

CH. 9 Corporate governance

Corporate governance is the system of rules, practices, and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

Corporate governance includes the processes through which corporations' objectives are set and pursued in the context of the social, regulatory and market environment. These include monitoring the actions, policies, practices, and decisions of corporations, their agents, and affected stakeholders. Corporate governance practices can be seen as attempts to align the interests of stakeholders.

Interest in the corporate governance practices of modern corporations, particularly in relation to accountability, increased following the high-profile collapses of a number of large corporations in 2001–2002, many of which involved accounting fraud; and then again after the recent financial crisis in 2008.

Corporate scandals of various forms have maintained public and political interest in the regulation of corporate governance. In the U.S., these include scandals surrounding Enron and MCI Inc. (formerly WorldCom). Their demise led to the enactment of the Sarbanes–Oxley Act in 2002, a U.S. federal law intended to improve corporate governance in the United States. Comparable failures in Australia (HIH, One.Tel) are associated with the eventual passage of the CLERP 9 reforms there, that similarly aimed to improve corporate governance. Similar corporate failures in other countries stimulated increased regulatory interest.

Corporate governance may be defined as follows:

Corporate governance refers to the accountability of the Board of Directors to all stakeholders of the corporation i.e. shareholders, employees, suppliers, customers and society in general; towards giving the corporation a fair, efficient and transparent administration.

Following are cited a few popular definitions of corporate governance:

(1) “Corporate governance means that company managers its business in a manner that is accountable and responsible to the shareholders. In a wider interpretation, corporate governance includes company’s accountability to shareholders and other

stakeholders such as employees, suppliers, customers and local community.” – Catherwood.

(2) “Corporate governance is the system by which companies are directed and controlled.” – The Cadbury Committee (U.K.)

The Difference Between Corporate Governance & Corporate Management:

Governance

Governance comes from the word “govern,” which means to control the actions of a group for the benefit of the whole. In the business world, this refers to policies that specifically restrict or direct how people can act. For example, governance policies might include prohibiting a board of directors from awarding contracts to board members’ companies or the companies of family members. A business might require its accounting department to have two signatures on any check it writes to reduce the threat of fraud.

Management

Management refers to the actions taken by a company to lead the business in a positive direction. Examples of management include setting budgets, giving staff members directions and making strategic plans about marketing or product development. Corporations usually have management teams once the company becomes too big for the founder or one individual to oversee the entire business. Management team members include titles such as department head, director, vice president and manager, chief executive officer, chief operating officer and chief financial officer.

Common Governance Activities

Businesses benefit from written policies and procedures that allow leaders to avoid specific conflicts of interests and fraudulent activities before they happen and to detect any fraud that might occur. Many governance policies pertain to financial activities, setting procedures for soliciting and awarding contracts, accounting practices and disbursing profits. Business set strict rules for human resources activities that fall under state and federal guidelines. When a corporation becomes a public company, corporate governance expands to include following SEC rules and providing transparency for shareholders. Unlike company policies that govern the behavior of individual employees, such as dress codes or grievance procedures, corporate governance policies pertain mostly to the operations of the business.

Common Management Activities

Management activities help a business operate, with instruction from top leaders directing the activities of staff members. Companies create plans for developing,

pricing, promoting and distributing their products, put systems into place to oversee their plans and review and assess their projections and performance. Companies manage their employees by training workers to help them perform better. Analyses of operations help management to determine if the company needs to change any practices, such as bringing contracted work in-house or vice versa, setting new goals, modifying the marketing mix and monitoring financial performance.

Need for Corporate Governance:

The need for corporate governance is highlighted by the following factors:

(i) Wide Spread of Shareholders:

Today a company has a very large number of shareholders spread all over the nation and even the world; and a majority of shareholders being unorganised and having an indifferent attitude towards corporate affairs. The idea of shareholders' democracy remains confined only to the law and the Articles of Association; which requires a practical implementation through a code of conduct of corporate governance.

(ii) Changing Ownership Structure:

The pattern of corporate ownership has changed considerably, in the present-day-times; with institutional investors (foreign as well Indian) and mutual funds becoming largest shareholders in large corporate private sector. These investors have become the greatest challenge to corporate managements, forcing the latter to abide by some established code of corporate governance to build up its image in society.

(iii) Corporate Scams or Scandals:

Corporate scams (or frauds) in the recent years of the past have shaken public confidence in corporate management. The event of Harshad Mehta scandal, which is perhaps, one biggest scandal, is in the heart and mind of all, connected with corporate shareholding or otherwise being educated and socially conscious.

