UNIT 10 CORPORATE GOVERNANCE*

Structure

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10.0 OBJECTIVES

After reading this Unit, you should be able to:

- Elaborate the meaning and significance of corporate governance;
- Enumerate the principles of corporate governance;
- Describe the models of corporate governance;
- Trace the growth of corporate governance;
- Discuss the International and Indian experiences in the growth of corporate governance; and
- Analyse the challenges of corporate governance.

10.1 INTRODUCTION

The notion of corporate governance has gained more prominence in recent years though concern for the effective functioning of the corporate organisations in a proper framework has been there for a long time. There has always been differentiation between public administration and the private administration. While the former is concerned about the public or governmental domain, which entails public policy implementation and functions through the legislature, executive and judiciary, the latter is concerned about the corporate entity that works for the profitability of the organisation. In such a context, with the

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coexistence of public and corporate sectors, the need for corporate governance was felt in recent years, with some corporates resorting to unethical means to earn huge profits. In particular, in the era of globalisation, where there is increasing corporate scandals, inflated revenues, financial crisis and the mismanagement by the board of directors, the need for a strong governance framework has been felt in ensuring efficient, and effective functioning of the enterprises.

In crux, effective corporate governance is essential for the growth, profitability, and stability of the business vis-à-vis economy and for welfare of the society at large. Good corporate governance promotes economic development, strong financial systems and the sustainability of the business. In this Unit, you shall be introduced to the concept of corporate governance, its meaning and significance. In addition, an analysis of the principles and models of corporate governance shall be done. The Unit shall give a trajectory of growth of corporate governance. It will also discuss the initiatives taken at the global and national level in the domain of corporate governance.

10.2 CORPORATE GOVERNANCE: MEANING AND SIGNIFICANCE

10.2.1 Meaning of Corporate Governance

The concept of corporate governance gained momentum in the late 1980s with the basic purpose of promoting balance in corporate enterprise and ensuring accountability. The term 'corporate' is derived from the Latin word 'corpus', which means a 'body'. The Cadbury Committee (1992) that coined the term corporate governance defines it as "the system by which companies are directed and controlled". Before we actually get into the other definitions of corporate governance, it is important to understand the basic structure and the stakeholders involved in a corporate entity. There are three key players in the corporate governance sector, i.e., (i) Shareholders – who have invested their money in the corporation; (ii) Executive Management – who runs the business and is responsible to the board of directors; and (iii) Board of Directors – who is elected by the shareholders and is accountable to them (Murthy, 2004).

The Board of Directors of the corporate entity is responsible for the governance of the company. The shareholder's role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The Board's actions are subject to laws, regulations and shareholders in general body meeting (Kumara Mangalam Birla Committee, 1999).

Thus, corporate governance is about the way the business is directed, monitored and controlled to attain its goals and objectives. It is guided by a set of principles, ethics, values, morals, laws, rules and regulations. The major objective of the corporate governance is to maximise the shareholder value in a company and also to ensure the transparency and earn the trust and confidence of the investors, customers, employers, the government and the people. This is possible when there is transparency, openness, boldness, fairness and justice (Murthy, *op.cit.*).

According to Adrian Cadbury (1992), "Corporate governance is concerned with holding the balance between economic and social goals, and between individual and communal goals. The governance framework is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to

align nearly as possible the interest of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for the state is to strengthen their economies and discourage fraud and mismanagement".

The definitions of corporate governance vary as per context and cultural situations (Armstrong & Sweeney, 2002). There are some scholars who are of the view that the companies should run in the interest of the shareholders, while there are others who insist that companies should take account of interests of various stakeholders in the society. The definitions thus vary as per the views taken up, which are either narrow or broad. The narrow view of corporate governance looks at the set of rules, regulations, laws, institutionalised procedures and norms (Alawattage & Wickramasinghe, 2004). The broader view of corporate governance goes beyond board processes and procedures, and considers the relationships between management, boards, shareholders and other stakeholders such as employees and the community (Bain & Band, 1996).

As put forward by Claessens (2006), the definitions of corporate governance fall into two categories. The first set of definitions is concerned with a set of behavioural patterns – the actual behaviour of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second set is concerned with the normative framework – the rules under which firms are operating, with the rules coming from such sources as the legal system, the judicial system, financial markets, and labour markets.

In the Indian context, corporate governance is defined in the following ways:

According to Securities Exchange Board of India (SEBI) "corporate governance is all about recognition by management about their role as corporate trustees and immutable rights of shareholders as they are the real owners of the company. It is all about dedication to carry out good business performance through proper ethics and values by differentiating corporate and personal resources in the process of company management".

