.

The remainder of this paper is organized as follows. The following section sets forth a theoretical analysis of the complex dialectical tensions among notions of legitimacy, economic performance and conflicting ideologies in relation to corporate governance. Section 3 outlines key events in the historical evolution of corporate governance in certain European countries and in the United States. Section 4 presents a summary of several prominent academic theories of corporate governance and relates these theories to the dialectical

[1] A State defined as the governing authorityexisting in a particular national territory, along with the legistative, administrative and judicial structures and institutions necessary to govern such a territory. States have taken various forms including Kingdoms, Empires and Dictatorships, as well as democratically elected governments.

tensions discussed in Section 1. Section 5 revisits the role of the State in restoring economic stability and mediating conflicts among contending parties, particularly in periods of financial crisis. Section 6 concludes the paper.

2. DIALECTICAL TENSIONS BETWEEN LEGITIMACY, PERFORMANCE AND IDEOLOGY IN CORPORATE GOVERNANCE

A political connotation is often associated with the word ‘governance’, leading to the presumption of a democratic process in which decision making is shared out fairly among members of an organized collectivity. Following this logic, a system of democratic governance would proceed in a manner whereby a group of persons, feeling themselves in solidarity with a community of values and interests, agreed to choose leaders who would be recognized as having a ‘legitimate’ right to govern according to a set of constituted rules or guidelines (Giddens, 1984). While this approach is the most common model for democratic institutions, the mere existence of an election does not systematically result in justice or equity. In effect, all forms of governance ultimately rest upon an idea of ‘legitimacy,’ absent which the governing authority cannot exercise power without resorting to force. If the nation state is the most prominent example of democratic governance, and equality of voting rights the ideal mode, it is not generally the practice in those organizations known as business enterprises. Thus, even though the concept of corporate governance involves a certain type of legitimacy, it is not the same kind of legitimacy found in a democratic system of government.

The concept of legitimacy can only be conceived of at the level of a particular group of persons who are joined together by a common set of interests (Dogan, 2004). With respect to corporate governance, this has led to a voting procedure based on the relative size of the pecuniary engagements of the participants. In contrast to the notion of a democratic process, pursuant to which all interested parties have an equal right to vote, the determination of voting rights in a corporate general assembly is based on the number of shares held by each shareholder. As a result, it is the financially most endowed who weigh most in the election of managing directors. Thus, while there is no democratic process in the political sense, this manner of selecting directors seems to facilitate the financing of business enterprises, at least according to financial economics theorists (Schleifer & Vishey, 1997). Clearly then, the specificities of modern codes of best practices of corporate governance are not congruent with the rights of citizens in a democratic state. Nevertheless, while business enterprises do not follow a democratic model, the election of managing directors can be said to produce legitimacy without necessarily being democratic (Jensen & Meckling, 1976).

Despite the lack of democracy at the heart of the business enterprise, companies are 'governed' by nation states through laws and regulations which specify the operating parameters of enterprises to a fine degree (Braudel, 1985). These legal mechanisms have grown and expanded in the wake of reoccuring financial crises and scandals. The modes of election, responsibilities and attributes of company directors are an integral component of such laws. Thus, even if the topic of corporate governance is of relatively recent origin, its basic parameters have been present in company laws since the early 19th century (Pierre, 2002). While Company Law has been the subject of significant research and examination, its adaptation to new economic circumstances has been inconsistent. Company Law has been primarily concerned with the technical aspects of forming and dissolving corporate entities, rather than the relationship between business enterprises and the greater society. The rise of corporate governance as a topic of interest in recent years has been largely due the increasing recognition of a divergence between the technical aspects of company law and desires on the part of civil society to control corporate entities. It is in the context of repeated financial crises that the subject of corporate governance has been found to be lacking (Baker & Hayes, 2004).

Despite the growing recognition of the inadequacy of Company Law, it is somewhat surprising that an interest in corporate governance did not emerge earlier, for example during the social upheavals of the 1960s and 1970s. Instead, it was in the United Kingdom, in 1991, that a concern for corporate governance emerged in the wake of revelations regarding the questionable practices of the press baron Robert Maxwell (Bower, 1992, 1996). These revelations produced evidence about undesirable corporate acts; revelations which were subsequently added to concerns about the collapse of the Bank of Credit and Commerce International (BCCI)(Beaty & Gwynne, 1993). These media thronged events influenced the work of the committee on *Financial Aspects of Corporate Governance* headed by Sir Adrian Cadbury (Cadbury Report, 1992). The recommendations of this committee focused primarily on improved internal controls, the functioning of boards of directors, and enhancing the role of external auditors. While a large place of honor was granted to the financial aspects of corporate governance, there was also a critique of the faulty decisions taken by managing directors; however, little effort was made to correct or control such decisions (Stein, 2008).

In a similar way, the Vienot I (1995) and Vienot II (1999) reports in France focused on establishing a balance between the role of managing directors, independent directors and shareholders. The parallels between the British and French reports did not end with recommendations regarding the powers of managing directors. The reports also demonstrated that the lobbying efforts of professional managers had been assimilated into the white papers issued by high level government commissions. In other words, even if the accountability of managing directors was at the heart of recommendations that the commissions put forth, the reports did not disturb the 'legitimacy' of corporate governance, because there was no other purpose than to reassure shareholders that their interests were being cared for (Financial Reporting Council, 2008).

