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UNIT -3 CORPORATE GOVERNANCE

Meaning & Definition of Corporate Governance

The term 'Governance' is derived from the Latin word 'Gubernare' which means 'to steer'. In the context of companies, governance means direction and control of a company. There is no single definition of corporate governance acceptable to all. Different experts have defined the term in their own ways.

In simple words, corporate governance refers to the accountability of the Board of Directors of a corporation towards its stakeholders. In order to protect and promote the interests of all stakeholders, corporate governance should encompass well defined set of system and processes.

"In a narrow sense Corporate Governance involves a set of relationships amongst the company's management, its board of directors, shareholders and other stakeholders."

In a broader sense, however, good corporate governance – the extent to which companies are run in an open and honest manner – creates overall market confidence, enhances efficiency of international capital and its allocation. It contributes ultimately to the nation's overall wealth and welfare. "Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment".

Def.

"Corporate Governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return.

"Corporate governance is the system by which companies are directed and controlled."

"Corporate governance is the system of laws, rules and factors that control operations of a company."

The Cadbury Committee Report suggests, "Corporate Governance is the social, legal and economic process through which companies function and are held accountable."

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The Institute of Company Secretaries of India has also defined the term Corporate Governance, as "corporate governance is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders.

Important features of corporate governance are as follows:

1. Transparency:

A key element of good corporate governance is transparency, projected through a code of good governance, which incorporates a system of checks and balances between key players – boards, management, auditors and shareholders. Transparency in company's action may be ensured through making non-partisan disclosures and timely dissemination of information complete in all respect equally to all shareholders about results; Annual General Meetings (AGMs); quarterly updates on company's performance, risks, outlook, opportunities and threats etc.

2. Accountability:

"Corporate Governance is a way of life and not a set of rules. It is a way of life that necessitates taking into account the shareholders interests in every business decision. This has brought into focus the accountability of the Board of Directors of a company and their constituent responsibilities."

(a) Towards Shareholders:

It occurs when the company adopts an equitable and fair approach towards its shareholders, resorts to timely resolution of shareholder's complaints and grievances, rewards the shareholders on regular basis and constitutes dedicated cells in the organization to address shareholders grievances.

(b) Towards Society:

Following are some of the ways by which a company can discharge its obligations towards the society:

(i) Providing assistance to victims during times of natural calamities;
(ii) Enlistment and education of the underprivileged and deprived;
(iii) Promotion of education and training in general;
(iv) Contributions, charity, donations for socially relevant causes;
(v) Steps for promoting welfare of mentally, physically or visually disabled;

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(vi) Establishment of schools, hospitals, parks etc.

3. Trusteeship:

"The doctrine of trusteeship is based on the Bhagavad Gita. The twin principles of 'aparigraha' (non-possession) and 'Sambhawa' (equalism) are the main principles of Bhagavad Gita. Corporates are the trustee of the shareholders and their money; they should use their wealth for the welfare of the society and the community at large." Trusteeship involves a strong code of discipline and ethical behavior as well as equally strong principle of accountability.

4. Employees' Welfare:

Good corporate governance is essentially concerned with company's human resource.

5. Environment Protection:

Irrespective of whether a company is polluting or non-polluting, protection of environment should be concern of every socially responsible organization. Each company must take steps to make sustainable use of resources, establish a healthy and safe working environment, maintain ecological balance, take proactive steps to minimize waste generation and preserve the environment. The securing of ISO Certification for environmental protection could be highlighted in the Annual Report.

6. Meeting Social Obligations:

There is a growing expectations that the business enterprise to be much more than a mere economic unit and be a good corporate citizen vigorously contributing to social issues and charity.

Corporate Governance – Need

Corporate governance is needed for the following reasons:

1. Separation of Ownership from Management:

A company is run by its managers. Corporate governance ensures that managers work in the best interests of corporate owners (shareholders).

2. Global Capital:

In today's global world, global capital flows in markets which are well regulated and have high standards of efficiency and transparency. Good corporate governance gains credibility and trust of global market players.

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3. Investor Protection:

Investors are educated and enlightened of their rights. They want their rights to be protected by companies in which they have invested money. Corporate governance is an important tool that protects investors' interests by improving efficiency of corporate enterprises.

4. Foreign Investments:

Significant foreign institutional investment is taking place in India. These investors expect companies to adopt globally acceptable practices of corporate governance and well-developed capital markets. Demanding International Standards of corporate governance and greater professionalism in management of Indian corporates substantiates the need for good corporate governance.

5. Financial Reporting and Accountability:

Good corporate governance ensures sound, transparent and credible financial reporting and accountability to investors and lenders so that funds can be raised from capital markets.