The Institute of Company Secretaries of India (ICSI, 2003) defines corporate governance as "a blend of rules, regulations, laws and voluntary practices that enable companies to attract financial and human capital, perform efficiently and thereby maximise long term value for the shareholders besides respecting the aspirations of multiple stakeholders including that of the society".

10.2.2 Significance of Corporate Governance

The Committee on Corporate Governance that was constituted in India in 2003 under the chairmanship of Narayana Murthy in its report states that "if management is about running businesses, governance is about ensuring that it is run properly." It is important that the companies are properly governed and managed as it is of great significance in recent times, not only to the business entity but also to the government, the various stakeholders and the society at large. Corporate governance is necessary to:

- Bring clarity to the respective responsibilities of directors, company managers, shareholders and auditors and enhance the accountability so as to strengthen trust in the corporate system vis-a-vis capital market.
- Attract investors – both local and foreign – and assure them that their investments will be secure and efficiently managed, and in a transparent and accountable process (i.e. strengthening capital market).
- Prevent fraud and malpractices or unethical behaviour by companies.
- Create competitive and efficient companies and business enterprises.

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- Enhance the performance of those entrusted to manage corporations.
- Promote efficient and effective use of limited resources.
- Ensure long-term value creation, performance, and sustainability of the company which will be in the interests of large stakeholders.
- Build public confidence in the corporation.

In addition, Medury (2003) observes that an effective corporate governance framework is needed, which will facilitate the enterprise to:

- Strive towards efficient use of resources, which in turn promotes economic development.
- Ensure compliance of the needed regulatory requirements, laws and regulations.
- Create confidence among the stakeholders.
- Promote shareholder activism. The investor has a key role in the present governance system. The faith and trust of the investor can be secured through information dissemination, participation and transparency in activities of enterprise; and
- Establish board of management's accountability to the enterprise, stakeholders and society at large.

The corporate frauds and governance failure occurring globally, make it necessary for institutionalising proper norms and laws with international requirements for governing a company.

10.3 PRINCIPLES OF CORPORATE GOVERNANCE

There are no globally accepted set of principles that can be applied to corporates. However, across the world many of the corporates, governments, practitioners and academicians have laid down certain basic principles for corporate governance. In other words, they are the guidelines based upon the ethics and values of the society for good corporate governance. In particular, the OECD Principles of Corporate Governance (2004) is the benchmark for policy makers, investors, corporations and other stockholders. The following are the major principles of corporate governance, put forward by the OECD Report:

1) ***Ensuring the Basis for an Effective Corporate Governance Framework*** **:** The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

2) ***The Rights of Shareholders and Key Ownership Functions*** **:**The corporate governance framework should protect and facilitate the exercise of shareholders' rights. The basic rights of the shareholders are secure methods of ownership registration; transfer shares; obtain relevant and material information on the corporation on timely and regular basis; participate and vote in general shareholders' meetings; elect and remove members of the board; and share in the profits of the corporation.

3) ***The Equitable Treatment of Shareholders*** **:** The framework should ensure equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

4) ***The Role of Stakeholders in Corporate Governance*** **:** The framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.

5) ***Disclosure and Transparency*** **:** The framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

6) ***The Responsibilities of the Board*** **:** The framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

The aim and objectives of these principles are to standardise and professionalise the management of enterprise, so as to promote inclusion of independent directors; enhance the board performance; and ensure transparency and accountability to the shareholders.

In addition the principles ensure:

- Effectiveness of audit committee and role of independent director. The audit committee has an important role to play in reviewing the operations of company relating to financial and other aspects.
- Independent leadership: This is necessary to oversee and guide the management to function in the best interests of the company and stakeholders.
- Building consensus among stakeholders.
- Accountability: The enterprises need to ensure proper accountability to all those stakeholders who are likely to be affected by the decisions of the management including social as well as environmental responsibility.
- Adherence to rule of law by functioning within the legal frameworks that are formulated by the authorities.

Check Your Progress 1

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the Unit.

1) Explain the concept and significance of corporate governance.

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2) Discuss the principles of corporate governance.

