UNIT 90 – UPSC - Corporate governance

In current business world, many people are aware of the standards on Corporate Governance. The effectiveness of the Corporate Governance has become a global concern. Mainly after many corporate collapse (e.g. Enron, Boeing etc), fraud cases (e.g. Lehman Brothers), shareholder suits (Sun Hung Kai Properties between Chairman Walter Kwok Ping-sheung and his younger brothers) or questionable strategic decisions are drawing attention to the top level decision-making body of the corporation and the board of directors.

The term, 'corporate governance', defines the processes by which organisations are directed, controlled and held to account. It holds authority, accountability, stewardship, leadership, direction and control exercised within the organisation. Numerous management theorists have elaborated the concept of corporate governance. Corporate governance is a system by which companies can relay to run, at the centre of the system is the board of director whose actions are subject to the law, regulations and the shareholders in general meetings. Shareholders in turn are responsible for appointing the directors and the auditors and it is up to them that the board of directors reports on its stewardship at the annual general meeting.

Margaret Blair defines corporate governance as a set of policies, way of life measures proportionately more than is customary. This measurement and others are deliberate, using specifications that anticipate your paper as one part of the entire proceedings, and not as an independent document (Cornelius & Kogut, 2003). In another definition by Organization for Economic Co-operation Development - OECD (2005), corporate governance is the way and methods by which organizations are directed and controlled. Corporate governance spells out the rights and responsibilities among the member of an organization and also the regulations and methods for making decision (Co-operation & Development, 2005).

Corporate governance is the way a by which company polices itself. Briefly, it is a technique of governing the company like a sovereign state, instating its own customs, policies and laws to its employees from the highest to the lowest levels. Corporate governance is intended to increase the accountability of company and to avoid massive disasters before they occur. Failure of energy giant Enron, and its bankrupt employees and shareholders, is major debate for the importance of corporate governance. Well-executed corporate governance should be similar to a police department's internal affairs unit, weeding out and removing problems. A company can also hold meetings with internal members, such as shareholders and debt holders as well as suppliers, customers and community leaders, to address the request and needs of the affected parties.

Objectives of corporate governance:

i. To build up an environment of trust and confidence amongst those having competing and conflicting interest.
ii. To enhance the shareholders' value and protect the interest of other stakeholders by enhancing the corporate performance and accountability.

Elements of corporate governance:
The essential elements of good corporate governance are as under:

1. Transparency in Board's processes and independence in the functioning of Boards. The Board should offer effectual leadership to the company and management for achieving sustained wealth for all stakeholders. It should provide independent judgment for achieving company's objectives.
2. Accountability to stakeholders with a view to serve the stakeholders and account to them at regular intervals for actions taken, through strong and sustained communication processes.
3. Impartiality to all stakeholders.
4. Social, regulatory and environmental concerns.
5. Clear and unambiguous legislation and regulations are fundamentals to effective corporate governance.
6. A healthy management environment that includes setting up of clear objectives and appropriate ethical framework, establishing due processes, clear enunciation of responsibility and accountability, sound business planning, establishing clear boundaries for acceptable behaviour, establishing performance evaluation measures.
7. Explicitly prescribed norms of ethical practices and code of conduct are communicated to all the stakeholders, which should be clearly understood and followed by each member of the organization.

8. The objectives of the company must be clearly documented in a long-term corporate strategy including an annual business plan together with achievable and measurable performance targets and milestones.
9. A well composed Audit Committee to work as liaison with the management, internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the Board on the key issues.
10. Risk is an important element of corporate functioning and governance, which should be clearly identified, analysed for taking appropriate remedial measures. For this purpose the Board should formulate a mechanism for periodic reviews of internal and external risks.
11. A clear Whistle Blower Policy whereby the employees may without fear report to the management about unethical behaviour, actual or suspected frauds or violation of company's code of conduct. There should be some mechanism for adequate safeguard to employees against victimization that serves as whistle-blowers.