The need for corporate governance is, then, imperative for reviving investors' confidence in the corporate sector towards the economic development of society.

(iv) Greater Expectations of Society of the Corporate Sector:

Society of today holds greater expectations of the corporate sector in terms of reasonable price, better quality, pollution control, best utilisation of resources etc. To meet social expectations, there is a need for a code of corporate governance, for the best management of company in economic and social terms.

(v) Hostile Take-Overs: Hostile take-overs of corporations witnessed in several countries, put a question mark on the efficiency of managements of take-over

companies. This factor also points out to the need for corporate governance, in the form of an efficient code of conduct for corporate managements.

(vi) Huge Increase in Top Management Compensation:

It has been observed in both developing and developed economies that there has been a great increase in the monetary payments (compensation) packages of top level corporate executives. There is no justification for exorbitant payments to top ranking managers, out of corporate funds, which are a property of shareholders and society.

This factor necessitates corporate governance to contain the ill-practices of top managements of companies.

(vii) Globalisation:

Desire of more and more Indian companies to get listed on international stock exchanges also focuses on a need for corporate governance. In fact, corporate governance has become a buzzword in the corporate sector. There is no doubt that international capital market recognises only companies well-managed according to standard codes of corporate governance.

Benefits of Corporate Governance:

1. Good corporate governance ensures corporate success and economic growth.
2. Strong corporate governance maintains investors' confidence, as a result of which, company can raise capital efficiently and effectively.
3. It lowers the capital cost.
4. There is a positive impact on the share price.
5. It provides proper inducement to the owners as well as managers to achieve objectives that are in interests of the shareholders and the organization.
6. Good corporate governance also minimizes wastages, corruption, risks and mismanagement.
7. It helps in brand formation and development.
8. It ensures organization is managed in a manner that fits the best interests of all.

Principles of corporate governance:

While corporate governance structure may vary, most organizations incorporate the following key elements:

All shareholders should be treated equally and fairly. Part of this is making sure shareholders are aware of their rights and how to exercise them.

Legal, contractual and social obligations to non-shareholder stakeholders must be upheld. This includes always communicating pertinent information to employees, investors, vendors and members of the community.

The board of directors must maintain a commitment to ensure accountability, fairness, diversity and transparency within corporate governance. Board members must also possess the adequate skills necessary to review management practices.

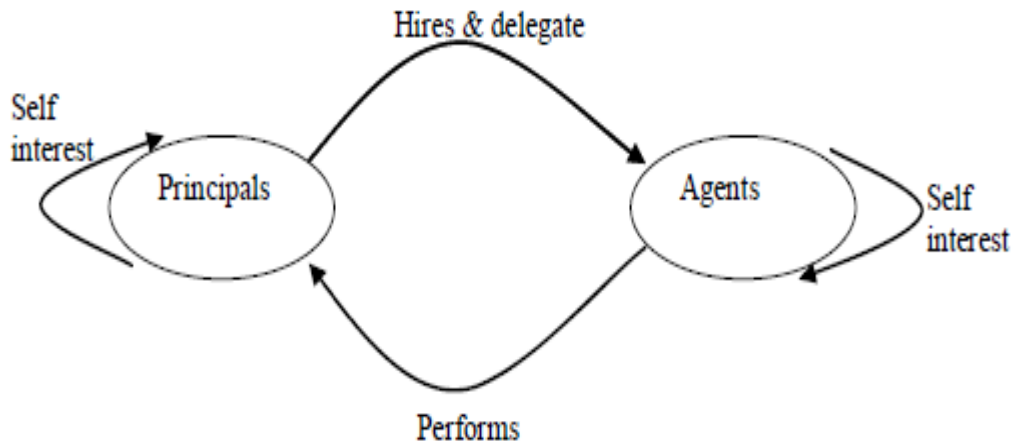
Organizations should define a code of conduct for board members and executives, only appointing new individuals if they meet that standard.

All corporate governance policies and procedures should be transparent or disclosed to relevant stakeholders.