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10.4 MODELS OF CORPORATE GOVERNANCE

The corporate governance pattern may differ from corporation to corporation. The nature of the corporate is determined by outlining the rights and responsibilities of all the stakeholders with the suitable legal and regulatory framework and the *de facto* realities of the corporate existence. The above mentioned factors differ from country to country. The practitioners and the researchers have identified three types of models such as the Anglo Saxon, Continental and Japanese. Each model is differentiated based on certain factors of the company which includes: major stakeholders in the company, share ownership pattern, composition of board of directors, regulatory framework, disclosure requirements of publicly-listed stock corporations and the interaction between the stakeholders. Let us discuss these models:

Anglo Saxon Model (The Anglo US Model)

Generally the Anglo US model is described as the outside shareholders or 'outsiders' control model. This model is prevalent in UK and USA. The key players in this model are management, board of directors and shareholders. Here the capital is raised through equity financing. It can be noticed that the New York Stock Exchange and the London Stock Exchange are placed in top positions across the world. In this model, the shareholders get powers to appoint and dismiss the directors, but they do not exercise direct control on the management of the enterprise. The boards of directors carry out the corporate activities with the help of various committees and the chief executive officer. The monitoring and supervisory control over the management is exercised by the board. The board dominates the company and controls the functioning of the management at arm's length. It is for this reason the model is called as outsider model.

Japanese Model

The Japanese model consists of a network of suppliers and buyer companies ("Keiretsu"). The Japanese model of corporate governance is concerned with the code and conduct of the board of directors who are selected on behalf of the investors. Here the boards of directors of the corporations consist of fully insiders. They are the heads of the central administrative body. The board of directors is responsible for monitoring and controlling the activities of organisation so as to enable its effective management and protect the rights of investors. The Japanese model basically represents the interests of companies and employees rather than shareholders. The Japanese boards are larger than the boards of UK, USA and Germany. The approximate number of members of the board is fifty.

Continental Model (Franco German Model)

The German model is different from the UK, USA and Japan models. However, some of the factors are similar to the model of Japan. For instance, in Germany, the long-term stakes of the corporations are held by the bank, which is similar to the Japanese model too, where the bank officials represent the stakes of Japanese corporations. Similarly, both the models have a two-tier system in managing their functioning. In Japan, the model consists of the general committee and the board of directors, whereas in Germany, the corporation consists of the management board and the supervisory board. As far as financial transactions are concerned, the German corporations prefer bank transaction instead of equity financing. Another significant feature of the continental model is that, a

major role is given to the auditors' committee which represents the stockholders and the labour.

From the Anglo-Saxon, Japanese and Continental models, it can be observed that models are different from one country to the other and sometimes, even within the same country, the models are different from one corporation to the other. However, irrespective of the changes that are there in various models of corporate governance, there are some set of features that are followed in almost all models with minor variations. Some of the key components, as highlighted by Medury (2003) include the following:

- Shareholders elect directors who represent them;
- Directors vote on key matters and adopt the majority decisions;
- Decisions are made in a transparent manner so that shareholders and others can hold directors accountable;
- The company adopts accounting standards to generate the information necessary for directors, investors and other stakeholders to make decisions;
- The company's policies and practices adhere to applicable national, state and local laws.

10.5 A TRAJECTORY OF THE GROWTH OF CORPORATE GOVERNANCE: INTERNATIONAL AND NATIONAL SCENARIO

10.5.1 International Scenario

At the global level, the late 1980s, 1990s and the early 2000 had witnessed a major eruption of financial scandals by big corporates such as Enron, WorldCom, and Arthur Anderson in US and Maxwell and Poly Peck, among others in UK. This had mooted the debates on the importance of corporate governance in general and the roles of board of directors (BOD) in particular. It further led to the enactment of the Accounting Industry Reform Act (Sarbanes-Oxley Act) of 2002 and the Code of Best Practices (Cadbury Code) of 1992 in US and UK respectively. The Sarbanes-Oxley Act had made a significant contribution in monitoring the operations of banks and other corporations more effectively in the US. After this Act, the corporations were brought under intense public scrutiny and the focus was laid more on the quality of corporate governance standards. It also led to the introduction of a Cadbury Code. The Cadbury Code, not only made all UK companies listed on the London Stock Exchange (LSE) to follow this Code, but also made them to give declaration statement of whether the Cadbury Code is followed or not in their annual reports. If certain code was not followed, they were also asked to explain the reasons for not complying with the same. This 'comply or explain' format of self-regulation served as standards for investors to understand the facts about corporates listed in stock exchange.

The Cadbury Report was followed by the Greenbury Report of 1995 (on executive pay package), the Hampel Report of 1998 (reviewed implementation of the Cadbury and Greenbury recommendations) which together became the Combined Code in 1998. Later, the Higgs Report of 2003 (on the role and effectiveness of non-executive directors), and the Smith Report of 2003 (on the role and effectiveness of audit committees) were incorporated into the updated and revised Combined Code of the LSE in 2003.

The Cadbury Report of 1992 had thus contributed to the development and adoption of

corporate governance. The report was also instrumental for the adoption of corporate governance framework, best practices in corporate governance, or even the codes that were adopted across different parts of the world including India (http://cadbury.cjbs.archios.info/report/further-reports).