While it is interesting to note that the emergence of corporate governance as a topic of interest has been the counterparty to corporate failures and financial crises, it is nonetheless surprising that the response to these dysfunctions was not simply an increase in the amount of legislation in the countries concerned. In effect, there has been dialectical logic guiding the evolution of corporate governance. The promulgation of codes of best practices was the initial response during the 1990s and the first decade of the 21st century rather than a resort to legislation (Cadbury Report, 1992; OECD, 2004). One can question the efficacy of an approach in which corporations seek to impose greater constraints upon themselves in order to promote greater accountability to their shareholders. However, if such a compulsion was not specifically required by legislation, it was nevertheless understood that the power of the State was being exercised in an indirect manner. In other words, the diffusion of codes of best practices developed into a collective requirement which was felt to be sufficiently strong to compel companies to align themselves in a concurrent manner in order to maintain legitimacy. The free-form aspects of this framework, employing evanescent concepts like the 'socially responsible corporation', are undoubtedly at the heart of studies which have sought to assess the efficacy of the best practices approach. It is within this context that various researchers have attempted to determine, through empirical studies, the impact of corporate governance practices on the 'economic performance' of enterprises. The results of these studies have been less than illuminating (Stein, 2008).

For example, Larker et al. (2004) concluded that indicators of good corporate governance explain very little about the effects of best practices on the behavior of managers or the economic performance of companies. Working with a database provided by Institutional Shareholders Services and several indices of good corporate governance, Brown and Caylor (2004) produced findings which contradicted prior studies regarding the importance of good corporate governance practices, finding instead that there was little effect. Schleifer and Vishny (1997) performed a global review of the basic parameters of corporate governance, and, in the end they admitted that their study remained at such a level of generality that it revealed little about the specifics of corporate governance: "*Although a lot has been written about law and corporate Governance in the United States, much less has been written (in English) about the rest of the world, including other wealthy economies. Yet legal rules appear to play a key role in corporate governance*."

Indeed, few studies of corporate governance have examined the importance of company law and the role of the State in promoting good corporate governance. It is, however, precisely the State and its legislative apparatus which regulates the relationships between boards of directors, managing directors, and shareholders. In effect, the prominence of financial economics has led to an incoherent understanding of the purpose and objectives of corporate governance. Even if financial economics approaches have their strengths, the conclusions reached are often trivial because of the questions being asked. A positive correlation among the variables pertaining to good corporate governance and economic performance might demonstrate the efficacy of best practices, but the opposite result would be a dismaying signal producing harsh questions about the degree of rigor of the study. Arguably then, the demand for good corporate governance responds more to social imperatives than economic performance measures (Baker, 2007).

The neo-liberal view of corporate governance which underpins the empirical finance literature rarely takes into account the sociological and legal foundations of corporate governance. Even if the research questions are logically based, they fail to consider the role of the State in corporate governance. The implementation of company laws to control large corporate enterprises not only facilitates the objective of making companies more accountable to shareholders, it also corresponds to social requirements for greater accountability and transparency. It is this more democratic vision of corporate governance which has produced an expanded view of the notion of good corporate governance to encompass the needs and interests of a wider group of stakeholders. The neo-liberal perspective on corporate governance focusing solely on economic performance is therefore being replaced by a vision which entails a more democratic understanding of the position of the business enterprise in society.

The enactment of this more democratic view of corporate governance has often led to confrontations. The topic of corporate governance has now become a manifestation of the conflict of ideologies between a neo-liberal view of the enterprise and a more social view. This more socially oriented view reflects a resurgence of the progressive desire to restrict and diminish corporate power. In other words, rather than focusing on relationships between directors and shareholders, corporate governance is seen as a way to control corporations. Hence, the business enterprise becomes one the primary scenes of conflict between capital and other interests in society, and questions of corporate governance become central to political thought.

To summarize, there is a dialectical tension between the notions of 'legitimacy', 'economic performance' and 'conflict of ideologies' in corporate governance. This tension is illustrated in Figure 1. To explicate the manner in which this dialectical tension has evolved through time, the following section discusses the role of the State in constructing and facilitating systems of corporate governance and mediating conflicts among legitimacy, economic performance and conflicting of ideologies.

*****Insert Figure 1*****

3. THE HISTORICAL ROLE OF THE STATE IN CORPORATE GOVERNANCE

Three historical periods illustrate the changing role of the State in corporate governance: the period prior to the 19th century, in which the role of the State was one of facilitating business enterprises as protected monopolies or State owned enterprises; the 19th century, during which time capitalist interests sought to dominate the State; the 20th century, during which period proponents of socialism and proponents of capitalism fought for control of the State. The following sections discuss these three periods, with a particular emphasis on events taking place in Great Britain in France. A focus on these two countries avoids overburdening the reader with exhaustive detail while providing an illustration of the key events in the evolution of the role of the State in corporate governance.

