“SOME REFLECTION ON CORPORATE GOVERNANCE”

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ABSTRACT

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) 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/members, management, and the board of directors. Other stakeholders include labor (employees), customers, creditors (e.g., banks, bond holders), suppliers, regulators, and the community at large. For Not-For-Profit Corporations or other membership Organizations the "shareholders" means members. While recent high-profile corporate governance failures in developed countries have brought the subject to media attention, the issue has always been central to finance and economics. The issue is particularly important for developing countries since it is central to financial and economic development.
Recent research has established that financial development is largely dependent on policies of the perform era has affected Corporate governance. Concentrated ownership investor protection in a country - de jure and de facto. With the legacy of the English legal system, India has one of the best Corporate governance laws but poor implementation together with socialistic of shares, pyramiding and tunneling of funds among group companies mark the Indian Corporate g landscape. Boards of directors have frequently been silent spectators with the DFI nominee directors unable or unwilling to carry out their monitoring functions. Since liberalization, however, serious efforts have been directed at overhauling the system with the SEBI instituting the Clause 49 of the Listing Agreements dealing with corporate governance. Corporate governance of Indian banks is also undergoing a process of change with a move towards more market-based governance. Corporate governance is a multi-faceted subject. An important theme of corporate governance is to ensure the accountability of certain individuals in an organization through mechanisms that try to reduce or eliminate the principal-agent problem. A related but separate thread of discussions focuses on the impact of a corporate governance system in economic efficiency, with a strong emphasis shareholders' welfare.

**KEYWORDS**: company authority, commercial supremacy, business power
INTRODUCTION

In A Board Culture of Corporate Governance, business author Gabrielle O'Donovan defines corporate governance as 'an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes'. O'Donovan goes on to say that 'the perceived quality of a company's corporate governance can influence its share price as well as the cost of raising capital. Quality is determined by the financial markets, legislation and other external market forces plus how policies and processes are implemented and how people are led. External forces are, to a large extent, outside the circle of control of any board. The internal environment is quite a different matter, and offers companies the opportunity to differentiate from competitors through their board culture. To date, too much of corporate governance debate has centered on legislative policy, to deter fraudulent activities and transparency policy which misleads executives to treat the symptoms and not the cause. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs.
Report of SEBI committee (India) on Corporate Governance defines corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company.” The definition is drawn from the Gandhian principle of trusteeship and the Directive Principles of the Indian Constitution. Corporate Governance is viewed as ethics and a moral duty.

NARRATION

In the 19th century, state corporation laws enhanced the rights of corporate boards to govern without unanimous consent of shareholders in exchange for statutory benefits like appraisal rights, to make corporate governance more efficient. Since that time, and because most large publicly traded corporations in the US are incorporated under corporate administration friendly Delaware law, and because the US's wealth has been increasingly securitized into various corporate entities and institutions, the rights of individual owners and shareholders have become increasingly derivative and dissipated. The concerns of shareholders over administration pay and stock losses periodically has led to more frequent calls for corporate governance reforms.
In the 20th century in the immediate aftermath of the Wall Street Crash of 1929 legal scholars such as Adolf Augustus Berle, Edwin Dodd, and Gardiner C. Means pondered on the changing role of the modern corporation in society. Berle and Means' monograph "The Modern Corporation and Private Property" (1932, Macmillan) continues to have a profound influence on the conception of corporate governance in scholarly debates today. From the Chicago school of economics, Ronald Coase's "The Nature of the Firm" (1937) introduced the notion of transaction costs into the understanding of why firms are founded and how they continue to behave. Fifty years later, Eugene Fama and Michael Jensen's "The Separation of Ownership and Control" (1983, Journal of Law and Economics) firmly established agency theory as a way of understanding corporate governance: the firm is seen as a series of contracts. Agency theory's dominance was highlighted in a 1989 article by Kathleen Eisenhardt ("Agency theory: an assessment and review", Academy of Management Review). US expansion after World War II through the emergence of multinational corporations saw the establishment of the managerial class. Accordingly, the following Harvard Business School management professors published influential monographs studying their prominence: Myles Mace (entrepreneurship), Alfred D. Chandler, Jr. (business history), Jay Lorsch (organizational behavior) and Elizabeth MacIver (organizational behavior). According to Lorsch and MacIver "many large corporations have dominant control over business affairs without sufficient accountability or monitoring by their board of directors."
Since the late 1970’s, corporate governance has been the subject of significant debate in the U.S. and around the globe. Bold, broad efforts to reform corporate governance have been driven, in part, by the needs and desires of shareowners to exercise their rights of corporate ownership and to increase the value of their shares and, therefore, wealth. Over the past three decades, corporate directors’ duties have expanded greatly beyond their traditional legal responsibility of duty of loyalty to the corporation and its shareowners.\[3\]

