CLASS NOTES
CORPORATE GOVERNANCE

- The growth of corporate sector and the competitive market has together introduced the concept of corporate governance.
- Corporate governance has become an integral part of business life so as to achieve the objectives and to protect the organizations from failure in future.
- There are two aspects which are important to understand the corporate governance:

a) the internal structure which includes the management, board structure etc. &

b) the external structure which includes shareholders and other stakeholders.

- This helps in ensuring an efficient internal control, robust management structure, appropriate performance measures & effective succession plans.
- At the domestic as well as international fronts, the organizations have been applying corporate governance as codes of best practices & have set examples for others.

EVOLUTION

- In the third century B.C., Patliputra, the capital of the Mauryan Empire was said to be the best example of a city which followed the best practices of governance.
- Arthashastra, mentioned the virtues of an ideal king which can be related to the chief of any organization
- These virtues are: — Well-being of the subjects; & Welfare of the subjects
- If we substitute the state with the organization and the king with the chief of the organization or the board of a company, and the subjects with the shareholders, the principles of corporate governance which is the belief that public good should be ahead of private good; and that the corporation's resources should not be used for personal benefit fits well.
- The duties of the king when applied for a business organization implies as follows:
  - Protecting the shareholders wealth,
  - Proper utilization of assets;
  - Maintenance of wealth;
  - Accountability & transparency.
- The advent of company law happened in the middle of 19th century.
- This was basically done to protect the interests of the shareholders in the joint stock companies.
- The concept of Board of Directors (BOD) as trustees of the shareholders emanated from the need for appropriate governance structure.
- The BOD would be responsible for overseeing the management of the organization in order to protect the interests of the shareholders.
- The ownership of shareholdings gradually shifted from individuals to institutional investors and also with privatization throughout the globe, control of assets shifted from State to market economy.
- This led to the views of various experts who felt good governance is a useful indicator of good performance in the market systems.
- In the developed market economies, the concern for Board governance framework became important due to rise in corporate sector financial and related irregularities at different points of time especially during the twentieth century.
- This showed the inefficiency in the governance structure.
- The framework of effective corporate governance gained recognition — with the gradual opening up of the global economy, trade, investment & international financial market liberalization.
- This was considered as an important instrument for sustained development of the world economy.
- Worldwide a series of expert committee reports led to the evolution of different codes of corporate governance to reflect the challenges of a competitive & globalised system.
- There is no fixed way as to how corporate governance can be incorporated in an organization's strategy.
- There are different views and different experts have given different definitions of corporate governance.
- The dictionary meaning of governance includes both 'the action or manner of governing' & 'a mode of living, behaviour, and demeanor'.
- Corporate governance is essentially concerned with the process by which organizations are governed and managed.
- It is a set of standards, which aims to improve the organization's image, efficiency, effectiveness and social responsibility.
- The concept of corporate governance primarily relies on complete transparency, integrity & accountability of the management, with an increasingly higher focus on investor protection and public interest.
- The challenges of upholding these pillars depend upon the ownership structure of the corporate.
- The corporate ownership structures are of two types: 1) "Insider" (concentrated) & 2)"Outsider" (dispersed).
- In the concentrated ownership structure, ownership control is concentrated in the hands of a small number of individuals, families, holding companies, banks or other non-financial companies.
- In this structure insiders exercise control over organization in different ways – insiders own the majority of the shares of the organization with voting rights.

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- Most nations, especially those governed by civil law, have concentrated ownership structure.
- In dispersed ownership structures, there are number of owners, each of whom holds a small number of shares of the organization.
- A key element of good governance is transparency projected through a code of good governance, which incorporate a system of checks and balances between key players – boards, management, auditors and shareholders.
- The corporate governance framework in many countries of the world is largely inward-focused
- It mainly highlights the composition of management structure at various levels.
- The composition at different levels is different assuming that the right structure will automatically ensure quality to delivery.
- Small shareholders have little incentive to closely monitor organizations' activities and tend not be involved in management decisions or policies.
- Common law countries such as United Kingdom and United States tend to have dispersed ownership structure.
- Each ownership structure has its own corporate governance challenges

GLOBAL EVOLUTION

- In the early 1990's in the United Kingdom, the United States and Canada began the modern trend of developing corporate governance guidelines and codes of best practice.
- This was in response to problems in the corporate performance of leading organizations, the perceived lack of effective board oversight that contributed to performance problems and pressure for change from institutional investors.
- In the year 1992 in the United Kingdom, the Cadbury committee report, defined corporate governance as "the system by which organizations are directed and controlled", became a pioneering reference code for stock exchanges both in UK and abroad.
- General Motors Board of Directors Guidelines in the U.S., and the Dey Report in Canada also proved to be influential sources for guidelines & code initiatives adopted by other countries.
- In July 2003, in U.K., the Financial Reporting Council (FRC) of the U.K. published the new Combined code which was referred to as "U.K. code (2003)" thereafter.
- The U.K. Code (2003) was based on the proposed revision of the Cabined Code (1998), in the report by Derek Higgs on the role and effectiveness of non-executive directors, which incorporated the recommendations on audit committees by Robert Smith.

