# Corporate Governance

**Subject : Commerce**

**Lesson Name : Corporate Governance**

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## Learning Outcomes

After reading this chapter, you should be able to

- know the definition of corporate governance
- understand the role of corporate governance;
- understand the importance of corporate governance;
- understand the objectives of corporate governance;
- describe corporate governance environment in our country;
- know the principles of corporate governance.

## 30.0 Introduction

Corporate governance in essence presents the company's culture, policies, relationship with stakeholders, commitment to values and ethical business conduct. It also includes timely and accurate disclosure of financial information which shows the financial situation, performance, ownership and governance of the company.

Source:www.moneytravels.com/money

In modern day corporations, shareholders' are separate from the managers. They delegate their decision rights to the manager to act in their best interests. In this way managers and not the owners (shareholders') actually take all the day to day and strategic decisions of the company. As a result shareholders lose control over managerial decisions. That is why in order to align the interests of shareholders' and managers a system of corporate governance controls is implemented.

The purpose of this chapter is to make you aware of the concept of corporate governance, the reasons for its felt need, its importance, its principles and the corporate governance environment.

## 30.1 Meaning of Corporate Governance

| **Value addition 30.1.1: Focus of the Section** |
| --- |
| **30.1 Meaning of Corporate Governance** |
| This section acquaints you with the concept of corporate governance and its nature. After going through this section you will appreciate the role of corporate governance for protecting the interests of the investors and the fair working of an organisation. |

After the Enron debacle of 2001, and other scandals involving large U.S. companies such as WorldCom, Global Crossing and Andersen, which triggered some of the largest insolvencies, the public confidence in the corporate sector was sapped. The popular perception was that corporate leadership was fraught with greed and excess.

In the U.K., many companies in order to show higher earnings and profitability misused the accounting standards. These large corporations actually exploited the accounting standards to show inflated profits and understate liabilities.

The tendency to combine the roles of Chairman and Chief Executive in one person and Board structures that were not conductive, tended to make matters worse. Spate of scandals and financial collapses in the late 1980s and early 1990s made the shareholders and banks worry about their investments.

These corporate disasters took place primarily due to insufficiency of implementable governance practices. To prevent the recurrence of such business failures, **Sir Adrian Cadbury Committee** was set up by the London Stock Exchange in May, 1991.

Corporate Governance refers to the conduct of business in accordance with the stakeholder's desires, which primarily means to create wealth for the stakeholder's, but at the same time conforming to the laws, rules & regulations established by the society. The stakeholder's include, beside the share holders, other participants in the corporation such as board of directors, managers, employees, workers, customers, vendors, lenders, dealers, regulators, society & the government.

Cadbury Committee, U.K, defined Corporate governance as follows:
**"**It is the system by which companies are directed and controlled**"**.

Strong Corporate governance is required to ever changing stock market and is an important instrument of investor protection. It is essential for the transparent disclosure of high quality accounting practice. It is the force that moves a viable and accessible financial reporting structure. The concept of good corporate governance connotes that ethics is as important as economics, fair play as crucial as financial success, morals as vital market share. Corporate Governance is about ethics in business. It is about transparency, openness and fair play in all aspects of business operations.

| Value addition 30.1.2: Check your Progress |
|---|
| **30.1 Meaning of Corporate Governance** |
| 1 What do you mean by stakeholders?<br>2 Who are the stakeholders in a company?<br>3 What are stakeholders interested in? |

## Definitions of corporate Governance:

'Corporate governance is the system by which companies are directed and controlled' (Cadbury Committee, 1992). Corporate governance is about relationships and structures. First, it is the relationship between a company's management, its board of directors, its auditors, its shareholders, its creditors and other stakeholders. Corporate governance is based on structures through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance", OECD April 1999. OECD's definition is consistent with the one presented by Cadbury [1992, page 15].

"Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, president of the Word bank, as quoted by an article in Financial Times, June 21, 1999.

Recently, an International Federation of Accountants (IFAC) report gave the following definition for 'enterprise governance':
…the set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organization's resources are used responsibly.
(IFAC, 2004)

**Value addition 30.1.3: Check your Comprehension**

**30.1 Meaning of Corporate Governance**

Can you define corporate Governance with the help of following keywords:
protecting stakeholders' interest; conforming to laws, rule and regulations; system of directing and controlling a company; ethics in business; transparency, openness and fair play in business; and promoting company's accountability.

