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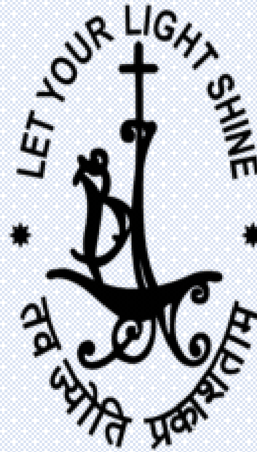

Presents

CORPORATE GOVERNANCE

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Corporate Governance

ABSTRACT

Corporate Governance has been a central issue in developing countries long before the recent spate of corporate scandals in advanced countries. Corporate governance gained tremendous importance due to economic liberalization and deregulation of industry and business. Another important factor that has been responsible for the sudden exposure of the corporate sector to a new paradigm for corporate governance in tune with the changing times is the need and demand for greater accountability of companies to their shareholders and customers.

The concept of corporate governance came in 1980's when several companies collapsed worldwide. Then, at international level and in India-Government, SEBI, RBI and Ministry of Corporate Affairs had done sincere efforts to bring the changes in the operating system of board of directors, financial and non-financial disclosures, compliance with codes of corporate governance, competitive remuneration policy, shareholders right and responsibilities, internal controls and company's management.

Corporate governance has to bring balance and equilibrium between various stakeholders like owners, promoters, employees, shareholders, customers, creditors, bankers, investors, government and society. The challenge involved in balancing the apparent conflicting interests of various stakeholders in indeed a difficult task. Under the circumstances, corporate governance principles and practices are followed in the true spirit. Corporate governance aim is to minimize chances of corruption, malpractices, financial frauds and misconduct of management.

With emergence of global competition, corporate India in general has realized that in order to grow, prosper and compete in international markets, they have to consolidate their strengths and run them most effectively in an efficient and transparent manner by adopting the best practices.

Corporate Governance standards for listed companies are regulated by the Securities and Exchange Board of India (SEBI) through clause 49 of the listing agreement of stock exchanges, SEBI issued circulars from time to time since 21st February, 2000 to ensure

compliance of various requirements on terms of corporate governance. A very few companies go beyond requirements of clause 49 in order to follow the principles on which corporate governance is based namely accountability, transparency, fairness, equity, effectively, flexibility and above all legality and integrity. Moreover, listed progressive companies made their Annual Reports fairly comprehensive to make it attractive enough for various stakeholders.

Corporate governance has to travel much beyond statutory bounds. Corporate governance should be an integral element of management and business practices. Corporate governance should ensure courtesy. Corporate governance is a continuous journey, It must keep on evolving in tune with changing nature of business and economics.

1.1 Introduction

Corporate governance has a broad scope. It includes both social and institutional aspects. Corporate governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed.

Corporate governance is the system of principles, policies, procedures, and clearly defined responsibilities and accountabilities used by stakeholders to overcome the conflicts of interest inherent in the corporate form. Corporate governance is the interaction between various participants like; Shareholder, Board of Director and Company Management in shaping corporation’s performance and the way it is proceeding towards. Corporate governance deals with determining ways to take effective strategic decisions and developed added value to the stakeholder.

Corporate governance ensures transparency which ensures strong and balance economic development. This is also ensuring that the interest of all shareholders is safeguarded. Corporate governance affects the operational risk and, hence, sustainability of a corporation. The quality of a corporation’s corporate governance affects the risks and value of the corporation. Effective, strong corporate governance is essential for the efficient functioning of markets.

Corporate Governance refers to the way a corporation is governed. It is the technique by which companies are directed and managed. It means carrying the business as per the stakeholders' desires. It is actually conducted by the board of Directors and the concerned committees for the company's stakeholder's benefit. It is all about balancing individual and societal goals, as well as, economic and social goals.

1.2 The Importance of Corporate Governance

It helps streamline the process and gives people accountability. The point of corporate governance is to help the decision-making process.

Accountability is what helps people within the company make decisions, whether it is finding out what person should be terminated from their position due to the mistakes that they've made or who should be acknowledged for their good work due to doing something exceptional in their field. With good corporate governance, it's pretty simple to know what the key members of the business are supposed to do.

- **Lowering Risk**

Another important aspect of corporate governance is mitigating or reducing the amount of risk that is involved. Through corporate governance, scandals, fraud, and criminal liability of the company can be prevented or avoided altogether.

Since the people involved in the organization know what they are accountable for, the actions of one person doesn't mean the downfall of the entire corporation. Properly identifying what the roles in the corporation are allows decisions to be made that won't have a negative effect on the overall corporation, and it means that the offender can be much more quickly identified and punished instead.