Principles of Corporate Governance:

Shareholder recognition is major factor to maintaining a company's stock price. Small shareholders with little impact on the stock price are brushed aside to make way for the interests of majority shareholders and the executive board. Good corporate governance seeks to ensure that all shareholders get a voice at general meetings and are allowed to partake.

Stakeholder interests should also be acknowledged by corporate governance. In particular, taking the time to address non-shareholder, stakeholders can help company to establish a positive relationship with the community and the press.

Board responsibilities must be clearly delineated to majority shareholders. All board members must be on the same page and share a similar vision for the future of the company.

Ethical behaviour violations in favour of higher profits can cause massive civil and legal problems down the road. Underpaying and abusing outsourced employees or skirting around lax environmental regulations can come back and bite the company hard if ignored. A code of conduct regarding ethical decisions should be established for all members of the board.

Business transparency is the key to promote shareholder trust. Financial records, earnings reports and forward guidance should all be clearly stated without exaggeration or "creative" accounting. Falsified financial records can cause your company to become a Ponzi scheme, and will be dealt with accordingly.

Corporate Governance as Risk Mitigation:

Corporate governance is of vital importance to a company and is almost as important as its primary business plan. When executed successfully, it can prevent corporate scandals, fraud and the civil and criminal liability of the company. It also improves a company's status in the public opinion as a self-policing company that is responsible and worthy of shareholder and debt holder capital. It commands the shared philosophy, practices and culture of an organization and its employees. Firm without a system of corporate governance is often regarded as a body without a soul or conscience. Corporate governance enables a company honest and free from trouble. If this shared attitude breaks down, then corners will be cut, products will be defective and management will grow complacent and corrupt. The end result is a fall that will occur when gravity in the form of audited financial reports, criminal investigations and federal probes finally catches up, destroying

the company instantaneously. Deceitful and unethical dealings can cause shareholders to escape out of fear, distrust and disgust.

Plethora of research has revealed that good corporate governance can result in improved share price performance. It is well established in management reports that there is a great potential for good performance by companies, which have got good corporate governance mechanism and the greatest benefit is in developing companies. Studies have showed that investors are enthusiastic to invest in a better-governed company. Corporate Governance can be strong mechanism for development especially in country like India.

The following issues are important for good Corporate Governance.

1. The rights and obligation of shareholders.
2. Impartial treatment of all stakeholders.
3. The role of all stakeholders clearly defined and the linkage for corporate governance established.
4. Transparency, disclosure of information and audit.
5. The role of board of directors clearly defined.
6. The role of non-executive members of the board clearly defined.
7. Executive management and compensation and performance clearly defined.

Theories of corporate governance:

1. **Agency Theory:** Agency theory is major theory in the theoretical framework of Corporate Governance (Kholeif, 2009). The theory placed shareholders as significant stakeholder (Lan & Heracleous, 2010). According to Chartered Institute of Management Accountants (CIMA), Agency theory as premise surrounding the relationships that exist between the owners (principals) of organizations and the managers or directors (agents) of organizations. The interest of agents might be in conflict with the interest of principal in achieving the organizational goal.
2. **Shareholder Theory:** Shareholder theory as evolved by Milton Friedman proclaim that corporate organizations' social responsibility is to use its resources and invest in business that will maximize its profits so far that, the business is open and free competition and with no deception or fraud (Lee, 2008). Milton Friedman contended that if business firms were to be ethically responsible then, their moral obligations or social responsibilities will be nothing, other than shareholders wealth maximization. Shareholders deliver their capital to organizations' managers, they are expected to use the capital for only organizations' purpose to increase shareholders returns (Dittmar, Mahrt-Smith, & Servaes, 2003).
3. **Stakeholder Theory:** Stakeholders are described by management experts as any person or company who is affected by organization's decisions or activities (Bryson, 2004). They are groups or individuals that benefit or harmed, and whose rights are violated or respected by organization operations (Freeman, 2010). Stakeholder theory states that business organizations should be concerned about the interest of other stakeholders when taking strategic decisions (Mainardes, Alves, and Raposo, 2011). In contrast to shareholder theorists that called for shareholder wealth maximization, stakeholder theorists canvassed for satiating stakeholders interests. From stakeholder viewpoint,