10.5.2 Indian Scenario

In India, the evolution of corporate law has lineage to the colonial era where several previous company legislations were structured based on parallel English legislations. However, after independence, the Government appointed a Committee under the chairmanship of H.C. Bhaba in the year 1950 to revise the Indian Companies Act of 1913. Based on the recommendations of this Committee and the provisions of the English Companies Acts, the landmark Companies Act 1956 was introduced in the parliament. The Companies Act 1956 came into force on 1st April 1956. It is the principal legal instrument which contains provisions regarding the role and functioning of the board of directors and the governance of the companies. Since its formulation, this Act has undergone several amendments, based on the requirements.

However, after deregulation, privatisation, marketisation, and globalisation in 1991, India has renewed its interest and realised the need for corporate governance in the country's corporate sector. Over the years, government has come up with elaborate governance reforms for Indian Companies based on the recommendations of series of committees - the Kumara Mangalam Birla Committee (1999), the Naresh Chandra Committee (2002), the Narayana Murthy Committee (2003), and the Adi Godrej Committee (2012). The present corporate governance norms, enshrined in the Companies Act, SEBI listing agreement and Clause 49 of the listing agreement are the result of deliberations by these committees. Yet another committee — the Uday Kotak committee formed in June 2017 has submitted its report in October 2017. This report has recommended major overhaul of corporate governance norms for listed companies.

The Ministry of Corporate Affairs, Confederation of Indian Industries (CII), the Securities and Exchange Board of India (SEBI), the Associated Chambers of Commerce and Industry (ASSOCHAM), Chartered Accountants, of India and Institute of Company Secretaries of India are the few organisations which are continuously playing a vital role in the development and implementation of corporate governance in India. Understanding the dynamic nature of market environment (national and international), investors' behaviour and company's characteristics, changing context and times, the above said organisations have been constituting various committees to recommend rules, regulations and policies in the form of reports for good corporate governance practices. The reports of various committees helped a lot in streamlining the corporate governance in India. Some of the key contributions made by the committees in the direction of corporate governance are tabulated as below

YEAR	CHAIRMAN/ COMMITTEE NAME	Constituted by	Key Contributions
1998	Rahul Bajaj	Confederation of Indian Industry (CII)	"Desirable Corporate Governance: A Code" was introduced with 17 recommendations.
1999	Kumara Mangalam Birla	Securities Exchange Board of India (SEBI)	Aimed "to promote and raise the standard of good corporate governance". It has attempted to evolve a Code of Corporate Governance based on Indian business environment.

2000	Standing Committee on International Financial Standards and Codes	Reserve Bank of India	It compared the status of corporate governance in India vis-à-vis internationally recognised best practices and standards and listed out suggestions to improve corporate governance standards in India.
2001	Consultative Group of Directors of Banks and Financial Institutions	Reserve Bank of India	It reviewed the supervisory role of Boards of Banks and Financial Institutions vis-à-vis compliance, transparency, disclosures, audit committee, etc., and made recommendations for making the role of board of directors more effective.
2002	High-Level Committee to examine various Corporate Governance under the Chairmanship of Shri Naresh Chandra.	Department of Company Affairs (DCA) under the Ministry of Finance, Department of Company Affairs, Government of India.	The committee analysed and recommended changes in the areas of governance and audit.
2003	Committee on Corporate Governance under the Chairmanship of Shri N.R. Narayana Murthy	SEBI	Reviewed the performance of corporate governance and determined the role of companies in responding to rumours and other price-sensitive information circulating in the market, in order to enhance the transparency and integrity of the market.
2003	The Committee on Regulation of Private Companies and Partnerships under the Chairmanship of Shri Naresh Chandra (Naresh Chandra Committee II)	Ministry of Finance, Department of Company Affairs, Government of India.	Aimed to ensure a scientific and rational regulatory environment. The main focus of this report was on (a) The Companies Act, 1956 & (b) The Indian Partnership Act, 1932.
2004	Expert Committee on Company Law under the Chairmanship of Dr. J.J. Irani	Ministry of Corporate Affairs	The Ministry of Corporate Affairs has proposed an overhaul of the existing Companies Act, 1956 and introduced governance reforms through the proposed company law viz. the Companies Bill, 2011.
2009	Voluntary Guidelines on Corporate Governance 2009	Ministry of Corporate Affairs (MoCA)	MoCA came out with "Voluntary Guidelines on Corporate Governance 2009" to encourage the Indian Corporates to voluntarily adopt the best corporate governance practices in their companies.
2012	Adi Godrej Committee	Ministry of Corporate Affairs	The aim was to formulate comprehensive policy framework to enable corporate governance of the highest quality in all classes of companies without impinging on their internal autonomy to order their affairs in their best judgement.