Pick the option that best suits.
This section…

| Completely understood | Partially Understood | Not understood |
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| Move on to next section | Move on to next section but note that you need to revise this. | You need to re read this and discuss it with your batch mates. |

## 30.2 Objectives of Corporate Governance

| **Value addition 30.2.1: Focus of the Section** |
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| **30.2 Objectives of Corporate Governance** |
| This section apprises you with the issues addressed by corporate governance. It also present the objectives of corporate governance. |

Corporate governance has the following objectives:

1. To align corporate goals with the goals of the stakeholders.
2. To strengthen corporate functioning and discourage mismanagement.
3. To make investment in profitable investment ventures so as to achieve corporate goals.
4. To specify responsibility of the Board of directors and managers in order to ensure good corporate performance.

Typical corporate governance structures usually address issues such as:

- roles of the CEO and chairman;
- board of directors – its composition, independence, qualifications, training, remuneration and representation of shareholders;
- audit committee – its selection and role;
- rights and treatment of shareholders and stakeholders;
- external auditors – their selection, duties and liability;
- disclosure and transparency.

**Value addition 30.2.2: Check your Comprehension**

**30.2 Objectives of Corporate Governance**

Pick the option that best suits.

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| Move on to next section | Move on to next section but note that you need to revise this. | You need to re read this and discuss it with your batch mates. |

| **Value addition 30.2.3: Test Yourself** |
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| **30.2 Objectives of Corporate Governance** |
| 1 Describe the objectives of corporate governance.<br>2 What are the issues addressed by corporate governance?<br>3 Give at least two key words that describe corporate governance. |

# 30.3 Need for Corporate Governance

| **Value addition 30.3.1: Focus of the Section** |
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| **30.3 Need for Corporate Governance** |
| This section familiarizes you with the need for corporate governance. There have been various factors leading to inadequate accountability of the corporate towards its stakeholders, cases of mismanagement, threat to the interests of the stakeholders and so on which lead to the need for corporate governance. |

**Separation of ownership from management:** The need for corporate governance arises out of the separation of ownership and management in modern corporations. In professionally managed corporations, shareholders do not have or very less operational controls in their hands. All kinds of decisions are been taken by managers employed by shareholders. This can be described as the 'principal–agent' problem.
Put simply, the question is: will the managers run the corporation exclusively for the long-term benefit of the shareholders, and what mechanisms can be put in place to ensure this takes place. Systems of corporate governance are designed to provide a framework for managing companies that embodies best practice rather than relying on individuals' integrity.

**Global capital:** Circulation of capital globally calls for creditability and trust on the part of global market players.

**Investor protection:** Corporate governance is an important tool for protecting investors' interests by improving efficiency of corporate enterprise. Since the investors have become enlightened towards protection of the money they have invested, the companies have to ensure good corporate performance.

**Foreign investments:** Significant foreign institutional investment demands international standards of corporate governance.

**Financial reporting and accountability:** In order to raise enough capital from the capital markets, sound, transparent and credible financial reporting and accountability is called for. This enhances the need for good corporate governance.

**Banks and financial institutions:** Companies can have banks and financial institutions grant them financial assistance only when they adhere to good corporate governance.

**Globalization of economy:** Corporate governance helps India to integrate with the world economy. In this way good corporate governance promotes globalization.

**Value addition 30.3.2: Check your Comprehension**

**30.3 Need for Corporate Governance**

Pick the option that best suits.
This section…

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| Move on to next section | Move on to next section but note that you need to revise this. | You need to re read this and discuss it with your batch mates. |

| Value addition 30.3.3: Test Yourself |
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| **30.3 Need for Corporate Governance** |
| 1 Describe any three reasons explaining the need of corporate governance. |

## 30.4 Importance or Role of Corporate Governance

| Value addition 30.4.1: Focus of the Section |
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| **30.4 Importance or Role of Corporate Governance** |
| This section apprises you with the fact that corporate governance has become an integral way in the conduct of business. |

Good Corporate Governance is indispensible to the very survival of a company. It is important for the following reasons:

a) Corporate governance requires that there should be a properly structured Board which is capable of taking independent and objective decisions to control the affairs of the company and external providers of capital.