- **Public Acceptance**

In terms of business, a company with corporate governance is widely accepted by the public. This is mostly due to the idea of disclosure and transparency that comes with corporate governance. With full disclosure and the ability for people who work in the business to get information, as well as the general public, there is a higher level of trust. There's also the fact that due to the way that corporate governance is setup, there is

a lower chance of fraud and company-wide criminal activity, which helps gain the trust of the public as well.

- **Public Image**

Today many corporations hold a high level of corporate governance. This is because a corporation has a public image to maintain. With corporate governance, the corporation takes more responsibility for its actions, and also allows it to keep tabs on what is going on as well as helps those in charge remain more aware of the public image of the corporation.

With the way that businesses are run today, it can be difficult for a corporation to become successful just by having a high level of profit. Due to the fact that a corporation is also evaluated based on its image, corporate governance is established to help ensure that image remains clean. Making sure there is a high level of awareness, ethical behavior, and understanding of what the public wants is all encompassed in corporate governance.

- **Having a Successful Business**

Corporate governance is an aspect of business that's become incredibly important in recent years, but it isn't the only part of business a person has to understand.

1.3 Objective of corporate governance:

The fundamental objective of corporate governance is to boost and maximize shareholder value and protect the interest of other stake holders. World Bank described Corporate Governance as blend of law, regulation and appropriate voluntary private sector practices which enables the firm to attract financial and human capital to perform efficiently, prepare itself by generating long term economic value for its shareholders, while respecting the interests of stakeholders and society as a whole. Corporate governance has various objectives to strengthen investor's confidence and intern leads to fast growth and profits of companies.

These are mentioned below:
A properly structured Board proficient of taking independent and objective decisions is in place at the helm of affairs.

1. The Board is balanced as regards the representation of suitable number of non-executive and independent directors who will take care of the interests and well-being of all the stakeholders.
2. The Board accepts transparent procedures and practices and arrives at decisions on the strength of adequate information.
3. The Board has an effective mechanism to understand the concerns of stakeholders.
4. The Board keeps the shareholders informed of relevant developments impacting the company.
5. The Board effectively and regularly monitors the functioning of the management team.
6. The Board remains in effective control of the affairs of the company at all times

1.4 Important Models of Corporate Governance

The seven important models of corporate governance. The models are: 1. Canadian Model 2. UK and American Model 3. German Model 4. Italian Model 5. France Model 6. Japanese Model 7. Indian Model.

1. Canadian Model:

Canada has a history of French and British colonisation. The industries inherited those cultures. The cultural background in these industries affected subsequent developments. The country has large influence of French mechanism.

In 19th century the Canadian industries were controlled by rich families. Since last five decades wealthy Canadian families sold their stocks during stock boom periods. Canada now resembles United States in industry structure.

Since last four decades there is change in industries in Canada in the areas:

i. Family owned companies are on the increase

ii. Use of new technologies

iii. More entrepreneurial activities

iv. Early entrance in initiating corporate governance

v. Diffuse ownership from earlier colonial masters.

2. UK and American Model:

Sarbanes Oxley Act:

In July 2002, the U.S. Congress passed the Sarbanes Oxley Act (SOX), particularly designed to make US corporations more transparent and accountable to their stakeholders.

The Act seeks to re-establish investor confidence by providing good corporate governance practice to prevent corporate scams and frauds in business corporations, to improve accuracy and transparency in financial reporting, accounting service of listed companies, enhance corporate responsibility and independent auditing.

The applicability of the Act is not confined only to publicly owned US companies, but also extends to other units registered with the Securities Exchange Commission. However, there is a common thread running between them, i.e., that governance matters. Unless corporate governance is integrated with strategic planning and shareholders are willing to bear the additional required expenses, effective governance cannot be achieved.

The above events encouraged the development of the present situation where different aspects of the Sarbanes Oxley Act are discusses, and its effects, limitations and internal control after the act were passed and what lies beyond its compliance.

Also discussed are the varied applications of the act in areas such as IT, the fee structure of the Big Four Accounting Firms, the mid-size accounting firms, supply chain management and insurance.

3. German Model:

Germany is known for industrialisation since beginning of 19th century. Germany exports sophisticated machinery in a large way since last five decades. The industries are financed by wealthy German families, small shareholders, banks and foreign investors. The large private bankers who invested in industry had a bigger say in running those industries and hence performance was not up to the mark.

Germany is considering proper steps towards corporate governance since second half of 19th century. The company law in Germany of 1870 created dual board structure to care of small investors and the public. The company law in 1884 made information and openness as the key theme. The law also mandated minimum attendance at the first shareholders meeting of any company.

World War I saw considerable changes in industries in Germany by dismantling the rich. As on date Germany has large number of family-controlled companies. The smaller companies are controlled by banks. The proxy voting by small investors was introduced in Germany in year 1884.