2013	The Companies Act, 2013	Ministry of Corporate Affairs	• It replaced the regulations of Companies Act, 1956. • Introduced 'one person company'. • Mandatory transfer of 2 per cent of average net profit of preceding three years for Corporate Social Responsibility. • Compulsory Internal Audit. • Maximum members for private company increased 200 from 50. • Appointment of at least one woman director in the company. • Prohibition of insider trading of securities.

Source: Compiled from various documents.

The above committees have broadly recommended various corporate governance measures such as size of board of management, its composition, members' qualifications, their remuneration ; roles and responsibilities of board members; meeting procedure; role of chairman; functions, roles and responsibilities of executive management; content of company's annual report to be submitted to board members and other stakeholders; roles, responsibilities and rights of shareholders; formation of remuneration committee; constitution of audit committee, auditor qualifications, content of company documents submitted for audit purpose, its independence and its assisting role in board of management; shareholder information; voluntary disclosure and transparency of information flow among all stakeholders; company performance; company's compliance with rules, regulations, laws and more importantly moral, ethical and environmental compliance; risk management, independence of the board of management etc.

Thus, based on the major recommendations of some of these committees, there was a major overhaul of corporate governance in India and many new modifications were made in the governance of corporate affairs in India at different point of time.

The efforts towards ensuring better corporate governance aim at promoting independence of the board, its accountability to stakeholders, transparency in its activities that lends credibility to the enterprise.

10.6 CHALLENGES OF CORPORATE GOVERNANCE

Ensuring effective corporate governance is not an easy task. Despite having corporate governance codes, there are certain challenges that the enterprises are confronted with and these encompass:

- An effective enforcement mechanism to ensure that the codes of governance are adhered to and governance standards are maintained.
- The conflict of interest of any board member that could influence the decisions taken by the company.
- Balanced composition of the board to ensure proper mix of skills and perspectives in board room decisions.
- Ensuring accountability to all the stakeholders.

- Monitoring of the functioning of the company especially of the board of directors and management by the shareholders.
- Effectiveness of audit committee and independent director.

There are efforts being made globally towards improving the functioning of corporate boards. There are challenges in the process. What is required is a professional board, committed to ensuring transparency and accountability in operations and commitment to stakeholders and working toward the sustainability of the enterprise.

Check Your Progress 2

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the Unit.

1) Discuss the models of corporate governance.

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2) Trace the growth of corporate governance in Indian scenario.

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10.7 CONCLUSION

As discussed in this unit, corporate governance occupies a place of prominence in the era of globalisation, wherein scandals of the corporate entities were brought to light in recent times. It was felt necessary that a strong corporate governance framework is essential not only to monitor the functions and activities of the companies, but also to ensure transparency and accountability, thereby protecting the rights of shareholders, stakeholders and the society at large. In this Unit, you were introduced to some of the principles of corporate governance that were put forward by OECD and also the various models of corporate governance followed in US, UK, Japan and Germany. The Unit also brought insights from the various countries and India in particular on the measures taken and challenges of corporate governance.

10.8 GLOSSARY

Keiretsu : Keiretsu is a Japanese term describing a group of affiliated corporations with broad power and reach. Keiretsu Forum is described as a conglomeration of individuals or small companies that are organised around private equity funding for mutual benefit. Keiretsu Forum believes that through a holistic approach that includes

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interlocking relationships with partners and key resources, they can offer an association that produces the highest quality deal-flow and investment opportunities (http://www.keiretsuforum.com).

Shareholder: It is referred to as a stockholder, any person, company, or institution who/ that owns at least one share of a company's stock.

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10.10 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points**:**

- Corporate governance is about the way the business is directed, monitored and controlled to attain its goals and objectives.
- Various definitions.
- Significance of corporate governance.

2) Your answer should include the following points:

- Ensuring the basis for an effective corporate governance framework.
- The rights of shareholders and key ownership functions.
- The equitable treatment of shareholders.
- The role of stakeholders in corporate governance.
- Disclosure and transparency.
- The responsibilities of the board.

Check Your Progress 2

1) Your answer should include the following points:

- Anglo Saxon Model (The Anglo US Model)
- Japanese Model
- Continental Model (Franco German Model)

2) Your answer should include the following Points:

- Kumara Mangalam Birla Committee
- Committee on Corporate Governance under the Chairmanship of Shri N.R. Narayana Murthy.
- The Companies Act, 2013.

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