b) It enforces the induction of independent directors at the top who bring a wealth of experience and host of new ideas. This is done to improve the strategic thinking.

c) It rationalizes the management and monitoring of risk that a corporation faces globally.

d) Corporate governance emphasizes the adoption of transparent procedures and practices by the Board, thereby ensuring integrity in financial reports.

e) It limits the liability of top management and directors, by carefully articulating the decision making process.

f) It inspires and strengthens investor's confidence by ensuring that there are adequate number of non-executive and independent directors on the Board, to look after the interests and well-being of all the stakeholders.

g) Corporate governance helps provide a degree of confidence that is necessary for the proper functioning of a market economy as it contemplates adherence to ethical business standards.

h) Globalization of the market place has pushed us in an era where in the quality of corporate governance has become very important for the survival of corporate. Compatibility of corporate governance practices with global standards has also become an important constituent of corporate success. Thus good corporate governance is a necessary pre-requisite for the success of Indian corporate.

| Value addition 30.4.2: Check your Comprehension |
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| **30.4 Importance or Role of Corporate Governance** |
| Pick the option that best suits.<br>This section… |

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| Move on to next section | Move on to next section but note that you need to revise this. | You need to re read this and discuss it with your batch mates. |

| Value addition 30.4.3: Test Yourself |
|---|
| **30.4 Importance or Role of Corporate Governance** |
| 1 What has made the concept of corporate governance so important in today's corporate world?<br>2 Recall any five reasons for the growing importance of corporate governance in today's scenario. |

## 30.5 Principles of Corporate Governance

| Value addition 30.5.1: Focus of the Section |
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| **30.5 Principles of Corporate Governance** |
| In this section you will study the commonly accepted principles of corporate governance. It is following of such principles that ensure ethical performance of the corporate. |

Commonly accepted principles of corporate governance include:

**Rights and equitable treatment of shareholders:** Rights of the shareholders should be respected by Organizations. Valuable information should also be communicated in understandable manner which actually encourages the shareholders not only to use their rights but also participate in general meetings.

**Interests of other stakeholders:** Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

**Role and responsibilities of the board:** The board should be of sufficient size and seems to be committed to fulfill its responsibilities and duties. The board members should be from different fields and competent enough to review and challenge management performance. There are issues about the appropriate mix of executive and non-executive directors. The key roles of chairperson and CEO should not be held by the same person.

**Integrity and ethical behaviour:** In order to manage risk and avoid legal hassles ethical and responsible decision making is very important. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that reliance by a company on the integrity and ethics of individuals is bound to eventual failure. Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

**Disclosure and transparency:** Organizations should clearly communicate the roles and responsibilities of board and management to shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. All investors should have access to clear, factual, timely and accurate disclosure of material matters concerning the organization.

**Adherence to the rules, laws and spirit of codes:** Organisation should follow the SEBI code on corporate governance to promote and raise the standards of corporate governance of listed companies.

| **Value addition 30.5.2: Check your Comprehension** | | |
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| **30.5 Principles of Corporate Governance** | | |
| Pick the option that best suits.<br>This section… | | |
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| Move on to next section | Move on to next section but note that you need to revise this. | You need to re read this and discuss it with your batch mates. |

| **Value addition 30.5.3: Test Yourself** |
|---|
| **30.5 Principles of Corporate Governance** |
| Give five leading hallmarks of good corporate governance. |

## 30.6 Corporate Governance Environment

| **Value addition 30.6.1: Focus of the Section** |
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| **30.6 Corporate Governance Environment** |
| Corporate governance has an environment wherein many parties are involved. Corporate governance environment consists of both internal and external environment of the corporate. This section describes the parties in the corporate governance environment and the internal and external factors operating in it. |

Parties involved in corporate governance include the regulatory body (e.g. the Chief Executive Officer, the board of directors, management and shareholders). Other stakeholders who take part include suppliers, employees, creditors, customers and the community at large.