shareholders are one of the important members of stakeholder. Shareholders have stake and are affected by organization's operations and achievement, same with other stakeholders such as employees, customers, suppliers, and environment. The stakeholder theorists appealed that, as business owes special and particular duties to shareholders, it also has various responsibilities towards other stakeholders (Heath and Norman, 2004).

Mechanism and control for corporate governance:

The mechanism and controls are planned to lessen the inadequacies that arise from moral incongruities and adverse selection. Ethical diversion is a very important issue for Corporate Governance, while designing mechanism and control.
The issues could be:

1. Monitoring the Role/effectiveness of the Board of Directors.
2. Remuneration of the Board Members and other employees in the company.
3. Responsibilities and accountability for Audit Committees financial reporting process, monitoring the choice of accounting policies and principles, monitoring internal control process and policy decisions for hiring and performance of the external auditors.
4. Issues and concerns of Government Regulations.
5. Understand the strategic issues of the competition.
6. Management labour market and concerns of control mechanisms.

It is established that Good corporate governance standards are necessary for the integrity of corporations, financial institutions and markets and have a bearing on the growth and stability of the economy. In India, good governance is practiced from ancient time from third century B.C. where Chanakya (Minister of Parliputra) expounded fourfold duties of a king viz. Raksha, Vriddhi, Palana and Yogakshema. It means that Substituting the king of the State with the Company CEO or Board of Directors the principles of Corporate Governance refers to shielding shareholders wealth (Raksha), increasing the wealth by proper utilization of assets (Vriddhi), maintenance of wealth through profitable ventures (Palana) and protecting the interests of the shareholders (Yogakshema or safeguard).

In Indian companies, corporate governance is new term. Over the past decade, India has made noteworthy strides in the areas of corporate governance reforms, which have improved public trust in the market. These reforms have been well received by the investors, including the foreign institutional investors. Companies around the world are realizing that better corporate governance adds substantial value to their operational performance in the following ways:

1. It improves strategic thinking at the top by inducting independent directors who bring a wealth of experience, and a host of new ideas.
2. It rationalizes the management and monitoring of risk that a firm faces globally.
3. It limits the liability of top management and directors, by carefully articulating the decision making process.
4. It assures the integrity of financial reports.
5. It has long term reputational effects among key stakeholders, both internally and externally.

The Corporate sector operated generally on a beliefs of cost of production plus in the protected economy. Since they were not exposed to any serious competition, Indian industries continued with existing technologies and remained insensitive about technological developments and happening. But this trend is changing in many corporate firms in due course of the time and the companies in India, some of them are becoming very much competitive and are harnessing technological, process and product innovation to become global players in their field. All such companies in India have given huge importance to the issue of corporate governance.

The major corporate governance initiatives launched in India since the mid-1990s are as under:

1. The CII Code: On account of the interest generated by Cadbury Committee Report of UK, the Confederation of Indian Industry (CII) took special initiative with the aim to develop and promote a code of Corporate Governance to be espoused and followed by Indian Companies both in private & public sector, Banks and Financial Institutions. The final draft of the code was circulated in 1997 and the final code called 'Desirable Corporate Governance Code' was released in April 1998. The Committee was driven by the conviction that good corporate governance was essential for Indian Companies to access domestic as well as global capital at competitive rates. The code was voluntary, contained detailed provisions with focus on listed companies.