6. Banks and Financial Institutions:

Banks and financial institutions give financial assistance to companies. They are interested in financial soundness of companies financed by them. This can be done through good corporate governance.

7. Globalization of Economy:

The economy today is globalized. Integration of India with the world economy demands that Indian industries should conform to the standards of international rules. Corporate governance helps in doing this.

Corporate Governance – Importance

Corporate governance is important for the following reasons:

1. It shapes growth and future of capital markets of the economy.
2. It helps in raising adequate funds from capital markets.
3. It links company's management system with its financial reporting system.
4. It enables management to take innovative decisions for effective functioning of an enterprise within the legal framework of accountability.
5. It supports investors by making corporate accounting practices transparent. Corporate enterprises have to disclose financial reporting structures.

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6. It provides adequate and timely disclosure, reporting requirements, code of conduct etc. Companies present material price sensitive information to outsiders and ensure that till the time this information is made public, insiders abstain from dealing in corporate securities. It, thus, avoids insider trading.

7. It improves efficiency and effectiveness of an enterprise and adds to material wealth of the economy.

8. It improves international image of the corporate sector and enables home companies to raise global capital.

UNIT-4

Corporate Governance – Top 3 Theories: The Agency Theory, The Stewardship Theory and The Stakeholder Theory

Various theories of corporate governance are described below:

1. The Agency Theory:

According to this theory there exists agency relationship between the shareholders and management of a company. Under a contract of agency, one party (the principal) appoints another party (the agent) to perform some functions on its behalf. Shareholders of a corporation delegate the decision making authority to the board of directors. As an agent, the board of directors is expected to exercise its authority on behalf of and in the best interests of the shareholders (the principal).

In reality, however, board of directors and chief executives may promote their own interests rather than the interests of shareholders. In other words, there can be a divergence of interests between shareholders and managers. Effective governance system is needed, therefore, to safeguard the interests of shareholders.

Agency theory presents a narrow view of corporate governance as it suggests that a company is responsible only to its shareholders. It does not consider the interests and rights of other stakeholders like employees, customers, suppliers, creditors, distributors, government, media, and the community.

2. The Stewardship Theory:

This theory is based on the assumption that the top managers of a company will act on their own as responsible stewards of the assets under their control. They work diligently to achieve high levels of profits which yield good returns to shareholders.

The interests of the company and its owners are aligned with those of managers when they work towards collective goals. The interests of

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shareholders are automatically served when the company's performance is maximised. Therefore, board of directors, and chief executives should be given adequate authority, and discretion to act as good stewards. A proper governance structure is required for this purpose.

Stewardship theory is based on the assumption that board of directors will always work for corporate performance and will use such performance in the interests of shareholders. This may not always hold true. Moreover, the theory overlooks the interests of stakeholders other than shareholders.

3. The Stakeholder Theory:

This theory suggest that a company must be run in the interests of all the stakeholders. The interests of stakeholders are numerous and may often be contradictory. Therefore, a harmony or compromise is required between them. A board of directors consisting of the representatives of various Stakeholder groups could be entrusted with this task.

The stewardship theory recognises the rights of shareholders as well as other stakeholders. But in practice, board of directors may not always be able to maintain equity. It is likely to overstress the interests of some stakeholders and underemphasize those of other stakeholders. It is a very difficult tight rope walk and a very effective system of governance is needed for this challenge.

Corporate Governance – Benefits of Good Corporate Governance

Good corporate governance provides the following benefits to a company:

1. Access to Capital Market – Globalisation and increase in the size of firms have enhanced the role of institutional investors and financial intermediaries. Investors now have a wider choice due to the opening up of financial markets. Companies which continuously create shareholder value and maximise wealth for shareholders are preferred by investors. Such companies have an easy access to capital markets both at home and abroad. Good corporate governance helps to create value and wealth for shareholders. It increases the confidence of investors in a company.

2. Acquisition and Retention of Talent – Well governed companies have an edge in attracting, retaining, and engaging well-qualified employees. Hardworking, ambitious, and competent people want to join and stay in a company which treats them as valuable assets.

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3. Risk Cover – Companies are now exposed to greater risks due to price deregulation, growing competition, and structural reforms. Good corporate governance helps to provide a risk cover by creating and maintaining mutual trust with different sections of society. It leads to increase in revenue and profitability.

4. Public Image – Good governance of a company helps to improve its goodwill and build brand image. Infosys, Wipro, TCS and other well governed companies enjoy international prestige. Positive image provides stability and growth to a company.