The Role of the State in Corporate Governance prior to the 19th Century

Corporate entities evolved from medieval merchant guilds and State owned enterprises (Jones, 2008). Because the accounting, auditing and internal control practices of merchant guilds were set forth in the charters and by-laws of those entities, the role of the State in regulating such practices was less developed than for State owned enterprises (Waymire & Basu, 2008). Consequently, the role of the State in the governance of corporate enterprises was initially one of setting forth rules pertaining to the economic performance of State owned enterprises. One of the most important State owned enterprises in Europe in the late medieval and Renaissance periods was the *Arsenale di Venezia,* a large shipyard and armory founded in the 12th century in Venice. The Arsenale was the most important industrial complex in Europe prior to the 18th century. Zambon and Zan (2007) have discussed the manner in which Venetian Senate mandated periodic stocktaking and the maintenance of ship production accounts in double entry format, with the passage of materials and work-in-process between units being recorded both in physical quantities and monetary values. Zambon and Zan argue that this was a clear example of the State seeking to solve the problem of costing and promoting the efficient use of resources within the Arsenal. Thus, the primary concern of corporate governance in the early Renaissance period was the ‘economic performance’ the enterprise.

Foucault (1991) has argued that “*in the late sixteenth century and early seventeenth century, the art of government found its first form of crystallization, organized around the theme of reason of state*” (pp. 96-97). Accounting historians have highlighted the importance of accounting developments during this period (Thompson, 1994). For example, Larrinaga and Macias (2009) examined the *Treatise on Accounts* written by Diego de Castillo in 1522. Diego de Castillo was a judge and legal scholar who was ordered by the King of Spain to write a manual of accounting practices in the vernacular Spanish language rather than the customary Latin of the law courts. The purpose was to allow ordinary merchants to understand the proper way to keep accounts in accordance with the laws. Larrinaga and Macias discovered that copies of this book could be found in most business enterprises throughout Spain during the 16th century. Thus, the focus of the Spanish State during this period was on enhancing the ‘legitimacy’ of accounts, and not necessarily on the ‘economic performance’ of enterprises.

During the period of exploration following the discovery of the Western Hemisphere, many enterprises were established throughout Europe as joint-ventures between royal governments and merchant entrepreneurs (Haudrère, 2006). Royal charters granted trading monopolies in exchange for an agreement that a certain percentage of profits would flow to the royal treasury (Jones, 2008). Thus, the focus of corporate governance was on the ‘economic performance’ of the enterprise. Queen Elizabeth I of England financed the outfitting of privateers and slave ships in the late 16th century, and the profits from these enterprises flowed directly to the Queen (Durant, 1953). One of the oldest British corporate enterprises was the *Honorable East India Company*, a joint-stock company formed to engage in trade with the India and China. In 1600, this company was granted a Royal Charter by Elisabeth I under the name the *Governor and Company of Merchants of London Trading into the East Indies*. After a rival English company challenged this monopoly in the late 17th century, the two companies merged in 1708 to form the *United Company of Merchants of England Trading to the East Indies,* commonly referred to as the *Honorable East India Company*. While the East India Company had a monopoly of trade with India, it also governed large parts of the Indian subcontinent, exercising military powers and serving as a virtual arm of the British crown. The *East India Company* ruled India until 1858, when the British crown assumed direct control. Hence, while the original focus of the British State was on 'economic performance,' this evolved over time into a focus on 'legitimacy' as well as an ideological aspect focusing on creating rationales for the expansion of the British Empire.

In a similar way, the "Declaration of the King establishing a company for trade in the Eastern Indies" was promulgated by Louis XIV in France in 1664. The statutes of this company included various privileges such as an exemption from taxes, an exclusive monopoly on trade with the Eastern hemisphere (to which was added in the 18th century, the West Coast of Africa), a guarantee of its financial obligations by the royal treasury, and the capacity to name ambassadors, to declare war and to conclude treaties. Clearly, this company had purposes and objectives wider than its name suggested. It was in fact an arm of the French State, in that it provided material support for wars against the English and Dutch, it contributed to the development of a national navy by affirming the French presence on the seas, and it promoted French civilization and the Christian religion (Haudrère, 2006). The accountability of this company was exclusively to the King of France and its focus was on legitimacy, economic performance and ideology in the form of expanding the power of France as a nation state.

In addition to the creation of the French East India Company, one of the most significant examples of the role of the State in corporate governance during the reign of Louis XIV was the introduction of standardized regulation of private company accounting practices through the Ordinance of 1673 and the publication of textbooks, like those in Spain, to explain the regulations to merchants (Miller, 1990).

During the 18th century, there began to be a change in the role of the State in corporate governance away from the joint-venture model to a model in which shares in chartered companies began to be traded in capital markets in cities such as London, Paris, and Amsterdam. The nascent industrial revolution prompted a need for capital and a desire on the part of the emerging bourgeoisie to participate in profit making enterprises. At the same time, speculative bubbles led to share price collapse, followed by increased regulation. For example, the *South Sea Company* was a British joint-stock company that traded in South America during the 18th century. Founded in 1711, the South Sea Company was granted a monopoly by the crown with respect to trade in Spain's South American colonies. In return, the company assumed a portion of the national debt of Great Britain. Speculation in the company's shares led to the South Sea Bubble of 1720. This event caused widespread financial panic requiring intervention by the British state. A similar fraud, involving a joint stock company occurred in France in 1720. John Law, a Scots émigré to France, purchased the charters of several companies and changed the name to the *Compagnie perpétuelle des Indes.* Law obtained a monopoly from Louis XV for the printing of currency and the right to collect taxes. In 1720, Law was named controller general of finances of France. However, in March 1720 his company went into bankruptcy when the shareholders tried to convert their shares into gold, which the company did not have. This scandal led to a prohibition against the formation of joint stock companies throughout Europe (Renaut, 2005), thus severely limiting the growth of the corporate form of business enterprise.