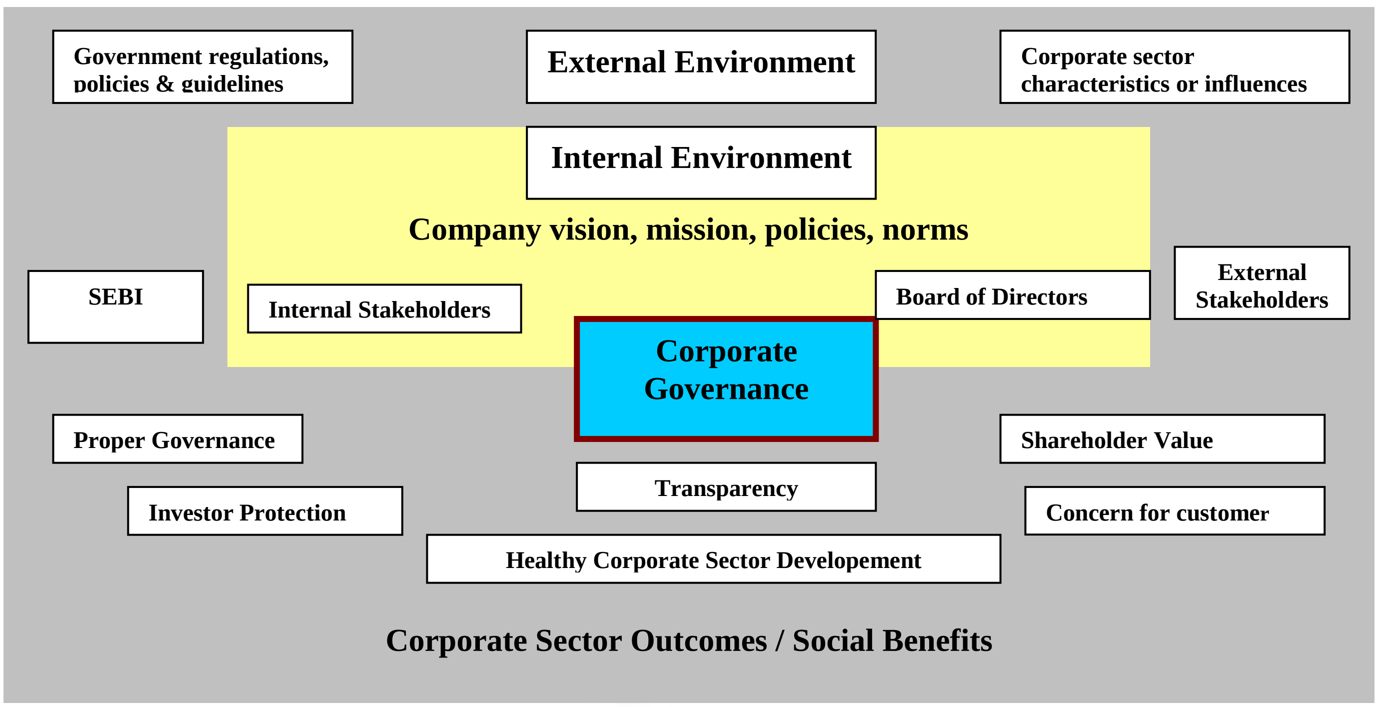
The board of directors often plays a key role in corporate governance. It is their responsibility to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the organisation to its owners and authorities. The Company Secretary, is a high ranking professional who is trained to uphold the highest standards of corporate governance, effective operations, compliance and administration.

All parties to corporate governance have an interest, whether direct or indirect, in the effective performance of the organisation. Directors, workers and management receive salaries, benefits and reputation, while shareholders receive capital return. Customers receive goods and services; suppliers receive compensation for their goods or services. In return these individuals provide value in the form of natural, human, social and other forms of capital.

A key factor in an individual's decision to participate in an organisation is the expected returns. In other words they provide financial capital and trust that they will receive a fair share of the organisational returns. If some parties are receiving more than their fair return, then participants may choose to discontinue participating, leading to organizational collapse.