Theories of Corporate Governance:

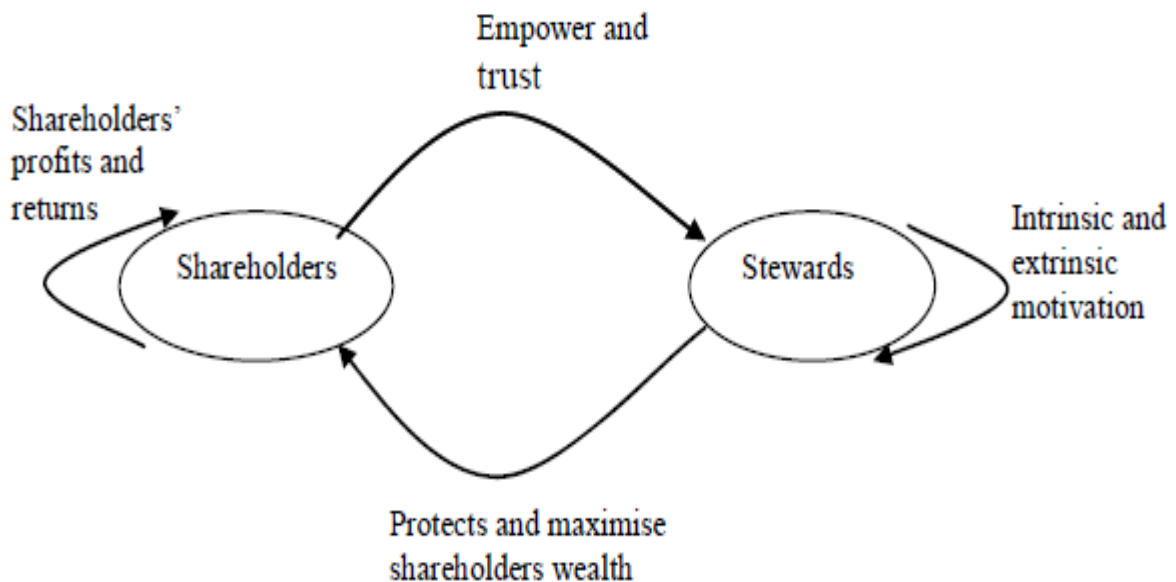
Agency Theory

Agency theory defines the relationship between the principals (such as shareholders of company) and agents (such as directors of company). According to this theory, the principals of the company hire the agents to perform work. The principals delegate the work of running the business to the directors or managers, who are agents of shareholders. The shareholders expect the agents to act and make decisions in the best interest of principal. On the contrary, it is not necessary that agent make decisions in the best interests of the principals. The agent may be succumbed to self-interest, opportunistic behavior and fall short of expectations of the principal. The key feature of agency theory is separation of ownership and control. The theory prescribes that people or employees are held accountable in their tasks and responsibilities. Rewards and Punishments can be used to correct the priorities of agents.



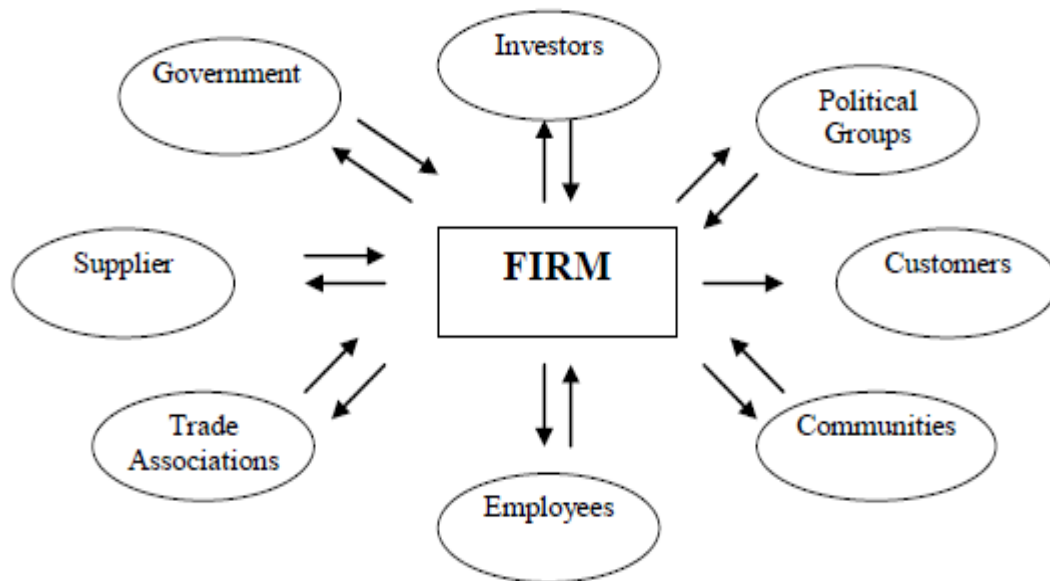
Stewardship Theory

The steward theory states that a steward protects and maximises shareholders wealth through firm Performance. Stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. The stewards are satisfied and motivated when organizational success is attained. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. The employees take ownership of their jobs and work at them diligently.