4. Italian Model:

The Italian business was also controlled by family holdings. The business groups and the families were powerful by mid of 20th century. Slowly the stock market gained importance during the second half of the 20th century. The Italian government did not intervene in the company management or their working.

When the Italian all the investment banks collapsed in 1931 the Fascist government in Italy took over the industrial shares and imposed a legal separation of investment from commercial banking. The Second World War brought a change from the government side to have a direct role in the economy, helping the weak companies and using corporate governance to improve these companies. This helped the economic growth of Italy particularly in capital intensive industries.

Since World War II the industrial policy was introduced. The policy had no need for investor protection. It led the investors to buy a government bonds and not invest in company shares. The growth of Italian industry came from the small specialised industries which remained unlisted in stock markets.

The small firms were controlled by families. The corporate governance was in the hands of bureaucrats or wealthy families. The corporate governance activities and confidence in stock markets started developing since last two decades. The Italian investors are aware of the importance of the corporate governance and protection of the rights.

5. France Model:

The French financial system traditionally was regulated by the religion. The controlling methods, borrowing and lending with the state constituting the main borrower. Religion had prohibited the interest to some extent. The lending was based on mainly mortgages of real estates. In early 19th century the French public took to hoarding gold and silver.

Coins composed measure part of money transactions in that period. The French industry was conservative in its outlook. The business used the retained earnings of one company to build other areas of business and companies.

The business was controlled by wealthy families who funded these business groups. The control of the company continued from generation to generation. Stage wise the corporate government was introduced in France along with economic development activities. This led to wealthy families controlling corporate sector to come under the watchful guidance of the state.

6. Indian Model:

East India Co. (EIC) in its trade had malpractices.

Current practice since 400 years since industrialisation in companies.

Environmental and world commercial are classic cases.

Family owned cos.

India has long history of commercial activities 2500 years old.

(a) The Managing Agency system 1850-1955

(b) The Promoter System 1956-1991

(c) The Anglo-American System 1992 onwards

The Securities and Exchange Board of India (SEBI):

Established SEBI Act in Jan. 1992 gave statutory powers and introduced had 2 issues.

(a) Investor protection and

(b) Market Development.

SEBI is part of department of Company Affairs Govt. of India.

SEBI has moved from control regime to prudential regulation.

It is empowered to regulate working of stock exchanges and its players including all listed us. SEBI is playing a key role in corporate governance in India.

These developments in U.K. had significant influence on India. Confederation of Indian Industries (CII) appointed a National Task Force headed by Rahul Bajaj, who submitted a 'Desirable Corporate Governance in India – a Code' in April 1998 containing 17 recommendations.

Thereafter Securities and Exchange Board of India (SEBI) appointed a Committee under the Chairmanship of Kumar Mangalam Birla. This committee submitted its report on 7 May 1999, Containing 19 Mandatory and 6 non-mandatory recommendations. SEBI implemented the report by requiring the Stock Exchanges to introduce a separate clause 49 in the Listing Agreements.

In April 2002 Ganguly Committee report was made for improving corporate governance in Banks and Financial Institutions. The Central Government (Ministry of Finance and Company Affairs) appointed a Committee under the Chairmanship of Mr. Naresh Chandra on Corporate Audit and Governance. This committee submitted its report on 23 December 2002.

Finally, SEBI appointed another committee on Corporate Governance under the Chairmanship of N.R. Narayan Murthy. The committee submitted its report to SEBI on 8 Feb. 2003. SEBI thereafter revised clause 49 of the Listing Agreement, which has come into force with effect from 01 January 2006.

Some of the recommendations of these various committees were given legal recognition by amending the Companies Act in 1999, 2000 and twice in 2002. With a view to gear company law for competition with business in developed countries, the Central Government (Ministry of Company Affairs) appointed an expert committee under the Chairmanship of Dr. Jamshed J. Irani in December 2004.

The Committee submitted its report to the Central Government on 31 May 2005. The Central Government had announced that the company law would be extensively revised based on Dr. Irani's Committee Report.

Corporate world is awaiting the changes to be made in company law. Parliament on 15 May 2006 had approved the Companies (Amendment) Bill, 2006 which envisages implementation of a comprehensive e-governance system through the well-known MCA-21 project.

Corporate governance has once again become the focus of media/public attention in India following the debacles of Enron, Xerox and WorldCom abroad, and Tata Finance/Ferguson, Satyam, telecom scams by few companies and black money laundering, employed by few at home.

With the opening of the markets post liberalisation in early 1990's and as India get integrated into world economy, the Indian companies can no longer afford to ignore better corporate practices which are essential to enhance efficiency to survive international competition.