The corporate governance environment can be divided into two parts: internal and external. The internal environment consists of company's board of directors, internal stakeholders,

**Figure: 30.1 Corporate Governance Environment and Outcomes**




**Source: Self Created**

to ensuring good corporate performance through setting codes of conduct for their managers and non-managers. Actions taken by parties external to the corporate are called regulatory actions. These actions focus on proper governance, investor protection, shareholder value, concern for customers, transparency and healthy corporate sector development. The parties and their actions are summarized in the diagram above.

| **Value addition 30.6.2: Test Yourself** |
|---|
| **30.6 Corporate Governance Environment** |
| 1 List the parties involved in the corporate governance environment.<br>2 What constitutes the internal environment of corporate governance?<br>3 What constitutes the external environment of corporate governance?<br>4 Describe the corporate governance environment with the help of a diagram. |

**Value addition 30.6.3: Check your Comprehension**

**30.6 Corporate Governance Environment**

Pick the option that best suits.
This section…

| Completely understood | Partially Understood | Not understood |
|---|---|---|
| Move on to next section | Move on to next section but note that you need to revise this. | You need to re read this and discuss it with your batch mates. |

**Value addition 30.6.4: Did You Know ?**

**Prevailing Governance Code**

Securities Exchange Board of India (SEBI) introduced clause 49 in the listing agreement for the first time in the year 2000-2001. Clause 49 contains both mandatory & non-mandatory requirements. Clause 49 deals with corporate governance norms that a listed entity should follow. This clause was based on the Kumar Mangalam Birla Committee Constituted by SEBI. However, in 2004, SEBI revised clause 49 of the listing Agreement which supersedes all other earlier circulars issued by SEBI on this subject.
The major new provisions included in clause 49 are:
The board will lay down a code of conduct for all board members & senior managements of the company to compulsorily follow.
The CEO & CFO will certify the financial statements & cash flow statement of the company.

- If while preparing financial statements, the company follows a treatment that is different from that prescribed in the accounting standards, it must disclose this in the financial statements.

The company will have to lay down procedures for informing the board members about the risk management and minimization procedures.

Where money is raised through public issue, rights issue etc, the company will have to disclose the applications of funds according to major categories as part of quarterly disclosure of financial statements.

Further, on an annual basis, the company will prepare a statement of funds utilized for purposes other than those specified in the prospectus and place it before the audit committee.

The company will have to publish its criterion for making its payments to non-executive directors in its annual report.

Apart from clause 49 of the listing agreement, Corporate Governance is also regulated through the provisions of the Companies Act 1956. Amendments in the Companies Act 2000 with regard to Corporate Governance are as follows:

Compliance with Accounting Standards (sec.210A) - Every P& C A/C & B/S of the company shall compulsorily comply with the accounting standards issued by the |CA| (Institute of charted Accounts of India).

Investor Education & Protection fund (sec. 205c) - This section requires the central government to establish a fund called the Investor education & protection & amounts of unpaid dividend, unpaid matured deposits, and unpaid application money recovered by the companies shall be credited to the fund.
Directors Responsibility Statement (sec 217 (2AA)) - This section states that the Boards report shall also include a Directors Responsibility Statement with respect to the follow matters:

- whether accounting standards have been followed in the preparation of annual accounts & reasons for material departures, if any,
- whether appropriate accounting policies have been applied & on consistent basis,whether directors had made judgments & estimate that are reasonable & prudent as to give a true & fair view of the state of affairs profit & loss company account,
- whether the directors had prepared annual accounts on a going concern basic,
- whether directors had taken proper &sufficient care for the maintenance of adequate accounting records for safeguarding assets of the company.Numbers of Directorships (sec 275) - A person cannot hold office as a director in more than 15 companies at the same time.

Audit Committee (sec 292 A) - Every public co. having a paid up capital of Rs. 5 crores or more shall constitute an audit committee. It shall consist of at least 3 directors are 2/3rd of the members shall be director’s other than Managing Directors or Whole time Directors.
Prohibition on inviting Public Deposits - Companies are prohibited to invite/accept depositsCorporate Identity Number - Registrar of Co’.s to allot a Corporate Identity Number to each co. registered on or after Nov.1, 2000.Small Depositor (sec 58 AA & 58AAA) - These sections contain provisions to protect depositors who have invested up to Rs. 20,000 in a financial year in a company.Disqualification of a Director (sec274 (g)) - Clause (g) of sec 274, Disqualifies a person (for 5 years) who is already a director of a public co. which:

- has not filed the annual accounts & annul returns for any 3 continuous financial years commencing on or after the fist day of April 1999,
- or,has failed to repay its deposits or interest on due date or redeem its debentures on due date or to pay dividend. & such failure continues for one year or more.Secretarial Audit (sec 383 A) - Companies having paid up share capital of Rs. 10 lakh or more but less than Rs. 2 crores have to conduct secretarial audit. A whole time company secretary has to file with Registrar of Companies a certificate as to whether the company has complied with all the provisions of the act. A copy of this certificate shall also be attached with the report of Board of Directors.