In the first half of the 1990s, the issue of corporate governance in the U.S. received considerable press attention due to the wave of CEO dismissals (e.g.: IBM, Kodak, Honeywell) by their boards. The California Public Employees' Retirement System (CalPERS) led a wave of institutional shareholder activism (something only very rarely seen before), as a way of ensuring that corporate value would not be destroyed by the now traditionally cozy relationships between the CEO and the board of directors (e.g., by the unrestrained issuance of stock options, not infrequently back dated).

In 1997, the East Asian Financial Crisis saw the economies of Thailand, Indonesia, South Korea, Malaysia and The Philippines severely affected by the exit of foreign capital after property assets collapsed. The lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies.
In the early 2000s, the massive bankruptcies (and criminal malfeasance) of Enron and Worldcom, as well as lesser corporate debacles, such as Adelphia Communications, AOL, Arthur Andersen, Global Crossing, Tyco, led to increased shareholder and governmental interest in corporate governance.

**IMPACT OF CORPORATE GOVERNANCE**

The positive effect of corporate governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development.

**ROLE OF INSTITUTIONAL INVESTORS**

Many years ago, worldwide, buyers and sellers of corporation stocks were individual investors, such as wealthy businessmen or families, who often had a vested, personal and emotional interest in the corporations whose shares they owned. Over time, markets have become largely institutionalized: buyers and sellers are largely institutions (e.g., pension funds, mutual funds, hedge funds, exchange-traded funds, other investor groups; insurance companies, banks, brokers, and other financial institutions).

The rise of the institutional investor has brought with it some increase of professional diligence which has tended to improve regulation of the stock market (but not necessarily in the interest of the small investor or even of the naïve institutions, of which there are many).
Note that this process occurred simultaneously with the direct growth of individuals investing indirectly in the market (for example individuals have twice as much money in mutual funds as they do in bank accounts). However this growth occurred primarily by way of individuals turning over their funds to 'professionals' to manage, such as in mutual funds. In this way, the majority of investment now is described as "institutional investment" even though the vast majority of the funds are for the benefit of individual investors.

Program trading, the hallmark of institutional trading, averaged over 80% of NYSE trades in some months of 2007. Unfortunately, there has been a concurrent lapse in the oversight of large corporations, which are now almost all owned by large institutions. The Board of Directors of large corporations used to be chosen by the principal shareholders, who usually had an emotional as well as monetary investment in the company (think Ford), and the Board diligently kept an eye on the company and its principal executives (they usually hired and fired the President, or Chief Executive Officer—CEO).

A recent study by Credit Suisse found that companies in which "founding families retain a stake of more than 10% of the company's capital enjoyed a superior performance over their respective sectorial peers." Since 1996, this superior performance amounts to 8% per year. Forget the celebrity CEO. "Look beyond Six Sigma and the latest technology fad. One of the biggest strategic advantages a company can have, BusinessWeek has found, is blood lines." In that last study, "BW identified five key ingredients that contribute to superior performance.
Not all are qualities unique to enterprises with retained family interests. But they do go far to explain why it helps to have someone at the helm—or active behind the scenes—who has more than a mere paycheck and the prospect of a cozy retirement at stake." See also, "Revolt in the Boardroom," by Alan Murray.