The Role of the State in Corporate Governance during the 19th Century

Braudel (1985) has maintained that capitalism can only exist where the State favors its development. He argues that "there are positive social policies which promote the expansion and success of capitalism". These policies include the maintenance of social stability and the establishment of a favorable environment for commercial activity. The existence of a capitalist economy presupposes positive acts on the part of the State, because only the State can guarantee the right of private property which is essential to capitalist activity (Braudel, 1985).

While the joint-stock form of business enterprise was prohibited in many countries during the 18th century, the industrial revolution prompted a need for capital which was increasingly provided through share market exchanges. The intermingling of capital and political interests led to cycles of corruption and reform, leading to the Company Acts in Great Britain (Hickson & Turner, 2005; Freeman, Person and Taylor, 2007) and the Commercial Code in France (Younkins, 2001). In both cases, there were interventions by the State to control the power and influence of capitalist enterprises, while simultaneously leading to conflits of interests on the part of legislators who became enmeshed in efforts to control the ownership of industrial, financial and commercial enterprises (Cooke, 1950).

In France, the Code of Commerce of 1807 authorized the creation of *sociétés anonymes* (corporations), as well as *sociétés en commandite par actions*. While *sociétés en* *commandite par actions* existed in the 18th century, they were not widely used. Because of limitations on the liability of shareholders for the acts of the company, the Code du Commerce required *sociétés anonymes* to be accountable to the State. In contrast, *sociétés en commandite par actions* were relatively free from regulation by the State because the liability of the managing directors was unlimited and this was thought to constitute a guarantee of accountability with respect to shareholders (Johnston, 2005).

In Britain, the *Joint Stock Companies Act 1844* (7 & 8 Vict. c.110) expanded the ability of business enterprises to incorporate as joint stock companies. Before this Act, incorporation was only possible through a royal charter or by a specific Act of Parliament. By limiting the formation of joint stock companies, the members of Parliament protected the privileges of the aristocracy and the rich bourgeoisie. Consequently, in Britain, many business enterprises operated as unincorporated associations with dozens of members (Hiskson & Turner, 2005). Any litigation involving the company had to be carried out in the joint names of all the members. Limited liability was subsequently introduced by the *Limited Liability Act 1855*. The British system of corporate governance was revised by the *Joint Stock Companies Act 1856* which has been recognized as the founding piece of UK company law. Unlike other Acts of Parliament preceding it, the 1856 Act provided a simple administrative procedure through which any group of seven people could register a limited liability company as a joint-stock company.

Despite the favorable conditions created by European governments to encourage the growth of capitalist business enterprises, repeated economic crises led to interventions by the State to control and stabilize the economic situation. It was during this period that the economies of many European countries began to evolve from being primarily agricultural to increasingly urban and industrial. Rural emigration, combined with a demographic explosion, depopulated the countryside and filled large industrial cities with an impoverished working class. Various political actors argued that intervention by the State was necessary to alleviate poverty and improve working class conditions (Pierre, 2002). Socialist politicians criticized the capitalist mode of production, and the more radical among them sought to eliminate capitalism entirely. Others argued in favor of more moderate approach to social change which included the formation of trade unions, social welfare programs and democratic access to political power. However, while there were efforts to alleviate industrial poverty during the Victorian era in Great Britain and the Second Empire in France, there was also increasing support given to industrial, commercial and banking oligarchies, as well as colonial expansion. Corporate entities were accountable primarily to the political elites who encouraged exploitation of commercial opportunities. A commercial treaty signed in 1860, between Great Britain and France, liberalized trade in agricultural products and manufactured goods, and lowered taxes and customs duties. The level of economic liberalism, globalization and international trade during this period was greater than at any time prior to the end of the 20^{th} century and it was largely facilitated by actions of the State (Pierre, 2002).

*****Insert Table 1*****

The Role of the State in Corporate Governance during the 20^{th} Century

Conflicts between advocates of liberal capitalism and proponents of socialism led to political turmoil throughout most of the 20th century. The role of the State with respect to corporate governance during this period was one of mediating between legitimacy, performance and ideology, with the articulation of these ideas being different according to one's political orientation. The socialist objective was to control the State in order to control or eliminate capitalist power. In contrast, the liberal capitalist perspective was to remove restrictions on enterprise. Corporate governance was therefore seen as a political struggle.

Unlike the Russian, Austro-Hungarian, German and Ottoman Empires, the British and French empires avoided the social revolutions of the immediate post World War I period. Nonetheless, in both Britain and France there were significant episodes of revolutionary politics. The founder of the French Socialist party, Jean Jaurès, specified the goals of the French Socialist party when he wrote in an 1896 manifesto: *"In my opinion there are three essential points which are necessary in order to characterize a socialist program: the intervention by the State in order to transfer from capitalist ownership to social ownership the diverse categories of the means of production and exchange; the conquest of public power through universal suffrage; and international cooperation among workers*." (Millerand, 1903). The French Socialist Party won 56 seats in the French Parliament in 1906, and by 1914 it had more than 100 members in the Chamber of Deputies.