The Kumar Mangalam Birla Committee Constituted by SEBI states that: Corporate Governance is a synonym for sound management, transparency & disclosure. Transparency refers to creation of an environment whereby decisions and actions of the corporate are made visible, accessible and understandable. Disclosure refers to the process of providing information as well as its timely dissemination.

Thus "Corporate Governance" despite some feeble attempts from various quarters has remained ambiguous and often misunderstood phrase. For Quite some time it was confined to only corporate management. It is not so. It is something much broader for it must include a fair, efficient and transparent administration to meet certain well defined objectives. Corporate governance also must go beyond law. The quantity, quality and frequency of financial and managerial disclosure, the degree and extent to which the board of Director (BOD) exercise their trustee responsibilities and the commitment to run transparent organization- these should evolve due to interplay of many factors and the role played by more progressive elements within the corporate sector. In India, a strident demand for evolving a code of good practices by the corporate themselves is emerging.

| **Value addition : Key Words** |
|---|
| **Summary** |
| Reflection of the company's culture, policies and relationship with stakeholders<br>Presence of internal and external parties to ensure good corporate performance |

## Summary

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large. The positive effect of good corporate governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development. Economic health of a nation depends substantially on how sound and ethical businesses are. Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization. The principles of corporate governance include: rights and equitable treatment of shareholders, interests of other stakeholders, role and responsibility of the board, integrity and ethical behaviour, disclosure and transparency and adherence to rules, laws and spirit of codes. There are both internal and external parties in the corporate governance environment to ensure good corporate governance through their voluntary and regulatory actions respectively.

# Exercises

## Short Questions

1. What do you mean by corporate governance?
2. Define corporate governance.
3. Explain the objectives of corporate governance.
4. Explain the importance of corporate governance.
5. Enumerate the principles of corporate governance.
6. Give an outline of corporate governance environment.
7. Briefly describe the parties involved in the corporate governance environment.

## Long Questions

1. "The positive effect of good corporate governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development". Do you agree?
2. "Economic health of a nation depends substantially on how sound and ethical businesses are". Comment.
3. In the light of the objectives of corporate governance, comment on the status of corporate governance in India.
4. "Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization". Elucidate.

| |
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| **Value addition: Prepare for the Exam** |
| **Past Questions** |
| 2005 Explain the concept of corporate governance and discuss the main issues involved in corporate governance.<br>2007 Discuss the need for corporate governance. What is the status of corporate governance in our country? |

## Glossary

**Audit committee:** It refers to a committee consisting of members of a client's board of directors who are responsible for dealing with the external and internal auditors.

**Stakeholders:** They refer to individuals and groups with a more or less direct interest in the life of a company or institution for example: shareholders, employees, clients and suppliers, public authorities, civil society (NGOs, local communities, residents, etc.).

**Ethics in business:** It addresses the morality of both economic systems (e.g., the free market, socialism, and communism) and the conduct of the organizations found within these systems (e.g., corporations in a free market system). Corporate ethics may be viewed as a subset of business ethics. Corporate ethics focuses specifically on issues of morality associated with business enterprises. These include relations internal to the organization (e.g., treatment of employees, dealings with shareholders, questions concerning product quality and customer service, etc.) as well as external relations (e.g., interactions with government, specific communities, society as a whole, the impact of corporate activities on the natural environment, etc.).

**Globalization:** It refers to worldwide economic integration of many formerly separate national economies into one global economy, mainly through free trade and free movement of capital as by multinational companies, but also by easy or uncontrolled migration.

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## 2. <u>Web Links</u>


1. http://en.wikipedia.org/wiki/Corporate_governance
2. http://www.mallory-properties.com/UserFiles/shakehand.gif
3. http://openlearn.open.ac.uk/mod/resource/view.php?id=213134
4. http://www.encycogov.com/WhatIsGorpGov.asp