5. Market Position – Good corporate governance creates customer loyalty which in turn helps to improve market share of the company.

6. Innovations – ITC, Hindustan Unilever, and several other companies have discovered new opportunities for business through their initiatives in the social sector.

Corporate Governance – 4 Main Models: The Anglo-Saxon Model, The Insider Model, Japanese Model and The Family Based Model

The corporate governance structure has certain basic elements. These elements are the pattern of share ownership, key players in the corporate sector, composition of the board of directors, interaction among the key players, the regulatory framework, and disclosure requirements for listed companies, and corporate decisions that require approval of shareholders. These elements differ between countries. As a result there are different corporate governance models.

These models are explained below:

1. The Anglo-Saxon Model (The Outsider Model):

The corporate governance model of the United States and commonwealth countries such as UK, Australia, Canada, India (to a large extent), etc., is known as the outsider model. This model is characterised by-

(i) A Well-developed Stock Market with, Considerable Depth and Liquidity – In the USA and the UK a vast majority of public companies are listed at stock exchanges. The capital market in these countries serves as a disciplinary mechanism. There is convergence between the interests of shareholders and managers due to the threat of takeover.

(ii) The Ownership Structure of Companies is Widely Dispersed – For example, the median size of the largest voting block is 5 per cent in the USA

and 10 per cent in the UK. The influence of shareholders on management is weak due to widely dispersed share ownership.

(iii) Strict Laws Concerning inside Trading and Disclosure of Information – These help to protect shareholders. A sound stock market provides exit routes to shareholders. The threat of replacing underperforming directors also helps to maximise shareholders value.

(iv) Unitary Board of Directors to Give Primacy to the Interests of Shareholders – Directors are elected by shareholders who have voting rights in proportion to their shareholding.

(v) The Board of Directors Consists Inside and Outside Directors – Inside directors are either employed in the company (called executive directors) or have significant relationship with the promoters. Outside or independent directors are neither employed in the company nor are related to the promoters.

(vi) Little Role of Trade Unions – These do not participate in strategic decisions of the company.

(vii) Key Players – Shareholders, directors and management. The company's power is distributed between these players. The ultimate authority lies with the shareholders. The residuary executive authority rests with the board of directors and managers.

The Anglo-Saxon model is market-oriented. It is characterised by a large number of listed companies, widespread shareholding, and a well-functioning capital market. The stock market exercises control over the functioning of companies. In addition, the legal framework and regulatory agencies are assumed to ensure protection of shareholders who elect directors.

The board of directors performs the functions of direction, control, and representation. Managers appointed by the board of directors implement policies and manage day-to-day affairs of the company. Institutional investors (pension funds, mutual funds, insurance firms, etc.,) are exercising increasing control over companies.

2. The Insider Model:

This model of corporate governance is prevalent in Germany, Japan, etc.

German Model:

This model exists in Germany, Switzerland, Australia, and Netherlands. Therefore, this is also known as Continental Europe Model.

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The main features of the German Model are as follows:

(i) Weak Stock Market:

Debt is the major source of finance due to restrictions on listing of companies. It is a bank-oriented rather than market-oriented system. Universal banks supply both loans and equity capital. The concentrated bank holdings and cross holding are not traded on the stock market. Therefore, the stock market is less developed and illiquid. The stock market exercises insignificant control over companies.

(ii) Concentrated and Cross Shareholdings:

In most German companies there are large controlling block holders of shares. According to Franks and Mayer, a single owner holds more than 50 per cent of the equity in more than half of the listed companies. The widely used mechanism of cross holding creates ownership pyramids.

A few big shareholders maintain control through substantial voting power. Block holders also form voting pacts such as multiple or capped voting systems. Bank may even exercise veto power.

(iii) Dual Class Shares:

One class of shares has more voting rights than the other class. Therefore, the principle of one share one vote is not applicable.

(iv) Dual Board or Two Tier Board:

All public limited companies (AG) and private limited companies (GmbH) with more than 500 employees have an executive's board (vorstand) and a supervisory board (Aufsichts-crat). The executive board consists of full time managers who are appointed by the supervisory broad.

Strategic planning, day-to-day management, and performance review are the main functions of the executive board. The supervisory board elected by the shareholders and employees approves the decisions and oversees the activities of the executive board. Banks are offered membership on the supervisory board.

(v) Low Legal Protection:

In the German model reliance is more on large investors and banks than on legal regulations. The insiders who work through banks control the disciplinary mechanism. Therefore, the German model is called the insider model. Disclosure standards are comparatively low.