Similar to the French Socialist party, the Labour Party in Britain adopted as its goal: "*the common ownership of the means of production, distribution and exchange*". By 1924, the British Labour Party was able to form a minority government with Ramsay MacDonald as prime minister. Allegations that the Labour Party had links with Soviet Communism led to Labour's defeat in the general election of October 1924. This reverse of fortunes caused Labour to assume a more moderate form of social democracy. However, during the worldwide economic depression of the 1930s this moderate policy was not popular with Labour's working class supporters and Marxist orthodoxy increased throughout the inter-war period. In the general election of 1929 the Labour Party won 288 seats out of 615 and was able to form a minority government. A lack of revenues forced the government to make budget cuts, which the trade unions opposed, thus splitting the Labour government. This split forced the Labour Party leftward, and at the start of the Second World War an official Party pamphlet maintained that capitalism and fascism were equivalent (Laski, 1939). A growing acceptance of these arguments led to nationalization of many enterprises in the immediate post World War II period, including banks, railroads, airlines, telecommunications, coal, electricity and gas production. By the mid 1950s significant portions of the economies of European countries were owned or controlled directly by the State. As a result, the question of corporate governance had returned to the question of how to enhance the economic performance of State controlled enterprises. However, the measure of economic performance was now related to a social purpose and not the maximization of economic performance.

During the later years of the 20th century, the British general public was persuaded to the idea that the State might not always be the most efficient way to manage business enterprises. This led to the neo-liberal policies of the Thatcher government, pursuant to which nationalized enterprises were privatized and an increasing emphasis was placed on deregulation and marketization. Following the privatization of nationalized enterprises, British industry, in consultation with civil servants, began promulgating of codes of best practices for corporate governance. These codes subsequently influenced developments in corporate governance in the European Union and the United States. In particular, the following reports became highly influential:

- The Cadbury Report on “Financial Aspects of Corporate Governance” (December 1992),
- Greenbury Report (July 1995),
- Hamel Report on “Corporate Governance” (June 1998),
- Turnbull Report on “Internal Control: Guidance for Directors on the Combined Code” (September 1999) and
- Higgs Report on the “Review of the role and effectiveness of non-executive directors” (January 2003).

The Role of the State in Corporate Governance during the 21st Century

The Enron and WorldCom scandals in the United States in 2002 led to the enactment of the Sarbanes-Oxley Act, which is the most significant piece of American legislation dealing with corporate governance since the Securities Acts of the 1930s. The Sarbanes-Oxley Act had an impact on corporate governance legislation in several European countries. For example, in France, the *Autorité des marchés financiers* (AMF) was created by the Financial Security Act of 2003. The purpose of this act was to improve the coordination and efficiency of France's financial regulatory system and to raise the French regulator's international profile. The remit of the AMF was to safeguard investments in financial products, ensure that investors receive relevant information, and maintain orderly financial markets. Thus, the primary purpose of the AMF was the protection of shareholder interests.

In a similar way, the British government created the *Financial Reporting Council* (FRC) as an independent regulator for both corporate reporting and governance. From April 2004 the FRC became a unified regulator with a wide range of functions including the setting of accounting standards, auditing standards, and the establishment of a combined code of corporate governance which is required to be observed by all listed companies on the London Stock Exchange (Financial Reporting Council, 2008). The primary emphasis of this code is expressed as follows:

> Good corporate governance should contribute to better company performance by helping a board discharge its duties in the best interests of shareholders; if it is ignored, the consequence may well be vulnerability or poor performance. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term (Financial Reporting Council, 2008, p. 1).

Despite the promulgation of codes of corporate governance, financial crises have continued into the 21st century, thereby leading to more interventions by the State in order to re-establish economic stability. In is unclear where these efforts will lead. What is clear is that the role of the State in corporate governance has been present from at least the 16th century. While there are parallels between the evolution of corporate governance in Europe and the United States, the manner in which corporate governance has evolved the United States has been quite different from Europe. This will be discussed in the next section.

The Development of Corporate Governance in the United States

The Commonwealth of Massachusetts was established as a joint-stock company in 1620, thereby making it the first corporate entity in English America. During the colonial period, many entities were formed, both for private and public purposes, as joint-stock companies, including toll roads, canals, and other types of enterprises. After the American Revolution, legislative action was required to form a corporate entity. As a result, the chartering of corporations by the states decreased during the 19th century because corporation laws focused on protecting the public interest, and not on fostering capitalist interests. Shareholders were given a voice in corporate governance, and corporate entities were required to confine themselves to the activities specified in their charters. As a result, during the 19th century many enterprises avoided the corporate form entirely (e.g. Andrew Carnegie created the United States Steel Company as a limited partnership, and John D. Rockefeller set up Standard Oil as a trust). Certain state governments began to realize that they could benefit by providing more permissive corporation laws. New Jersey was the first state to adopt a corporation law which had the specific purpose of attracting business enterprises to that state. Delaware soon followed and it quickly became the most corporation-friendly state in the country (Moye, 2004). (See Table 2 for an outline of the key historical developments in corporate governance in the United States).