Nowadays, if the owning institutions don't like what the President/CEO is doing and they feel that firing them will likely be costly (think "golden handshake") and/or time consuming, they will simply sell out their interest. The Board is now mostly chosen by the President/CEO, and may be made up primarily of their friends and associates, such as officers of the corporation or business colleagues. Since the (institutional) shareholders rarely object, the President/CEO generally takes the Chair of the Board position for his/herself (which makes it much more difficult for the institutional owners to "fire" him/her). Occasionally, but rarely, institutional investors support shareholder resolutions on such matters as executive pay and anti-takeover, aka, "poison pill" measures.

PARTIES TO CORPORATE GOVERNANCE

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. In corporations, the shareholder delegates decision rights to the manager to act in the principal's best interests.
This separation of ownership from control implies a loss of effective control by shareholders over managerial decisions. Partly as a result of this separation between the two parties, a system of corporate governance controls is implemented to assist in aligning the incentives of managers with those of shareholders. With the significant increase in equity holdings of investors, there has been an opportunity for a reversal of the separation of ownership and control problems because ownership is not so diffuse. A board of directors often plays a key role in corporate governance. It is their responsibility to endorse the organization’s strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the organization to its owners and authorities.

**DOCTRINE**

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. Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness. In particular, senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports.
Commonly accepted principles of corporate governance include:

- **Rights and equitable treatment of shareholders**: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to 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 needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors.

- **Integrity and ethical behavior**: Ethical and responsible decision making is not only important for public relations, but it is also a necessary element in risk management and avoiding lawsuits. 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 clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

Issues involving corporate governance principles include:

- Internal controls and internal auditors.
- The independence of the entity's external auditors and the quality of their audits.
- Oversight and management of risk.
- Oversight of the preparation of the entity's financial statements.
- Review of the compensation arrangements for the chief executive officer and other senior executives.
- The resources made available to directors in carrying out their duties.
- The way in which individuals are nominated for positions on the board.
- Dividend policy.
Nevertheless "corporate governance," despite some feeble attempts from various quarters, remains an ambiguous and often misunderstood phrase. For quite some time it was confined only to corporate management. That is not so. It is something much broader, for it must include a fair, efficient and transparent administration and strive to meet certain well defined, written objectives. Corporate governance must go well 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 (largely an ethical commitment), and the commitment to run a transparent organization- these should be constantly evolving due to interplay of many factors and the roles played by the more progressive/responsible elements within the corporate sector. In India, a strident demand for evolving a code of good practices by the corporation, written by each corporation management, is emerging.

**MECHANISMS AND CONTROLS**

Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor managers' behavior, an independent third party (the external auditor) attests the accuracy of information provided by management to investors. An ideal control system should regulate both motivation and ability.
INTERNAL CORPORATE GOVERNANCE CONTROLS

Internal corporate governance controls monitor activities and then take corrective action to accomplish organizational goals. Examples include:

- **Monitoring by the board of directors**: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes, ex ante. It could be argued, therefore, that executive directors look beyond the financial criteria.

- **Internal control procedures and internal auditors**: Internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting.
- **Balance of power**: The simplest balance of power is very common; require that the President be a different person from the Treasurer. This application of separation of power is further developed in companies where separate divisions check and balance each other’s actions. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people (customers, shareholders, employees) outside the three groups are being met.

- **Remuneration**: Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behavior, and can elicit myopic behavior.

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**EXTERNAL CORPORATE GOVERNANCE CONTROLS**

External corporate governance controls encompass the controls external stakeholders exercise over the organization. Examples include:

- competition
- debt covenants
- demand for and assessment of performance information (especially financial statements)
- government regulations
• managerial labor market
• media pressure
• takeovers

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