The Most Significant Changes in the Code were as Follows:

➔ the expanded definition of independent director;
➔ an increase in the recommended proportion of independent directors from one-third to a majority of the Board for larger listed organizations;
➔ Separate Chairperson & CEO
➔ Chairperson being an independent directors
➔ Stringent guidelines on membership of the Audit Committee;
➔ Increased emphasis on the need for internal audit and control functions;
➔ Allows for some differences in corporate governance arrangements for larger and smaller organizations, particularly pertaining to the number and proportion of independent directors on the Board and number of members on certain Board committees.

- Following various other committee recommendations in different nations of the world, there have been efforts to homogenize the code of corporate Governance, particularly in listed organizations.
- In the U.S., in 1998, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) sponsored a committee known as the Blue Ribbon Committee – recognized the importance of audit committees and issued ten recommendations to enhance their effectiveness.
- In response to these recommendations, the NYSE and the NASD, as well as other exchanges, revised their listing standards relating to audit committees.
- In 2002, the Sarbanes-Oxley Act was passed in response to a number of major corporate and accounting scandals involving prominent companies in the United States.
- This Act is considered to be one of the most significant changes to federal securities laws in the United States.
- An interesting aspect in the Sarbanes Oxley Act is the protection to whistleblowers.
- The Organization for Economic co-operating and Development (OECD) Principles of Corporate Governance, originally adopted by the 30 member countries of the OECD in 1999, have provided a good insight into corporate governance framework at a macro level.
- The revised OECD Principles of Corporate Governance 2004, reflect a global consensus in contributing to the economic viability and stability of economies.

BUSINESS ETHICS

- The mentions about the ethics, relates to the demarcation between right and wrong.
- It is actually the moral values & certain codes of conduct which are presumed to be followed by an individual as well as an organization.
- Garret has defined ethics as "the science of judging specifically human ends & the relationship of means of those ends".
- In some way it is also the art of controlling means so that they will serve specifically human ends".

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- There are no fixed set of rules which can define as the action right or wrong.
- Ethics is not legally defined but it does not permit to violate the laws.
- Role of ethics and values is quite important for business organization and we call it as business ethics.
- It deals with certain sets of rules of any business organization.
- It is the set of permissible rules which have a positive impact to the organization.
- It deals with certain set of values of the organization leading to the socially responsible behaviour of the organization.
- It is the application of ethical principles in a business organization.

THE COMMON FEATURES OF BUSINESS ETHICS

- ❖ It demarcates between the right and wrong,
- ❖ It deals with the operating issues in an organization;
- ❖ It relates to the corporate social responsibility;
- ❖ It directs the organization to be good corporate citizens apart from being profitable;
- ❖ It defines the descriptive (what is being done) as well as normative ethics (what should be done);
- ❖ Though it is not legal but it is much larger than any law.

PILLARS OF CORPORATE GOVERNANCE

- Corporate governance is a combination of five pillars.
- The objectives of these pillars help an organization in the implementation of strategy.
- These pillars are:

1. Accountability
2. Fairness
3. Transparency
4. Integrity
5. Social responsibility

- Accountability should be applicable at all levels from the lower management to the top management, and then only it works
- Fairness means treating all the stakeholders equally without any demarcation of caste, status etc. This involves effective communication as well
- Transparency means, disclosing all the information which are relevant and important for all the shareholders and stakeholders so that they are not in dark about the performance of an organization.
- Integrity comes through a professional culture where each employee is given importance which makes him/her to perform at their best
- Social responsibility applies at the top management level – The decision taken at the top should be such that they benefit the organization as a whole.

MODELS OF CORPORATE GOVERNANCE

- There are seven basic models of corporate governance.
- ❖ Canadian Model
- ❖ UK and American Model
- ❖ German model
- ❖ Italian model
- ❖ France model
- ❖ Japanese model
- ❖ Indian model

CANADIAN MODEL

- Canada is country which has a large influence of French culture.
- This is because it was a colony of France and Britain.
- Till 19th century, the industries in Canada were basically family businesses but for the past five decades the scenario has changed and now it resembles the US industry structure.
- Looking at its corporate governance structure it is visible that it was one of the early initiators of corporate governance.