The question that comes to the minds of Indian investors now is, whether our institutions and procedures are strong enough to ensure that such incidents will not happen again, or has the Indian corporate sector matured enough to practice effective self-regulation? These developments tempt us to re-evaluate the effectiveness of corporate governance structures and systems in India.

Economic liberalisation and globalisation have brought about a manifold increase in the foreign direct investment (FDI) and foreign institutional investment (FII) into India. More and more Indian companies are getting themselves listed on stock exchanges abroad. Indian companies are also tapping world financial markets for low cost funds with ADR/GDR issues.

Companies now have to deal with newer and more demanding Indian and global shareholders and stakeholder groups who seek greater disclosure, more transparent explanation for major decisions, and, above all, a better return for their stake. There is,

thus, an increased need for Indian boards to ensure that the corporations are run in the best interests of these highly demanding international stakeholders.

Initiatives by some Indian companies and the CII have brought corporate governance to a regulatory form with the introduction of Clause-49 in the Listing Agreement of companies with the stock exchanges from January 2000. The first to comply with the requirements of Clause-49 were the Group-A companies, which were required to report compliance by March 31, 2001.

However, the code draws heavily from the UK's Cadbury committee, which is based on the assumption of a dispersed share ownership – more common in the UK – than the concentrated and family-dominated pattern of share ownership in India. In addition, in regard to corporate governance the Indian corporate have also overhauled themselves.

1.5 Four pillars of corporate governance:

1)The board

The board must be a high-functioning, well-composed, independent, engaged, diverse, and experienced board with effective ongoing evaluation practices. It is common to see more and more how boards are removing and adding new directors to enforce diversity and independence, as Tesla did back in July when they added two directors to diversify a board that was closely tied to Musk.

2)Governance structures

Provisions and structures that empower shareholders and protect their rights. Directors must declare any conflict of interest and refrain from voting on matters in which they have interest. The company and the board must enforce a culture of integrity and compliance. There are plenty of examples of conflict of interest, the most recent one being The Financial Industry Regulatory Authority who has deep ties to the securities industry. To create and cultivate this culture you must adopt a conflict of interest policy, implement a code of business conduct and a clear process to report and deal with non-compliance, even including a whistle-blower policy.

3)Appropriate compensation

Pay that incentivizes relative outperformance over the long term. The board must set directors fees that will attract very good candidates, but at the same time won’t create conflict regarding independence. Another key function of the board done through the Compensation Committee is to establish performance targets and objectives for top executives, including the CEO, and continuously evaluate their performance. It is very important that the compensation, including equity and stock option plans), is strongly tied to performance.

One current situation regarding compensation is the fight that Jerry Jones (Dallas Cowboys owner) has against the NFL´s Compensation Committee regarding the Commissioner new salary deal.

4)Risk oversight

Effective, integrated, and ongoing oversight of relevant industry- and company-specific risks.

Companies should regularly identify and assess the risks they face, including financial, operational, reputational, environmental, industry-related, cyber security and legal risks.

The board must establish the risk tolerance of the company and must develop a framework and accountabilities to manage risk. It should also review the systems and controls that management has in place to identify, assess, mitigate and monitor risk. Directors are responsible for understanding the current and emerging short and long-term risks the company faces and the performance implications. They should challenge management’s assumptions and the adequacy of the company’s risk management processes and procedures. There are countless stories about risk oversight, including Equifax who was made aware of a potential breach six months before the data breach that affected at least 145 million Americans.

CONCLUSION:

It is evident from above that it is essential that good governance practices must be effectively implemented and enforced preferably by self-regulation and voluntary adoption of ethical code of business conduct and if necessary, through relevant regulatory laws and

rules framed by Government or its agencies such as SFBI, RBI. The effective implementation of good governance practices would ensure investors’ confidence in the corporate companies which will lead to greater investment in them ensuring their sustained growth. Thus, good corporate governance would greatly benefit the companies enabling them to thrive and prosper. Further, in the context of liberalization and globalization there is growing realization in the emerging economies including India that a country’s business environment must be maintained and operated in a manner that is conducive to investors’ confidence so that both domestic and foreign investors are induced to make adequate investment in corporate companies. This will be conducive to rapid capital formation and sustained growth of the economy.

Some persons regard certain good corporate practices as ‘irritants’ to the growth of their businesses since they require the implementation of minimum standards of corporate governance. However, fact of the matter is that the observance of practices of good corporate governance will ensure investors’ confidence in the companies which have record of good corporate governance.

Further, it needs to be emphasized that practices and principles of good corporate governance have been evolved which stimulate business rather than stifle it. In fact, in good corporate governance structure what is ensured is that companies must preferably follow voluntarily ethical code of business conduct which are conducive to the expansion of investment in them and ensure good outcome in terms of rates of return.

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