*****Insert Table 2*****

Beyond the corporation laws, there was another form of corporate governance in the United States which took the form of laws against the creation of interlocking corporate ownership (anti-trust), laws against restraints of trade (anti-monopoly), and regulations regarding prices and rates of return on capital in certain industries. Both federal and local governments enacted price and rate of return on capital controls in industries like water distribution and sewerage, urban lighting and transportation, interstate railroads and shipping, telecommunications, electricity and gas production, (Cooke, 1950). Many aspects of the US economy were strictly regulated by federal or state governments through commissions or boards which established prices either according to a fixed rate of return on capital or through price caps. For example, in 1906 the U.S. Congress passed the Hepburn Amendment to clarify several Supreme Court decisions and to force the railroad industry to establish a fixed price rate schedule. This law also gave the Federal Interstate Commerce Commission the legal authority to set rail tariffs and rates based on rate of return on capital measures that were directly related to accounting for capital equipment costs (Heier, 2006).

This system began to fall apart in the 1980s, when a trend towards neo-liberalism, fostered by the political ideology of President Ronald Reagan, led to deregulation in many industries. This trend towards neo-liberalism continued through the 1990s and 2000s. Many of the formerly regulated industries in the United States (e.g. banking, electricity, airlines, and telecommunications) were no longer held accountable to the State. This deregulation led to financial crises and a recognition that intervention and regulation by the State was needed. As the same time, it was clear that intervention by the State has often proven to be inadequate to protect citizens and stakeholders in a globalized economic environment. Traditional forms of corporate governance, largely dependent on the concept of protecting shareholder interests, have been ineffective in addressing public demands for financial stability, employment, health and worker safety, product safety, environmental protection, immigration, unfair tariffs, and so forth. The laws pertaining to corporate governance have evolved in response to historical and economic events, which for the most part have involved scandals and other fraudulent acts. Consequently, company laws have been inadequate in controlling corporate activity in an era of globalized capital markets and multi-national corporate enterprises. While shareholders may be granted voting rights by law, the laws of corporate governance do not provide power to shareholders to control corporate activity, unless the shareholders own sufficient shares to control the corporate entity.

Furthermore, the interests of shareholders do not necessarily coincide with the interests of other stakeholders. Shareholders want increasing share prices, while employees and workers want to retain their jobs. As a result, there is a conflict of interest among stakeholders, which the laws of corporate governance do not address. Employment laws are outside of the laws of corporate governance. Likewise, if the majority of the citizens of a particular country believe that certain types of corporate activities are not desirable (e.g. sale of arms manufacture; cigarette production; producing toxic materials; etc.) the laws pertaining to corporate governance do not address these issues. Consequently, while there may be efforts by the State to control corporate activities, the laws of corporate governance are not part of these control mechanisms. This leads to a social issue in which the objectives and purposes of corporate governance are confused. While the laws of corporate governance focus on shareholders and their interests, the State is called upon to control all aspects of corporate activity. Thus, the idea of corporate governance is often ambiguous because the laws pertaining to corporate governance may espouse a neo-liberal orientation based on shareholder interests, while the more general laws may seek to restrain the propensity of corporations to engage in socially detrimental practices in the pursuit of profits. The general laws are based on democratic processes, but so are the laws pertaining to corporate governance. This leads to a sort of 'schizophrenia' among the citizens of advanced capitalist countries because while they may sometimes want market oriented solutions to problems, they also want restrictions on what corporations are allowed to do. Thus, corporate governance becomes a mediating process among conflicting views of legitimacy, economic performance and conflicts of ideology in which the role of the State is increasingly central. Academic theories of corporate governance have not addressed this tension between legitimacy, performance and conflicts of ideology. The following section reviews the principal academic theories of corporate governance in relation to issues of legitimacy, performance and conflicts of ideology.

4. ACADEMIC THEORIES OF CORPORATE GOVERNANCE

According to Charreaux (2004), theories of corporate governance can be divided into those which focus on disciplinary aspects of governance versus those which focus on cognitive aspects. Within the disciplinary area there are those which focus on shareholders and those which focus on stakeholders.

The Shareholder Disciplinary Model

The primary theory of corporate governance underpinning academic research in finance, economics and accountancy, rests on the shareholder disciplinary model in which the objective of corporate governance is to discipline managers so that their interests are congruent with those of shareholders (Shleifer and Vishny, 1997). The basic premise underlying this model is that shareholders are the residual owners of the company, and as such, their legal rights are determined by the principles governing the possession, use and transfer of private property. The shareholder disciplinary model, and the legal principles upon which it rests, have led to the fundamental notion that it is the responsibility of corporate managers to protect the interests of shareholders. Thus, the accountability of managers is to shareholders.

Research relying on the shareholder disciplinary model has focused on the structure and functioning of boards of directors, the legal rights of shareholders, the control of executive compensation, and the audit of financial statements so as to prevent embezzlement and fraudulent behavior both on the part of corporate managers and employees of the enterprise. It is within this logic that the US Sarbanes-Oxley Act increased legal sanctions for misstatements of financial reports and reinforced the independence of both boards of directors and auditors. Sarbanes-Oxley did not call into question the idea that a good system of corporate governance is one which focuses on the interests of shareholders.