UK & AMERICAN MODEL

- Sarbanes Oxley Act (SOX) was passed in July 2002 with the aim to provide more transparency and accountability to US corporate
- This act focuses on the following :
- ➢ Re-establish investor confidence through good corporate governance practices;
- ➢ Improve accuracy & transparency in financial reporting;
- ➢ Accounting service of listed organizations;
- ➢ Increased corporate responsibility;
- ➢ Auditing independently

GERMAN MODEL

- Since 19th century Germany is known as the hub of industrialization.
- For the past five decades Germany has been exporting sophisticated Machinery.
- The financing of the German industries is being done by rich German families, small shareholders, bankers and foreign investors.
- Since the second half of 19th century Germany has been taking steps towards corporate governance.
- The company law was introduced in 1870 and 1884 company law highlighted on making the information transparent.
- As of now Germany has more number of family controlled businesses.

ITALIAN MODEL

- Since a long time the Italian business has been dominated by the family holdings –This trend continued till the 20th century.
- In the second half of the 20th century, the stock market gained importance.
- In 1931 all the Italian investment banks collapsed which led to the fascist government taking over of all the industrial shares and imposing a legal separation of investment from the commercial banks since World War II, with the introduction of the Industrial policy with no need for investor protection.
- Since long the corporate governance lied with bureaucrats and rich families.

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- In the last two decades, the corporate governance is in an organized form.
- Now the investors in Italy are aware of their rights and importance of corporate governance.

FRENCH MODEL

- The financial system in France was controlled by religion and the state was the main borrower.
- The basic form of lending was mortgage and coins were the major part of money transaction.
- The French industry was based on a consecutive outlook.
- The corporate governance was introduced in France in a stage-wise manner with economic development activities.

JAPANESE MODEL

- Japan has been a conservative county where the business families were at the bottom of the pyramid.
- This led to the stagnation of the businesses.
- After World War II the change in business took place and the entry of American traders was allowed.
- A new culture started building up and Japanese industry started gaining which was a mix of private and state capitalization.
- In the early 1930's during depression, the fall of family business started to take place and in 1945 the Americans took charge of Japanese economy.
- The concept of corporate governance evolved only in the past 20 years.

INDIAN MODEL

- India has a long history of commercial activities.
- The formal structure of corporate governance was given by CII in 1998 which was termed as "Desirable corporate governance code".
- In the year 2000, SEBI established a committee under the chairmanship of Mr. Kumar Mangalam Birla to make the report.
- In the same year the ministry of finance set up Naresh Chandra committee which was supposed to examine the roles, duties and independence of auditor
- In 2003 SEBI revised the clause 49 of listing agreement for listed companies based on the report of N.R. Narayanswami committee
- The Indian model has mandatory compliance related to the BOD, audit committees, Subsidiary compliances relating to whistle Blower Policy, shareholders rights, and audit qualification and performance evaluation of board member.

CORPORATE GOVERNANCE & STRATEGY

- There is a strong relationship between corporate governance and strategy
- These are certain points which describe the relationship between the two.

➔ Corporate governance when related to strategic management means the set of rules and policies of an organization;

➔ Corporate governance stresses the importance on stakeholders at large;

➔ It distinguishes between the roles of owners and the managers;

➔ It helps the organization in effective strategic decision making;

➔ It helps the organization in developing fairness towards its investors.

CHALLENGES

- The corporate governance is all about direction, management and control of an organization.
- The challenges of corporate governance can be listed as follows

➢ Board appointments: This is the major issue as due to issues like pressure from promoters etc. the appointments of the board may be biased. The organizations need to be very careful while appointing the board as this may become a hindrance in the success of the organizations.

➢ Performance evaluation of Directors: as there may be cases where the evaluation of the performance of the directors may not be allowed

➢ Appointment of Independent Directors: As per the code it is mandatory to appoint an Independent director but this appointment may be biased in many cases as the promoters/investors may pressurize the organization to appoint their own person. This unethical practice may act as a bottleneck for the success of the organization.

➢ Removal of Independent Directors: The law says that the Independent directors can be removed anytime. This law at times may become a challenge for the organizations. In this case also the promoters/investors may put pressure to remove an independent director who does not take decisions in their favour.

➢ Accountability towards stakeholders: There may be various reasons where the organizations overlook the welfare of the stakeholders. There are number of examples globally where organizations have adopted unethical practices to make more profits.

➢ Transparency issues: Many organizations get stuck into the quagmire of unethical practices which leads to transparency issues.

➢ Conflict in organization: The conflict inside the organization creates a major challenge. If the conflict is not resolved then it is presumed that the organization may not succeed and will lead to ill practices like bribe etc.

➢ Level of mistrust: If the organization loses its credibility then it is very difficult to build it again. Regaining the trust of stakeholders and shareholders becomes a major challenge.

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