2. Kumar Mangalam Birla Committee Report: While the CII code was well established by corporate area and some advanced companies also adopted it. It was realized that under Indian conditions, a statutory rather than a voluntary code would be more meaningful. Subsequently, the second major initiative was undertaken by the Securities and Exchange Board of India (SEBI) which set up a committee under the chairmanship of Kumar Mangalam Birla in 1999 which has prime objective of promoting and raising of standards of good corporate governance.

The Committee in its Report observed "the strong Corporate Governance is vital to resilient and vibrant capital market and is an important instrument of investor protection. In the beginning of 2000, the SEBI Board accepted and ratified the key recommendations of this committee and these were incorporated into Clause - 49 of the Listing Agreement of the Stock Exchanges. These recommendations, aimed at providing the standards of corporate governance, are divided into mandatory and non-mandatory recommendations. The recommendations have been made applicable to all listed companies with the paid-up capital of Rs. 3 crore and above or net worth of Rs.25 crore or more at any time in the history of the company. The decisive responsibility of putting the recommendations into practice rests directly with the Board of Directors and the management of the company.

3. Report of Task Force: In May 2000, the Department of Corporate Affairs (DCA) set up a broad based study group under the chairmanship of Dr. P.L. Sanjeev Reddy, Secretary of DCA. The group was given the determined task of examining ways to "operationalise the concept of corporate excellence on a sustained basis" so as to "sharpen India's global competitive edge and to further develop corporate culture in the country". In November 2000, the Task Force on Corporate Excellence set up by the group produced a report containing a numerous recommendations for raising governance standards among all companies in India. It also recommended setting up of a Centre for Corporate Excellence.

4. Naresh Chandra Committee Report: A committee was appointed by Ministry of Finance and Company Affairs in August 2002 under the chairmanship of Naresh Chandra to scrutinize and recommend inter alia amendments to the law involving the auditor-client relationships and the

role of independent directors. The committee made recommendations in two key aspects of corporate governance, financial and non-financial disclosures, and independent auditing and board oversight of management.

5. Central Coordination and Monitoring Committee: A high level Central Coordination and Monitoring Committee (CCMC) co-chaired by Secretary, Department of Corporate Affairs' and Chairman, SEBI was set up by the Department of Corporate Affairs to monitor the action taken against the disappearing companies and dishonest promoters who misused the funds raised from the public. It was decided by this committee that seven Task Forces be set up at Mumbai, Delhi, Chennai, Kolkata, Ahmedabad, Bangalore and Hyderabad with Regional Directors/Registrar of Companies of respective regions as convener, and Regional Offices of SEBI and Stock Exchanges as Members. The main task of these Task Forces was to identify the companies, which have disappeared, or which have mutualised the funds mobilized from the investors and suggest appropriate action in terms of Companies Act or SEBI Act.

Bhattacharya, CB. et al in McKinsey Report (2011) talks about how companies can use Corporate Responsibility towards stakeholders as a conduit for furthering its goals. Ultimately stakeholders prefer companies which produce tangible and psychological benefits which favour good Corporate Governance. Better governance reforms reduce uncertainty and are engines of stability and continued progress has helped Asian Corporates to transform themselves during the period of globalization, as per report by Asian Productivity Organization, Tokyo in 2004.

The private corporate such as the Tata Group, Aditya Birla Group, Infosys Technologies, Wipro Technologies, Godrej Group, Mahindra & Mahindra Group and Larson & Toubro (L&T.), of companies are giving more importance to the issue of corporate governance.

To summarize, Corporate Governance is the application of best management practices, compliance in true spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders. Fundamentally, its process and structure by which the business and affairs of the company are directed and managed in order to enhance long term shareholder value through enhancing corporate performance and accountability, whilst taking into account the interests of other stakeholders. In India, though it was old age concept and adopted in the realm of Chanakya' time, but Indian companies adopted the principle of corporate governance after 1990. Good corporate governance is important for overall market confidence, the efficiency of capital allocation, the growth and development of countries' industrial bases, and ultimately the nations' overall prosperity and wellbeing.