The Disciplinary Partnership Model

Many academic researchers argue that the focus of corporate governance should not be limited to relationships between managing directors and shareholders; instead it should take into consideration the whole range of strategic partners who are the source of value creation in the enterprise (Bessire & Meunier, 2005). These researchers propose a partnership model of corporate governance pursuant to which there are incentives for stakeholders to make specific investments favourable to the enrichment of the company as a whole. Such an approach is based on the presumption that a partnership model will in the long run be more efficient than a shareholder model (Zingales, 2000). In other words, the compensation paid to employees and other stakeholders will be sufficiently great that it will motivate stakeholders to increase the economic performance of the company. In the United States incentives have taken the form of bonuses and wage increases based on performance of the company, as well as other types of incentives such as company funded pensions and health insurance. Share option grants are also an important motivational device in this context. The overall purpose of these incentives is to place the stakeholders in a position congruent with the economic interests of the enterprise as a whole.

Paradoxically the partnership model has been difficult to implement in European countries due to the existence of social welfare systems, which already provide health insurance, retirement schemes and relatively long vacations, thus mitigating the incentive aspect of such incentives. Moreover, a partnership model does not prevent conflicts among stakeholders. Consequently, it is the role of the State to act as mediator to protect the interests of society as a whole. The challenge is that during periods of increasing globalisation and economic crisis, dissatisfied stakeholders may find it difficult to demand larger shares of the economic value added, either because there an insufficient amount of economic value to be divided, or because capital providers can transfer their investments to enterprises in other countries promising greater returns on investment. In this context, the challenge faced by the State is to promote more accountable corporate governance in situations where the power of the State does not extend beyond national borders.

Socio-cognitive Approaches to Corporate Governance

Various researchers have gone beyond the disciplinary models of corporate governance to describe a socio-cognitive approach. This model is derived from idea of increasing the competences of all employees through training and new technologies (Bessire and Meunier, 2005). Following this approach, protecting the interests of shareholders, or even taking into consideration the contributions of stakeholders, is not sufficient to guarantee sustainable value creation. It is therefore necessary to develop the kinds of knowledge which can create ways to resolve conflicts of interests among the various recipients of portions of the value added. This involves the enactment of devices likely to support value creation by mobilizing factors such as training, knowledge and competences (Charreaux, 2004).

The concept of sustainable value creation, which underpins the socio-cognitive model, results in considering the enterprise as a growing body of competences (Dosi, 1994). A sustainable enterprise needs to be innovative and innovating (Lazonick and O' Sullivan, 2000). Three conditions permit the emergence of innovative companies: new competitive technologies; organisational strategies fostering cognitive development, and favourable institutional conditions with respect to labour legislation, finance and company law. These conditions depend on actions by the State to create institutions charged with encouraging innovation. The socio-cognitive model of corporate governance, focused on the concept of innovation, can lead to distribution of value added in a different manner from the shareholder and partnership models, because it privileges those who contribute most to new ideas and new processes. It can also lead to renovation of the structures of corporate governance to encourage organisational development. Within this logic, the board of directors would include representatives from all parts of the enterprise who are likely to create value. Finally, the State would need to create institutions to facilitate training, knowledge creation and development. While the socio-cognitive model is intended to lead to innovation and more sustainable companies, it is not a normative theory; it is a pragmatic approach to corporate governance which can help to reconcile the conflicting claims of legitimacy, performance and ideology through the mediating power of the State.

5. CORPORATE GOVERNANCE AND THE ROLE THE STATE IN CONTROLLING FINANCIAL CRISES

Despite the neo-liberal trends of the last several decades, the State is now faced with the necessity to reassert its more traditional role in corporate governance due to a worldwide financial crisis. This crisis highlights the role of the State in promoting both economic stability and greater accountability in corporate governance. The importance of reestablishing the surveillance and regulatory mechanisms that have been historically applied by the State cannot be overestimated. Without an undergirding of social stability the collectively will suffer. The question is not how to choose between total governmental control and total deregulation, but how to identify the practices which are most likely to promote economic stability and corporate accountability.

Business enterprises are often viewed as if they were individuals who rationally deliberate about how to achieve objectives. In fact, business enterprises are social constructions derived from practices which have evolved through time. This leads to misunderstandings about the role and purpose of corporate governance, permitting the idea that market forces will eventually lead to achievement of the common good and that the market will respond to excesses through an equilibrium process. The promotion of codes of best practices in corporate governance has led to the idea of exhorting enterprises to be socially responsible. This concept loses sight of the fact that the market is not an individual; instead it is an aggregation of actions carried on by persons who take individual decisions about priorities. It is simplistic to say that improved corporate governance will improve economic performance and secure stable and just outcomes for everyone (Williams, 2008). Therefore, it is necessary for the State to promote economic stability though prudential regulation of corporate activity and to adopt socio cognitive approaches to corporate governance which will hopefully lead to a better allocation of value added across a broad spectrum of stakeholders.