Stakeholder Theory

Stakeholder theory incorporated the accountability of management to a broad range of stakeholders. It states that managers in organizations have a network of relationships to serve – this includes the suppliers, employees and business partners. The theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests is assumed to dominate the others.



Models of Corporate Governance:

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, 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:

The Anglo-US Model (The outsider model)

The Anglo-US model is characterized by share ownership of individual, and increasingly institutional, investors not affiliated with the corporation (known as outside shareholders or “outsiders”); a well-developed legal framework defining the rights and responsibilities of three key players, namely management, directors and shareholders; and a comparatively uncomplicated procedure for

interaction between shareholder and corporation as well as among shareholders during or outside the AGM.

Equity financing is a common method of raising capital for corporations in the United Kingdom (UK) and the US. It is not surprising, therefore, that the US is the largest capital market in the world, and that the London Stock Exchange is the third largest stock exchange in the world (in terms of market capitalization) after the New York Stock Exchange (NYSE) and Tokyo.

There is a causal relationship between the importance of equity financing, the size of the capital market and the development of a corporate governance system. The US is both the world's largest capital market and the home of the world's most-developed system of proxy voting and shareholder activism by institutional investors. Institutional investors also play an important role in both the capital market and corporate governance in the UK.

Key Players in the Anglo-US Model

Players in the Anglo-US model include management, directors, shareholders (especially institutional investors), government agencies, stock exchanges, self-regulatory organizations and consulting firms which advise corporations and/or shareholders on corporate governance and proxy voting. Of these, the three major players are management, directors and shareholders. They form what is commonly referred to as the "corporate governance triangle."

The Anglo-US model, developed within the context of the free market economy, assumes the separation of ownership and control in most publicly-held corporations. This important legal distinction serves a valuable business and social purpose: investors contribute capital and maintain ownership in the enterprise, while generally avoiding legal liability for the acts of the corporation. Investors avoid legal liability by ceding to management control of the corporation, and paying management for acting as their agent by undertaking the affairs of the corporation. The cost of this separation of ownership and control is defined as "agency costs".

The interests of shareholders and management may not always coincide. Laws governing corporations in countries using the Anglo-US model attempt to reconcile this conflict in several ways. Most importantly, they prescribe the election of a board of directors by shareholders and require that boards act as fiduciaries for shareholders' interests by overseeing management on behalf of shareholders.

Composition of the Board of Directors in the Anglo-US Model

The board of directors of most corporations that follow the Anglo-US model includes both “insiders” and “outsiders”. An “insider” is as a person who is either employed by the corporation (an executive, manager or employee) or who has significant personal or business relationships with corporate management. An “outsider” is a person or institution which has no direct relationship with the corporation or corporate management. A synonym for insider is executive director; a synonym for outsider is non-executive director or independent director.

Traditionally, the same person has served as both chairman of the board of directors and chief executive officer (CEO) of the corporation. In many instances, this practice led to abuses, including: concentration of power in the hands of one person (for example, a board of directors firmly controlled by one person serving both as chairman of the board of directors and CEO); concentration of power in a small group of persons (for example, a board of directors composed solely of “insiders”; management and/or the board of directors’ attempts to retain power over a long period of time, without regard for the interests of other players (entrenchment); and the board of directors’ flagrant disregard for the interests of outside shareholders.

The Anglo-American Model of industry structure and corporate governance is detailed in Fig. 2.1:

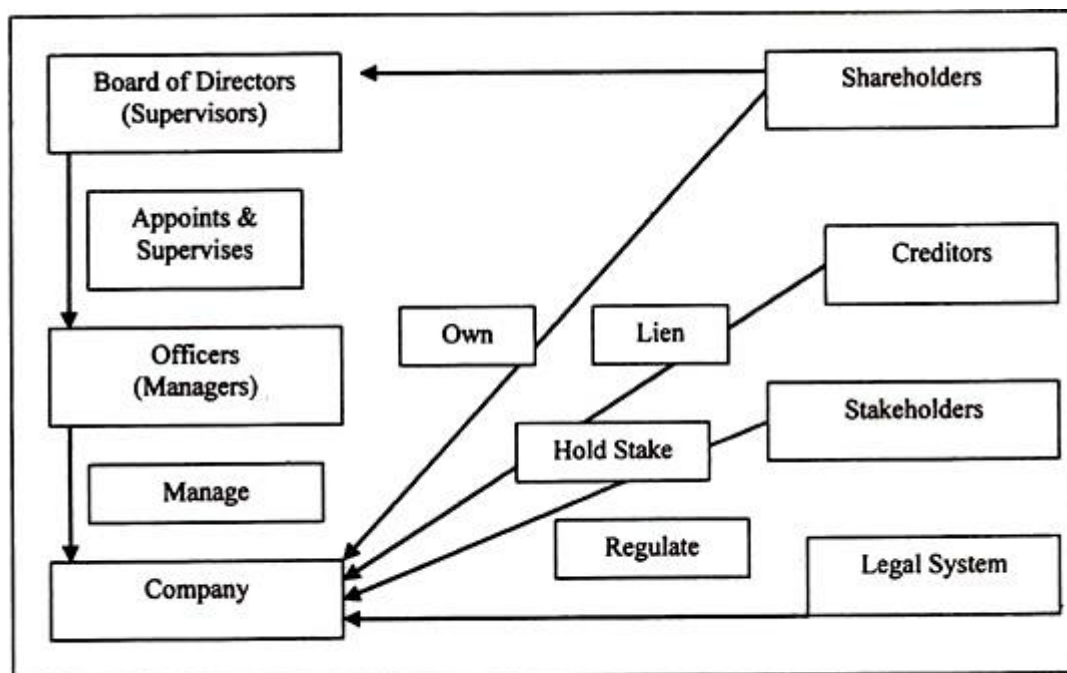


FIG. 2.1 : THE ANGLO-AMERICAN MODEL

The German model

In the German model, there is a two-tiered board system consisting of a management board and a supervisory board. The management board is made up of inside executives of the company and the supervisory board is made up of outsiders such as labor representatives and shareholder representatives. The two boards are completely separate, and the size of the supervisory board is set by law and cannot be changed by the shareholders. Also in the German model, there are voting right restrictions on the shareholders. They can only vote a certain share percentage regardless of their share ownership.

The German Model of industry and corporate governance is shown in Fig. 2.2:

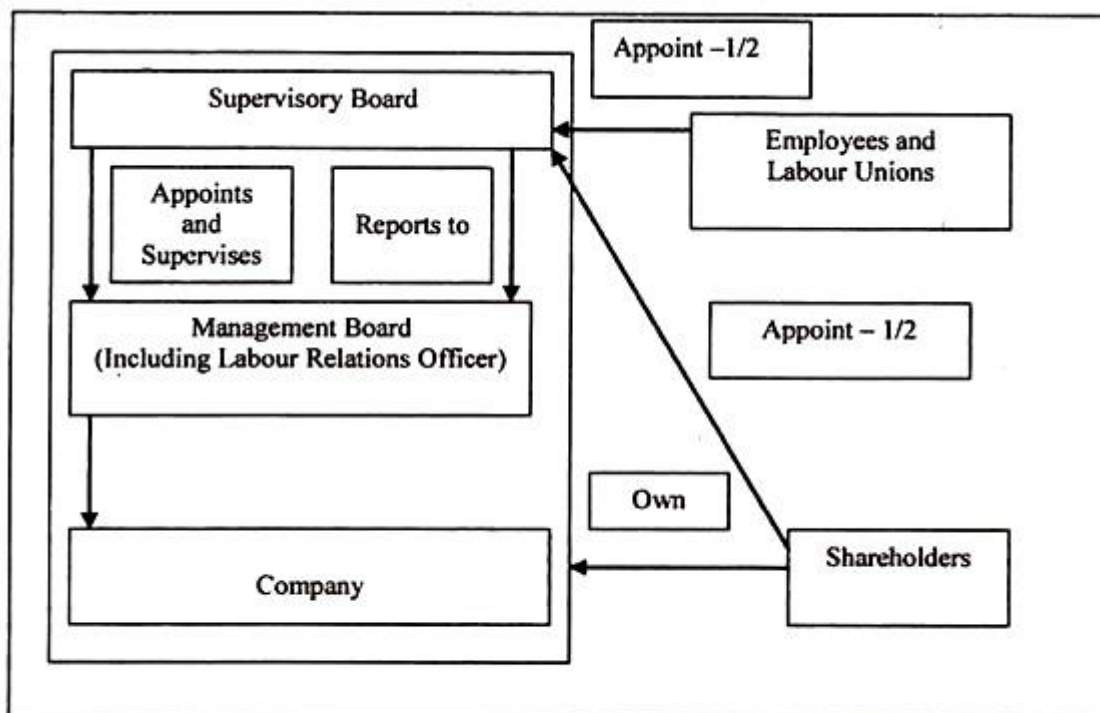


FIG. 2.2: THE GERMAN MODEL

The Japanese Model

The Japanese model is characterized by a high level of stock ownership by affiliated banks and companies; a banking system characterized by strong, long-term links between bank and corporation; a legal, public policy and industrial policy framework designed to support and promote “keiretsu” (industrial groups linked by trading relationships as well as cross-shareholdings of debt and equity);