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(vi) Employee Participation:

In German companies, employees elect one third to one half (depending on the total member of employees) directors on the supervisory board. The rest of the directors are non-executives such as representatives of banks and firms having business relationship, and professional advisers.

Thus, concentrated ownership, cross shareholding, bank finance, two tier board structure, weak capital market, little legal protection for investors and weak public disclosures are the key features of the German model.

The German model reduces institutional pressures for short term decisions and allows long range strategic planning. It is relationship-oriented. It provides representation to employees. But this model overlooks the interests of small shareholders. The model is not suitable for global capital market as it is too secretive.

3. Japanese Model:

The Japanese corporate governance model is characterised by the following features:

(i) Keiretus:

Industrial groups (e.g., Mitsubishi) are linked by cross- shareholdings and trading relationships. Most of these groups are diversified and vertically integrated by cross holdings.

(ii) Consortium Financing:

Banks and other financial institutions are the main source of funds for Japanese companies. They provide both debt and equity capital. They are led by a major bank known as main bank. Banks hold majority of shares on a long-term basis and build strong relationship with the client companies.

(iii) Government – Industry Linkage:

The industrial groups employ retired civil servants and work together on government sponsored committees. Retired Government officers are appointed as directors to seek preferential treatment from the government. These bureaucrats also ensure effective implementation of government politics.

(iv) Employee Participation:

Long serving and committed employees are offered membership on the board of directors. Senior managers and former employees account for 90 per cent of the company directors.

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(v) Unitary Board Structure:

Boards of major corporations represent the company as an integrated social unit. The entire board takes all major decisions of the company. In theory, the ultimate power to oversee the company's functioning lies with the board of directors.

But in practice the board of directors has by tradition surrendered most of its authority to the president of the company. The presidents along with an operating committee of top executives select new members of the board of directors and evaluate the company's performance.

(vi) High Degree of Autonomy:

Banks and financial institutions do not exercise direct control over a company so long as the company is run well in terms of market share and growth. But in case of poor performance and doubtful governance, the main bank intervenes by exercising oversight over the management and reviewing the company's investment plans.

Thus, long-term company bank relationship, high level of stock ownership by banks cross holdings, board of directors controlled by insiders, employee representation, retired government officers board members, and intervention by the main bank in emergency are the main characteristics of the Japanese model. This model is m any sided and represents trust and relationship-oriented to corporate governance.

The Japanese Model involves participation of employees in corporate governance which ensures their long-term commitment to the company. The model seeks to balance the interests of all stakeholders unlike the Anglo — Saxon model which gives primary to the interest of shareholders.

4. The Family Based Model:

Family based model of corporate governance exists in several underdeveloped and emerging countries of East Asia India, Korea, Malaysia, Middle East, Brazil, Mexico, Chile, Turkey, Egypt, Kuwait, Saudi Arabia, UAE, etc.

The main characteristics of this model are as follows:

i. Closely Held Companies:

In most of the listed companies, the promoter's family is a dominant shareholder accounting for more than 50 per cent of the issued share capital. The founder, his relatives and associates dominate. In case of public enterprises, Central or State Government is the major shareholder. Family

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owns the company for long term and ownership is inherited by succeeding generations.

ii. Family Control:

The family exercises full control due to ownership, cross holding, inter-locking directorships. Business families are held in high esteem, the regulatory framework is weak and outside shareholders have apathy. Banks and financial institutions provide considerable finance to family owned and managed companies. But they do not exercise much control. Their nominees on the board of directors of the borrowing company generally support the family control.

iii. Unitary Board of Directors:

There is a single board of directors. The controlling family appoints most of the directors and the chief executive. The board is staffed with family members, friends, and business associates. Outsiders (independent directors) are appointed to meet the regulatory requirement.

iv. Family Interest:

The Company is run primarily for the benefit of the family. Owners extract private gain by transfer of wealth through sale of assets at lower than market prices. Funds are sometimes diverted for family's interest. In some cases there have been conflicts of interest between the controlling family and minority shareholders. Managers act primarily for the controlling family.

Family based model fills the monitoring gap of market mechanism because the family exercises an effective control. It is driven by long term interest of creating wealth for the family. But the model expropriates the minority interest. Tensions within the controlling family may hamper the functioning and performance of companies. Corporate governance practices are not very sound and effective.

The family based model of corporate governance is changing due to globalisation and liberalisation. Internationalisation of capital markets, global competition, increasing role of financial institutions, tightening of regulatory framework are the major forces due to which companies in developing countries are improving their corporate governance practices. For example, Indian companies which want to raise capital abroad and get listed on foreign stock exchanges are adopting international standards concerning accounting and public disclosure.

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