6. CONCLUSION

This paper has focused on the question whether corporate governance is primarily a matter of ‘legitimacy’, that is, the legitimacy of the enterprise from a legal perspective, and also the legitimacy of the State which seeks to control business enterprises in an increasingly globalized environment; or alternatively, whether corporate governance can be considered to be primarily a matter of ‘economic performance’ in the face of increasingly competitive capital markets; or finally, whether corporate governance can be seen to be a matter of ‘conflicts of ideology’, in which the objective is to achieve greater control and accountability for corporate enterprises. We have investigated these three perspectives through an examination of the historical role of the State in corporate governance. Essentially, the role of the State has been and continues to be to act as a mediator between conflicting perspectives in order to promote greater accountability to various types of power (i.e. royal, bourgeois, or civil). While the advocates of financial economics argue that the role of corporate governance is to enhance economic performance of the enterprise for the benefit of its shareholders, it clear that this has not been the primary role of the State through time. The role of the State in corporate governance has been to serve as a mediator among conflicting perspectives regarding legitimacy, performance and ideology, while enhancing economic stability and promoting greater levels of accountability. This has not been an easy task, and it is one which has been infused with political tensions and conflict. Nevertheless, it can be concluded that the role of the State in corporate governance has been central.

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TABLE 1
KEY DATES IN THE EVOLUTION OF
CORPORATE GOVERNANCE IN EUROPE

1200	*Venice Arsenale* is established.
1522	*Treatise on Accounts* by Diego de Castillo in Spain.
1600	The *East India Company* chartered by Elizabeth I of England.
1664	*French East Indies Company* authorized by Louis XV.
1720	*South Sea Bubble* in Britain prompts a financial crisis requiring intervention by the State resulting in a law that prevents formation of joint stock companies.
1720	*John Law* scandal in France causes financial crisis requiring intervention by the State.
1807	*Code du Commerce* in France authorizes Sociétés Anonymes (corporations).
1844	*Joint Stock Companies Act* permits the formation of joint stock companies (corporations) in Britain.
1855	*Limited Liability Act* in Britain restricts shareholder liability for corporate acts.
1856	Revised *Joint Stock Company Act* becomes the founding piece of British company law.
1860	Commercial treaty between Britain and France liberalizes trade in agriculture and manufactured products.
1896	French Socialist party formed with the goal of achieving control of the State and removing the means of production from the hands of capitalist ownership.
1906	French Socialist party wins seats in French Parliament.
1918	British Labour Party adopts the objective of achieving common ownership of the means of production, distribution and exchange.
1929	Labour Party forms a government in Britain.
1950s	Widespread nationalization of corporate enterprises throughout Europe.
1980s	Privatization of nationalized enterprises, deregulation and liberalization of markets.
1990s	Promulgations of *Codes of Best Practices* in Corporation Governance.
2004	Creation of the *Financial Reporting Council* in the United Kingdom.
2008	Financial Reporting Council promulgates a *Combined Code on Corporate Governance.*

TABLE 2
KEY DATES IN THE EVOLUTION OF
CORPORATE GOVERNANCE IN THE UNITED STATES

1632	*Massachusetts Bay Company* chartered by King Charles I of England.
1732	*New London Society for Trade and Commerce in Connecticut* was the first profit-seeking corporation organized under a state legislative charter.
1811	New York passed the first law allowing incorporation of manufacturing companies.
1819	United States Supreme Court in *Dartmouth v. Woodward* determined that a corporation is an artificial being, invisible, intangible and existing only in the contemplation of the law, thus restricting the right to form corporations.
1830	New Jersey granted a monopoly to the *Camden and Amboy Railroad Company* to provide railroads in certain specific areas.
Mid 1800s	Corporations in most states are formed only by acts of the state legislature and only for a specific purpose.
1886	The US Supreme Court, in *Santa Clara County v. Southern Pacific Railroad* defined corporations as “persons” with legal rights.
1888	*New Jersey Holding Company* act allowed corporations to acquire other corporations.
1889	New York brings anti-trust actions against the Sugar Trust.
1890	The Federal *Sherman Anti-Trust Act* allowed the federal government to break up trusts.
1892	*New Jersey Corporation Trust Company* was formed to create other corporations. This allowed holding companies to exist despite the Sherman Anti-Trust Act.
1899	Delaware enacted laws favoring corporations and establishing legal rights similar to those of New Jersey. By the 1920s, Delaware won the “race to the bottom” in favor of corporations.
1906	Hepburn Amendments enacted by the U.S. Congress authorizing the Interstate Commerce Commission to set railroad tariffs based on accounting for the capital costs of equipment.
1911	Federal government breaks up the *Standard Oil Trust*.
1933	US Federal *Securities Act of 1933* requires registration of securities that are traded in public stock markets.
1934	US Federal *Securities Exchange Act of 1934* created the Securities Exchange Commission (SEC) and requires annual audited financial statements to be issued to shareholders. Audits must be made by independent accountants (i.e. Certified Public Accountants).
1938	Creation of the *Committee on Accounting Procedure* (CAP) of the *American Institute of Certified Public Accountants*. CAP is designated by the SEC as the accounting standards setting body for the United States.
1959	The AICPA creates the *Accounting Principles Board* (APB) to replace the CAP as the accounting standards setter for the US.
1973	The *Financial Accounting Standards Board* (FASB) created to replace the APB as the accounting standards setter for the US.
2002	Sarbanes-Oxley Act requires a majority of independent directors and appointment of the auditor by an audit committee of the board consisting solely of independent directors.

FIGURE 1
THE DIALECTICAL TENSION BETWEEN VIEWS OF CORPORATE GOVERNANCE