boards of directors composed almost solely of insiders; and a comparatively low (in some corporations, non-existent) level of input of outside shareholders, caused and exacerbated by complicated procedures for exercising shareholders' votes.

Equity financing is important for Japanese corporations. However, insiders and their affiliates are the major shareholders in most Japanese corporations. Consequently, they play a major role in individual corporations and in the system as a whole. Conversely, the interests of outside shareholders are marginal. The percentage of foreign ownership of Japanese stocks is small, but it may become an important factor in making the model more responsive to outside shareholders.

Key Players in the Japanese Model

The Japanese system of corporate governance is many-sided, centering around a main bank and a financial/industrial network or keiretsu. The main bank system and the keiretsu are two different, yet overlapping and complementary, elements of the Japanese model. Almost all Japanese corporations have a close relationship with a main bank. The bank provides its corporate client with loans as well as services related to bond issues, equity issues, settlement accounts, and related consulting services. The main bank is generally a major shareholder in the corporation. In the US, anti-monopoly legislation prohibits one bank from providing this multiplicity of services. Instead, these services are usually handled by different institutions: commercial bank - loans; investment bank - equity issues; specialized consulting firms - proxy voting and other service The Japanese Model of industry and corporate governance is shown as below:

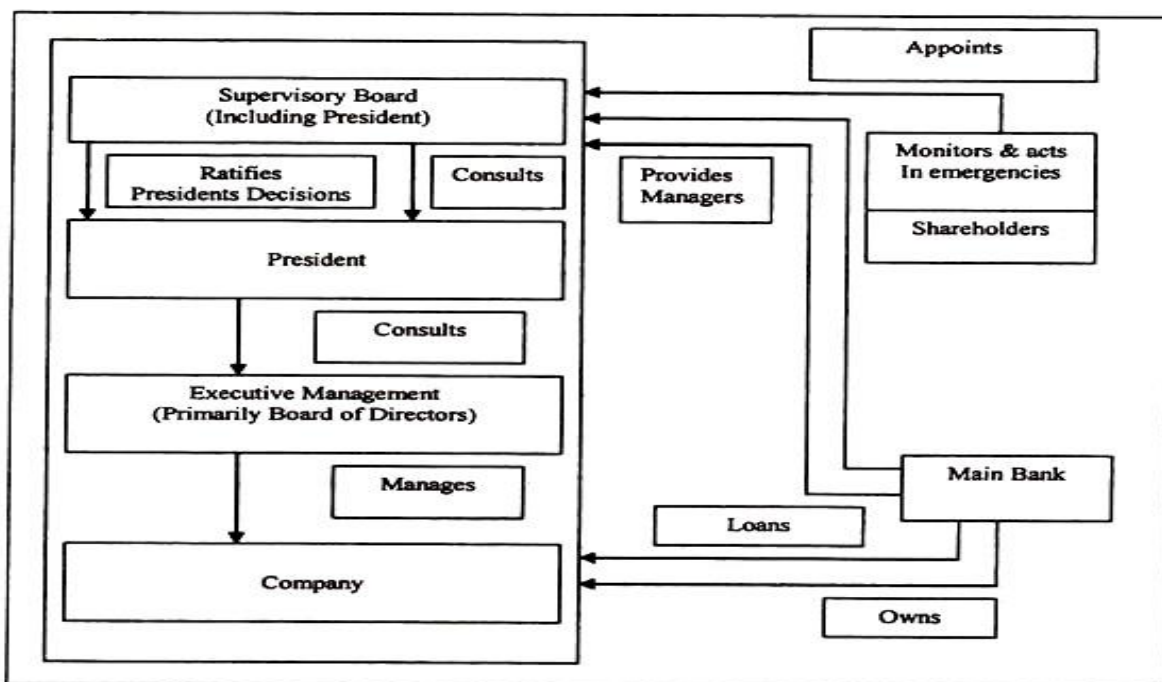


FIG. 2.3: THE JAPANESE MODEL